The Texas Tax Lawyer

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CHAIR'S MESSAGE

At the Section's Annual Meeting in San Antonio on June 25, I assumed the role of Chair of the Section. In addition, the following fine individuals were unanimously elected as officers of the Section:

Position	Name
Chair-Elect	William P. Bowers
Secretary	Gene Wolf
Treasurer	Kevin J. Thomason

I look forward to working with them, along with our Council and our Committee Chairs and Vice Chairs, to serve you in the upcoming year.

Before describing our goals for the year, however, I should mention that the Section approved a major bylaws change at the Annual Meeting. We revised the bylaws to fundamentally alter the way we elect our officers and Council members. These bylaws changes were in response to several floor nominations at our Annual Meeting in June 2003. The new bylaws procedures provide a more orderly method for nominating and electing our Council and officers. The new bylaws are included in this issue of the Texas Tax Lawyer.

Under the new nominating procedures, a Nominating Committee will select candidates for the offices of Secretary, Treasurer and Chair-Elect and three Council members for the succeeding year. Any Section member may recommend candidates to the Nominating Committee. Thereafter, each candidate must submit a candidate questionnaire, a copy of which is included herein. Based on these candidate questionnaires and such other information as they deem appropriate, the Nominating Committee shall report its nominations to the Council. Thereafter, the Council at its last meeting preceding the Annual Meeting will elect the new officers and Council members from those nominations. This year's Nominating Committee consists of the Chair (as an ex-officio member) and three past Chairs: Cindy Ohlenforst, Robert Gibson and Willie Hornberger.

I encourage you to submit nominations and candidate questionnaires to me at david.wheat@tklaw.com. Also, please do not hesitate to contact me if you have any questions about the new procedure.

Now for our goals for the upcoming year:

1. Raise Section Profile. We seek to raise the profile of the Section both in Texas and nationwide. The Section has made some progress toward this goal through its participation in the Texas Federal Tax Institute (which has become one of the leading corporate and partnership tax seminars in the country). We intend to continue on this path by finding a way to comment on regulations and interfacing with the IRS and Treasury. Until recently, the rules governing the State Bar of Texas have prevented the Section from actively commenting on legislation and regulations. Recently, however, we have seen a loosening of the rules and are working with the new General Counsel of the State Bar of Texas to navigate these rules.

2. Improve Quality of CLE. Obviously a major service that the Section provides to you is outstanding CLE. We intend to improve the quality of CLE and also to make CLE materials available to you on the Section's website. Also, we will continue to improve the quality of the articles which appear in the Texas Tax Lawyer.

3. Increase Membership. We are in the process of reaching out to former members to determine why they are no longer listed as members of the Section. By doing so, we hope to improve the services that we provide to our members and thereby increase membership.

4. Improve Public Service. We will continue the good work that my predecessors began by working with Texas C-Bar, supporting the Justice for All Calendar sponsored by the State Bar, and enhancing participation between the Section and tax programs at Texas law schools.

5. Small Firm – Solo Practitioners. The Section has much to offer to small firm and solo practitioners. We will seek ways to offer more to them, including through appropriate CLE and pricing of our services.

As you can see, much is happening. There is plenty of room for your participation in this process. Please contact me so that I may help you get involved in the Section. Active members are the life blood of the Section.

Thank you for the opportunity to serve this year as your Chair. I look forward to working together to achieve our goals in the upcoming year.

David Wheat

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

Name: ______________________________

Firm Name: ______________________________

Address: ______________________________

City, State, Zip: ______________________________

Email address: ______________________________

Position: ______________________________

Describe your involvement in the State Bar of Texas:

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Describe your involvement in other Bar activities:

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Describe other relevant experience for the position:

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SECTION OF TAXATION OF THE STATE BAR OF TEXAS

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

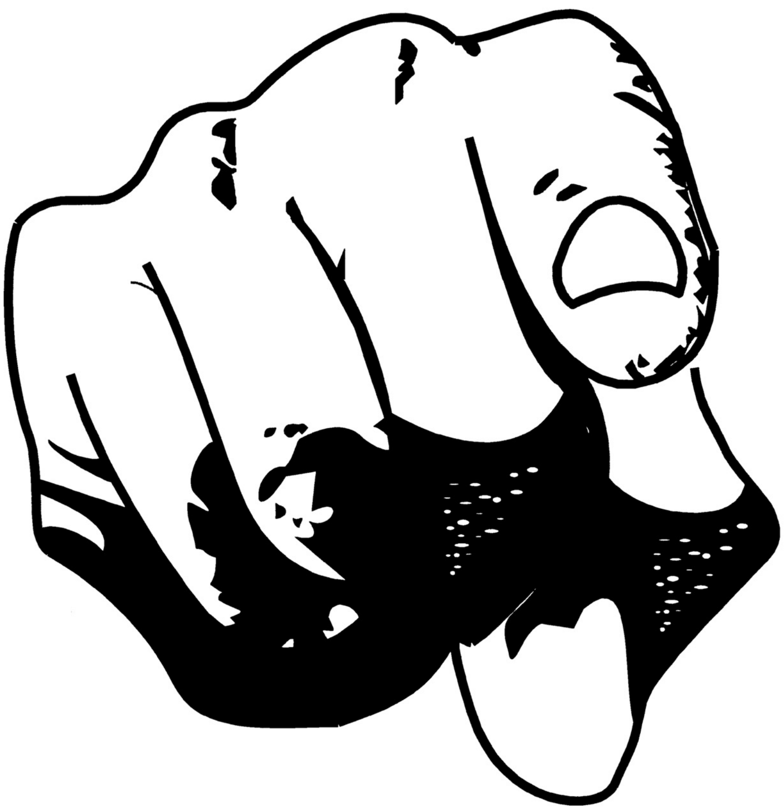
November	
19	10:30 A.M. – 12:30 P.M. Council/Committee Chairs Meeting Thompson & Knight LLP 1700 Pacific Avenue, Suite 3300 Dallas, Texas 75201 (214) 969-1468
December	
10	Deadline for submitting articles for the February 2005 issue of the Texas Tax Lawyer
12	Prepare section mid-year report (due Jan. 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

Want to Get Involved?

The CLE Committee wants

YOU!



Join the CLE Committee to assist in planning the Advanced Tax Law program offered in the Fall of each year.

To join the committee, please complete the Committee Selection Form at the back of the newsletter and forward it to:

Daniel Baucum
Law Office of Daniel Baucum
16950 Dallas Parkway, Suite 111
Dallas, Texas 75248

ENERGY AND NATURAL RESOURCES TAX: RECENT DEVELOPMENTS

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 O. Nelson,[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. Intangible Drilling Costs

The Internal Revenue Service ("IRS") issued three private letter rulings addressing a taxpayer's failure to make a timely election under Section 263(c) to expense intangible drilling costs ("IDCs"). These rulings are: PLR 200428010 (Mar. 29, 2004), PLR 200428011 (Mar. 29, 2004), and PLR 200428012 (Mar. 29 2004). At issue in the rulings was Section 264(c), which allows a taxpayer to make an election to deduct IDCs as expenses.

Section 1.612-4(d) of the Treasury Regulations provides that the option to deduct IDCs may be exercised by claiming the IDCs as a deduction on the taxpayer's return for the first taxable year in which the taxpayer pays or incurs the IDCs. A formal statement is not required, but if the taxpayer fails to deduct the IDCs, then the taxpayer is deemed to have elected to recover the IDCs through depletion.

The taxpayers in these rulings failed to timely make an election. The failure occurred because of a change in tax professionals, change in accounting systems, and the implementation of new accounting software. In each of the rulings, because the partnership agreement at issue specified that the partnership would elect to deduct currently IDCs paid or incurred, the IRS concluded that the requirements of Treasury Regulation 1.612-4(d) to expense IDCs had been satisfied. The taxpayer also represented that it would file its return for the tax year at issue with the election to expense the IDCs.

B. Enhanced Oil Recovery Credit

The IRS ruled in PLR 200427012 (Mar. 19, 2004) that the use of a water alternating gas injection method into a severely unsaturated oil reservoir qualified as a tertiary recovery method for purposes of the enhanced oil recovery credit. Under the project at issue, lean hydrocarbon gas was injected into a reservoir, on an alternating basis with water injections. At issue was whether Section 1.43-2(e)(3) of the Treasury Regulations applied, which states that waterflooding and cyclic gas injection do not qualify as a qualified tertiary recovery method allowing for enhanced oil recovery credits.

The IRS preliminarily noted that the water alternating gas injection resembles cyclic gas injection. However, based on the representation of the taxpayer that the project changes the properties of the under-saturated reservoir oil by swelling the oil and reducing its viscosity, the IRS concluded that the method qualified as a tertiary recovery project, provided it otherwise met the requirements of Section 43 and the Treasury Regulations thereunder.

C. Change in Litigating Position on Fuel Tax

The IRS Chief Counsel's Office released Chief Counsel Notice 2004-002 on March 26, 2004, advising its attorneys of a change in IRS litigating position. The IRS will no longer argue that the one-claim rule bars consideration of the merits of additional fuel tax claims. The one-claim rule generally provided that, under certain conditions, no more than one claim could be filed for taxed fuel used in a nontaxable way during the claimant's tax year. This change in litigating position comes after recent Federal court decisions holding that the one-claim rule does not bar additional claims.

D. Qualifying Income under Section 7704(d)(1)(E)

In PLR 200422023 (May 28, 2004), the IRS ruled that income of a publicly traded partnership ("PTP") that was attributable to its petroleum product terminals (e.g., centralized locations where fuel is received and stored) and certain pipelines was qualifying income under Section 7704(d)(1)(E). Under the Code, a PTP means any partnership if: (1) interests in that partnership are traded on an established securities market; or (2) interests in that partnership are readily tradable on a secondary market (or the substantial equivalent thereof). Section 7701(a) provides that a PTP shall be treated as a corporation. However, Section 7701(c)(1) provides that Section 7701(a) shall not apply to any PTP for any taxable year if such partnership met the gross income requirements of Section 7704(c)(2) for such taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence. A partnership meets the gross income requirements of Section 7704(c)(2) for any taxable year if 90% or more of the gross income of such partnership for such taxable year is qualifying income.

Section 7704(d)(1)(E) provides that the term "qualifying income" means, among other things, income or gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, or products thereof), or marketing of any mineral or natural resources (including fertilizer, geothermal energy or timber). Based on such definition, the IRS concluded that income derived from the product terminal facilities and the operation of the certain pipelines was qualifying income.

E. Comments Requested on Treasury Regulations and IRS Forms

The IRS has requested public comment on the following:

- Information collections under final Treasury Regulations (T.D. 8448) under Section 43 on the enhanced oil recovery credit.
- Final Treasury Regulations (T.D. 8586) relating to the tax treatment of gain from the disposition of natural resource recapture property.
- Form 8835, Renewable Electricity Production Credit.

All comments were due by September 14, 2004.

F. Rates, Factors, and Credit Amounts

1. Percentage Depletion. The IRS issued Notice 2004-48, 2004-30 I.R.B. 88, which provides that the applicable percentage for determining percentage depletion for oil and gas produced from marginal properties is 15% for 2004. As part of Notice 2004-48, the IRS published applicable percentages for marginal production for taxable years beginning in calendar years 1991 through 2004, which are set forth below:

Calendar Year	Applicable Percentage
1991	15%
1992	18%
1993	19%
1994	20%
1995	21%
1996	20%
1997	16%
1998	17%
1999	24%
2000	19%
2001	15%
2002	15%
2003	15%
2004	15%

2. Renewable Electricity Credit. The IRS issued Notice 2004-29, 2004-17 I.R.B. 828, which sets forth the 2004 inflation adjustment factor and reference prices used in determining the availability of the renewable electricity production credit under Section 45(a). For calendar year 2004, the inflation adjustment factor is 1.2230, and the reference prices are 3.24 cents per kilowatt hour for facilities producing electricity from wind energy resources and 0 cents per kilowatt hour for facilities producing electricity from closed-loop biomass and poultry waste energy resources. The credit for electricity produced from renewable resources remains at 1.8 cents for the 2004 calendar year.

3. Section 29 Credit. The IRS issued Notice 2004-33, 2004-18 I.R.B. 847, which sets forth the inflation adjustment factor, the nonconventional source fuel credit, and the reference price for calendar year 2003, as required by Section 29. For 2003, the inflation adjustment factor is 2.1336, the nonconventional fuel credit is $6.40 per barrel-of-oil equivalent or qualified fuel, and the reference price is $27.56.

4. Enhanced Oil Recovery Credit. The IRS issued Notice 2004-49, 2004-30 I.R.B. 88, which sets forth the inflation adjustment factors used to determine the enhanced oil recovery credit under Section 43 for calendar year 2004 and later. Because the inflation adjustment factor depends on GNP implicit price deflators, the IRS also published GNP price deflators for calendar year 2004 as well as previous years. The IRS also noted in Notice 2004-49 that the enhanced oil recovery credit for qualified costs paid or incurred in 2004 should be determined without regard to the phase-out for crude oil price increases. The table below contains the inflation adjustment factor and phase-out amounts for taxable years beginning in the 2004 calendar year as well as the previously published inflation adjustment factors and phase-out amounts for taxable years 1991 – 2003.

Calendar Year	Inflation Adjustment Factors	Phase-Out Amount
1991	1.000	0
1992	1.0363	0
1993	1.0708	0
1994	1.0992	0
1995	1.1160	0
1996	1.1485	0
1997	1.1720	0
1998	1.1999	0
1999	1.2030	0
2000	1.2087	0
2001	1.2353	0
2002	1.2633	0
2003	1.2785	0
2004	1.2952	0

G. Depreciation Recovery Periods

In *PDV America, Inc. v. Commissioner*, T.C. Memo 2004-118 (May 12, 2004), the Tax Court addressed the issue whether above-ground storage tanks located at refined product terminals are included in: (i) MACRS Asset Class 57.0 and treated as 5-year property; or (ii) MACRS Asset Class 57.1 and treated as 15-year property. The petitioner's subsidiary, CITGO Petroleum Corp. ("CITGO"), operated the refined petroleum product terminals at issue. CITGO uses above-ground storage tanks (the "tanks") for the storage, marketing, and distribution of petroleum and petroleum products.

In its opinion, the Tax Court noted that Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the class lives to be used when computing depreciation allowances under Section 168. Asset Class 57.0, entitled "Distributive Trades and Services," assigns a 5-year recovery period to Section 1245 assets used in marketing petroleum and petroleum products. Asset Class 57.1, entitled "Distributive Trades and Services – Billboard, Service Station Buildings and Petroleum Marketing Land Improvements," assigns a 15-year recovery period to Section 1250 property, including depreciable land improvements, whether Section 1245 property or Section 1250 property, used in the marketing of petroleum and petroleum products. The Tax Court further noted that Section 1245 property includes storage facilities used in connection with the distribution of petroleum and petroleum products.

Both parties agreed that the tanks were used in the marketing and distribution of petroleum and petroleum products and, therefore, should be classified under either Asset Class 57.0 or Asset Class 57.1. Both parties also agreed that in order to classify the tanks properly, the Tax Court had to decide whether the tanks constituted inherently permanent structures using the six-factor test set forth in *Whiteco Indus. v. Commissioner*, 65 T.C. 664, 672-673 (1975).

Based on the *Whiteco* factors, the Tax Court held that the tanks were not inherently permanent structures. In support of its decision, the Tax Court found that: (i) the tanks were capable of being moved; (ii) the tanks were not designed or constructed to remain permanently in one place; (iii) circumstances existed that showed that the property may or will have to be moved (e.g., the tanks may require moving for environmental reasons); (iv) the time and crew requirements for removing the tanks would not be substantial; (v) damage sustained from dismantling and reconstructing the tanks would not render them unusable; (vi) the tanks were not affixed to their foundations in a manner indicating that the tanks were to remain there permanently. Accordingly, the Tax Court classified the tanks in Asset Class 57.0, thereby causing the tanks to be treated as 5-year property.

H. Cost Depletion

1. Safe Harbor for Purposes of Computing Cost Depletion. Rev. Proc. 2004-19, 2004-10 I.R.B. 563, provides an elective safe harbor that owners of oil and gas properties can use in determining a property's recoverable reserves for purposes of computing cost depletion under Section 611. The IRS believes this guidance will help avoid complex factual arguments over what is the appropriate quantity of probable or prospective reserves for purposes of computing cost depletion.

If a taxpayer makes a safe harbor election, then for purposes of computing cost depletion: (i) the total recoverable units that a taxpayer's domestic oil and gas producing properties is estimated to contain as of a specific date will be treated as being equal to 105% of the property's "proved reserves" (both developed and undeveloped) as of that date; and (ii) the total recoverable units that a taxpayer's domestic oil and gas producing properties is estimated, on a revised basis, to contain as of a taxable year will be deemed to equal 105% of the property's "proved reserves" (both developed and undeveloped).

To ensure that Rev. Proc. 2004-19 is properly administered, the IRS has the right to examine and adjust, if appropriate, the estimate of proved reserves. To make a safe harbor election (for taxable years ending on or after March 8, 2004), a taxpayer must attach a statement to its timely filed (including extensions) original federal income tax return for the first taxable year for which the safe harbor is elected. Rev. Proc. 2004-19 sets forth the information that must be provided in the statement. An election, once made, (i) may not be revoked for the taxable year of the election; (ii) is effective for all subsequent taxable years until revoked; and (iii) applies to all of the taxpayer's domestic oil and gas producing properties.

2. Audit Guidelines. In a field directive dated July 30, 2004, the IRS' Large and Midsize Business Division, provided audit guidelines related to claims for cost depletion deductions claimed pursuant to the safe harbor of Rev. Proc. 2004-19 (discussed above). In the field directive, the IRS made the following recommendations to examiners:

- When a taxpayer elects the safe harbor, examiners should ensure that it has been properly implemented. This may require a detailed review of computational methods and data transfer procedures . . . This office should be contacted if this safe harbor election does not lead to more efficient audits, or if properties are being transferred between subsidiaries to circumvent the purpose of the safe harbor.
- When a taxpayer does not elect to use the safe harbor provided in Rev. Proc. 2004-19 for all of its domestic oil and gas properties, examiners should follow the Petroleum Industry Coordinated Paper on Cost Depletion – Recoverable Reserves dated January 13, 1997.
- For taxable years ending prior to March 8, 2004, examiners should request assistance of the Petroleum Industry Technical Advisors in resolving the issue.

I. Section 29 Credits

1. Guidance for Certain Royalty Interest Owners. In Rev. Proc. 2004-27, the IRS concluded that certain royalty interest owners were allowed to claim the Section 29 credit in the year income was received rather than in the earlier tax year in which the owner of the operating interest sold the qualified fuel. The revenue procedure applies to taxpayers using both the cash method and accrual method of accounting. The IRS based its conclusion on the fact that a royalty interest owner generally receives its share of income one or more months after the operating interest owner sells the qualified fuel and royalty interest owners have been claiming the Section 29 credit in the taxable year in which they receive the income, rather than in the prior year of sale. In Rev. Proc. 2004-27, the IRS stated that, although the proper taxable year to claim the credit is the taxable year in which the operating interest owner sells the fuel, in order to promote consistency and as a matter of administrative convenience, it will allow royalty interest owners within the scope of the revenue procedure to claim an otherwise allowable Section 29 credit with respect to a sale of qualified fuel in the taxable year (including the 2003 taxable year) in which they receive the income from the sale of qualified fuel. This ruling was necessary because the Section 29 tax credit expired for coal seam gas produced and sold after December 31, 2002.

2. Continued Guidance on Common Issues. In PLR 200427017 (Mar. 16, 2004), the taxpayer, which was a limited liability company classified as a partnership for federal tax purposes, owned and operated a facility for the production of synthetic fuel from coal feedstock. The taxpayer represented that the facility would be relocated and certain repairs had been made to the facility, but no repairs significantly increased the capacity of the facility. The taxpayer further represented that, following the relocation, the fair market value of the original property comprising the facility would be more than 20% of the facility's total fair market value (the cost of the new property plus the value of the original property).

The taxpayer requested the eight rulings stated below, and the IRS concluded as follows:

- Request: The synthetic fuel produced at the facility is a "qualified fuel" within the meaning of Section 29(c)(1)(C).

- Request: The production of the qualified fuel from the facility will be attributable solely to the taxpayer within the meaning of Section 29(a)(2)(B), and the taxpayer will be entitled to Section 29 credits from qualified fuel produced by the facility and sold to unrelated persons.

The IRS concluded that the taxpayer could treat the fuel produced at the facility as a solid synthetic fuel produced from coal constituting "qualified fuel" within the meaning of Section 29(c)(1)(C). The IRS further concluded that, because the taxpayer owned the facility and operated and maintained the facility through its agent, the taxpayer was entitled to Section 29 credits. The IRS noted that its ruling was provided as part of the relief described in Announcement 2003-70, where the IRS stated that it would continue to issue rulings on significant chemical change, but only under the guidelines set forth in Rev. Proc. 2001-30, 2001-19 I.R.B. 1163, as modified by Rev. Proc. 2001-34, 2001-22 I.R.B. 1293.

- Request: The construction contract at issue was a binding written contract in effect before January 1, 1997, within the meaning of Section 29(g)(1)(A).

The IRS stated that a contract is binding only if it is enforceable under local law against a taxpayer and does not limit damages to a specified amount (e.g., by use of a liquidated damages provision). A contract provision that limits damages to an amount equal to at least 5% of the total contract price is treated as not limiting damages. Based on those principles, the IRS concluded that the facility was constructed pursuant to a binding written contract in effect before January 1, 1997.

- Request: The facility is "placed in service" for purposes of Section 29(g)(1) on the date that the facility is first placed in a condition or state of readiness and availability to produce a qualified fuel.

- Request: If the facility was "placed in service" before July 1, 1998, the relocation of the facility after June 30, 1998, or replacement of parts after that date, will not result in a new placed in service date for the facility, provided the fair market value of the original property is more than 20% of the facility's total fair market value at the time of the relocation or replacement.

The IRS stated that the "placed in service" date for purposes of the Section 29 credit has consistently been construed as having the same meaning for purposes of the depreciation deduction and the investment tax credit. Therefore, a property is "placed in service" when it is placed in a condition or state of readiness and availability for a specifically assigned function. The IRS further noted that when property is placed in service is a factual determination, and it would express no opinion on when the facility was placed in service. As to relocations and repairs, the IRS concluded that, consistent with Rev. Rul. 94-31, 1994-1 C.B. 16, the relocation of the facility after June 30, 1998, or the replacement of parts after that date, would not result in a new placed in service date, provided the fair market value of the original property was more than 20% of the facility's total fair market value at the time of the relocation or replacement.

NOTE: In an internal legal memorandum released April 11, 2003, the IRS also stated that a facility is placed in service when it is in a condition or state of readiness and available to produce commercially usable synfuel. *See* ILM 200411002.

- Request: If the facility was placed in service before July 1, 1998, the facility will continue to be treated as placed in service before July 1, 1998, if sold to a new owner after such date.

The IRS concluded that the placed in service deadline is made by reference to when a facility is placed in service, not when the facility is transferred or sold to a different taxpayer.

- Request: The Section 29 credit attributable to the taxpayer may be allocated to the members of taxpayers under Section 702(a)(7) in accordance with each member's interest in the taxpayer when the credit arises.

The IRS concluded that the Section 29 credit attributable to the taxpayer can be allocated to the members of the taxpayer under the principles of Section 702(a)(7) in accordance with each member's interest in the taxpayer when the credit arises. The IRS further stated that a member's interest in the taxpayer is determined based on a valid allocation of the receipts from the sale of the Section 29 qualified fuel. The IRS expressed no opinion regarding what constitutes a valid allocation.

- Request: A termination of taxpayer under Section 708(b)(1)(B) will not preclude the reconstituted partnership from claiming the Section 29 credit.

The IRS concluded that a termination of the taxpayer under Section 708(b)(1)(B) would not preclude the reconstituted partnership from claiming the Section 29 credit.

For similar rulings, see also PLR 200426014 (March 16, 2004), PLR 200430018 (April 7, 2004), PLR 200431009 (April 14, 2004), and PLR 200431003 (April 16, 2004).

ENDNOTES

1 Thompson & Knight LLP, 1700 Pacific Avenue, Suite 3300, Dallas, Texas 75201, (214) 969-1187, (214) 880-3182 (fax), mary.mcnulty@tklaw.com.

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

ESTATE AND GIFT TAXES: RECENT DEVELOPMENTS

Steve R. Akers[1]

I. Kimbell v. U.S., No. 03-10529 (5th Cir. May 20, 2004)

A. Basic Facts

1. The decedent formed an FLP, retaining 99% limited partnership interest. The 1% general partner was an LLC, owned 50% by the decedent (her son and daughter-in-law each owned 25%). The son was manager of the LLC.

2. About 13% of the assets transferred to the partnership consisted of working oil and gas interests, which required active management.

3. The district court emphasized that the partnership agreement provided that 70% of the limited partners could remove the general partner. The general partner did not owe a fiduciary duty, but a duty of care and loyalty. Those particular facts were not important to the 5th Circuit's analysis.

B. Holdings

1. The court reversed the district court's decision that "(1) family members cannot enter into a bona fide transaction, and (2) a transfer of assets in return for a pro rata partnership interest is not a transfer for full and adequate consideration."

2. The district court erred in denying taxpayer's motion for summary judgment on the issue of whether the transfer of assets to the partnership "was a bona fide sale for full and adequate consideration so as to remove the transaction from the application of §2036."

3. Because the bona fide sale for full and adequate exception applies for transfers to the partnership, the court did not need to address whether the decedent retained an interest to which §2036(a)(1) [retained possession, enjoyment or rights to the transferred property] or (a)(2) [retained right to designate the persons who would possess or enjoy the transferred property] would apply for transfers to the partnership.

   However, the court did not address whether the bona fide sale for full and adequate consideration exception applies to transfers to the LLC. Instead, the court held that even if the exception does not apply, the decedent did not retain sufficient control of the assets transferred to the LLC to make her transfer subject to §2036(a), because she was only held a 50% interest in the LLC and her son had sole management powers over the LLC.

4. The court remanded to the District Court the issue of whether the Decedent's interest in the partnership was an assignee interest or a limited partner interest for purposes of valuing her interest.

C. Court's Analysis

1. Purpose of §2036. The purpose of §2036 is to prevent the circumvention of federal estate tax by the use of inter vivos transactions that do not remove the lifetime enjoyment of property purportedly transferred by a decedent.

2. Standard for "Bona Fide Sale" Requirement in §2036 Exception.

   a. Not Mean Arm's Length. The court rejected the district court's conclusion that "bona fide" means arm's length and that intrafamily transactions cannot meet the bona fide sale requirement.

   b. Guidance From Wheeler. The court looked for guidance to Wheeler v. U.S., 116 F.3d 749 (5th Cir. 1997), which is the only Fifth Circuit case (and the only circuit level case cited to the court) addressing the bona fide sale for full and adequate consideration exception to §2036.

      (1) Basic requirement: "whether the transferor actually parted with the … interest and the transferee actually parted with the requisite adequate and full consideration."
      (2) The requirement receives "heightened scrutiny" in intrafamily transfers. However, just because transfers occur between family members does not impose an additional requirement that is not set forth in the statute to be "bona fide."
      (3) The absence of negotiations is not a compelling factor, particularly when the exchange value is set by objective factors.
      (4) In summary, the issue under *Wheeler* is whether "the sale … was, in fact, a bona fide sale or was instead a disguised gift or a sham transaction."

   c. Regulations Standard. Under the regulations, a transaction is a bona fide sale if it is made in good faith. Reg. §20.2036-1(a), 20.2043-1(a).

   d. Intent. The decedent's subjective intent and the presence of tax planning motives do not prevent a sale from being bona fide if it is otherwise real, actual, or genuine. However, "[a] transaction motivated solely by tax planning with no business or corporate purpose is nothing more than a contrivance without substance that is rightly ignored for purposes of the tax computation."

e. Business purpose—Two FLP cases that concluded that the bona fide sale exception applied (Church and Stone) both involved fact situations where the partnership was created for genuine business purposes.

f. Business purpose—Prior Tax Court cases, which held that the bona fide sale exception did not apply, recognized that the exception would apply if the transfer were not a sham or a disguised gift. Harper ("not appear to be motivated primarily by legitimate business concerns"); Thompson (no active business, business enterprise or trade or business); Strangi (no "functioning business enterprise"). [However, the court's analysis did not require the existence of active business operations to meet the bona fide requirement. The court was just observing that even cases that held for the IRS would have held differently if active businesses issues or concerns had existed.]

g. Summary of Bona Fide Sale Standard: "…a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/ transferee actually parted with the partnership interest issued in exchange…. In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine." [Observe, this statement of the standard does not directly refer to business purpose at all.]

3. Application of Bona Fide Sale Requirement

a. Objective Facts. The district court ignored evidence that the transaction was entered into for "substantial business and other non-tax reasons." Objective facts included:

(1) Decedent retained assets for her support
(2) No commingling of partnership and personal assets
(3) Formalities were satisfied
(4) Assets were actually assigned to the partnership
(5) Assets contributed (including working interests) required active management
(6) The partnership satisfied business strategies that could not be satisfied by merely holding assets in a revocable trust
- Legal protection from creditors, especially important because decedent owned oil and gas working interests
- Decedent wanted to continue oil and gas operations beyond her lifetime, and partnership allowed keeping pool of capital together in one entity
- Reduced administrative costs by keeping all accounting functions together
- Avoid costs of recording transfers of oil and gas properties in passing them from generation to generation
- Preserve property as separate property for her descendants
- Provide for succession of management should something happen to her son
- All disputes could be resolved through mediation or arbitration
- The recitation of purposes in the partnership agreement is confirmed by objective facts

c. De Minimis Contributions by Others. The fact that only de minimis contributions were made by others does not justify treating the partnership as a sham. There is no principle of partnership law requiring that a minority partner own a certain minimum percentage for the entity to be legitimate and its transfers bona fide.

d. Son Managed Before and After. The fact that the decedent's son managed the assets both before and after the partnership was created does not matter. What is important is that he contributed his management expertise after the partnership was formed.

e. Summary of Court's Application of the Bona Fide Standard. "[T]here is no contention that the transfer did not actually take place. The assets were formally assigned to the Partnership and Mrs. Kimbell was actually credited with a pro rata interest. There is no evidence that partnership formalities were ignored or that Mrs. Kimbell used Partnership assets for personal expenses. Finally, applying the heightened scrutiny applicable to transactions between family members, we are satisfied that the taxpayer has established through objective evidence recited above that the transaction was not a disguised gift or sham transaction. The … taxpayer's… substantial business reasons … were strongly supported by the nature of the business assets (divided working interests in oil and gas properties) conveyed …"

4. Standard for Full Consideration Exception.
a. Wheeler Guidance. Wheeler "requires only that the sale not deplete the gross estate." "In other words, the asset the estate receives must be roughly equivalent to the asset it gave up."

b. Objective. The adequate and full consideration test is an objective inquiry, not related to perceived testamentary or tax savings motives.

c. Summary of the Standard. "In order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts …"

5. Application of Full Consideration Requirement

a. Inconsistency Argument Rejected. The government's inconsistency argument (that it is inconsistent for the estate to argue that the partnership interest is worth only 50% of the assets transferred to the partnership but claim that the partnership interest received in exchange for assets transferred was adequate and full consideration) is rejected. The court observed that the Tax Court in Stone, T.C. Memo 2003-309 rejected that argument. The court gave a common sense practical answer:

"We would only add to the Tax Court's rejection of the government's inconsistency argument that it is a classic mixing of apples and oranges: The government is attempting to equate the venerable "willing-buyer-willing seller" test of fair market value (which applies when calculating gift or estate tax) with the proper test for adequate and full consideration under §2036(a). This conflation misses the mark: The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid—a classic informed trade-off."

b. Close Scrutiny Not Automatic Proscription. Close scrutiny must be applied in an intrafamily situation, but that does not mean "automatic proscription or impossibility vel non."

c. Partnership Transfers Context. In the context of transfers to a partnership: **"The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets etch partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partnership, and (3) whether upon termination or dissolution of the partners the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts. [Stone] at 580. The answer to each of these questions in this case is yes. Mrs. Kimbell received a partnership interest that was proportionate to the assets she contributed to the Partnership. There is no question raised as to whether her partnership account was properly credited with the assets she contributed. Also, on termination and liquidation of the Partnership, the Partnership Agreement requires distribution to the Partners according to their capital account balances."**

d. Recycling Theory Dismissed. The "recycling of value" position of the Tax Court was totally dismissed. The court said that issue is better addressed under the bona fide sale prong of the analysis (i.e., as to whether the transaction was a sham transaction).

6. LLC Analysis: Not Analyze Applicability of Bona Fide Sale Exception But Insufficient Control to Constitute Right to Designate Who Can Enjoy LLC Property.

a. District Court Analysis. The district court had included the assets transferred to both the partnership and the LLC were included in the estate under §2036(a). There was no specific discussion of the LLC transfers in the district court's opinion. The government's brief clarifies that the government's motion for summary judgment and the district court opinion did not address the assets transferred to the LLC. It stated that the parties had agreed for the district court to amend its opinion to include the LLC interest.

b. Different Analysis for LLC Transfers. The Fifth Circuit opinion approaches the LLC transfers differently than the transfers to the partnership. [Why the analysis is different is not explained.] The court does not explain why the bona fide sale for full and adequate exception does not apply to transfers to the LLC. Instead, the court says that even if the bona fide sale for full and adequate consideration does not apply, the decedent did not retain "sufficient control" of assets transferred to the LLC to cause §2036(a) to apply. The court's reasons: The decedent only had a 50% interest in the LLC and her son was the manager. [Apparently, the court believed that it was such an easy straightforward conclusion that the decedent did not have sufficient control to cause her to have a "right" to designate who can possess or enjoy the LLC assets, that there was no necessity to apply its analysis of the bona fide sale exception.]

7. Observations.

a. Major Blow to IRS. The opinion is a major blow to the IRS's §2036 attack on FLPs and LLCs. It applies the bona fide sale for full and adequate consideration exception to the creation of the FLP. Section 2036 is about the only attack that has led to any success for the IRS. Most well planned FLPS would appear to meet the exception announced in Kimbell. Undoubtedly, the IRS will try to put a "spin" on the Kimbell decision—but it is a MAJOR taxpayer victory at the circuit court of appeals level.

b. Gift of Partnership Interests. Observe that the full consideration exception would not apply to a subsequent gift of partnership interests. (In that case, the issue would be whether the partnership interests [with appropriate discounts] would be brought back in the estate under §2036 (if the donor retained the power to use the property or designate who can possess or enjoy the property), or whether the partnership assets [without a discount] would be brought back into the estate by tying the transfer of assets to the partnership and the subsequent transfer of an interest in the partnership as a single integrated transaction.

c. Not an Improper Whipsaw. The court clearly rejects the IRS's argument that it is being improperly whipsawed—that the transfer of assets to the partnership is treated as a transfer for full consideration even though it is included in the estate only after applying a steep discount. The court's rejection of this argument is a very practical analysis that makes sense in real-life. The opinion recognizes that investors routinely make investments that cannot be liquidated the next day for the full amount invested. Thus, it is not surprising to say that the transfer was for full consideration even though, at the time of the decedent's death, the decedent does not have the right to retrieve the full value contributed.

d. Business Purpose Discussion. A major caveat to the court's analysis is that the bona fide sale requirement is satisfied if there is at least some degree of non-tax purpose. The gist of the concern would appear to be the following statement that appears in the opinion: "A transaction motivated solely by tax planning with no business or corporate purpose is nothing more than a contrivance without substance that is rightly ignored for purposes of the tax computation. See Gregory v. Helvering, 293 U.S. 564, 469 (1935)."

(1) The Wheeler case did not apply a business purpose test to the meaning of "bona fide." The Wheeler court said the modifier "bona fide" does not mean that a different "adequate and full consideration" test would be applied in intrafamily situations. Instead, it said that the "bona fide" qualifier" requires that neither transfers nor the adequate and full consideration for them be "illusory or sham." The Wheeler court concluded: "Certainly an intrafamily transfer—like any other—must be a "bona fide sale" for the purposes of section 2036(a). But assuming, as we must here, that a family member purports to pay the appropriate value of the remainder interest, the only possible grounds for challenging the legitimacy of the transaction are whether the transferor actually parted with the remainder interest and the transferee actually parted with the requisite adequate and full consideration."

(2) It is interesting that the initial summary statement of the "bona fide sale" standard is merely that "the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange." (This is the same standard announced in Wheeler, which also stated that the transfers must not be "illusory or sham.") The initial summary statement goes on to add that in intrafamily situations, there is "heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine." Accordingly, apparently the determination of whether the requisite "business purpose" exists is in determining that the transfer is not a "sham transaction" or "disguised gift" and that the transaction is "genuine."

(3) The Kimbell decision is similar to the Stone opinion in looking to business purposes in determining that the "bona fide" requirement is met.

(4) The opinion makes very clear that the court can only look to objective factors (p. 10).

(5) What is not clear is HOW MUCH "business or corporate purpose" is required.

(6) The court was able to recite a wide number of business purposes satisfied by the partnership. The opinion mentioned various times that the partnership included some active business interests requiring management (i.e., the 13% of the assets in oil and gas working interests) but the opinion nowhere suggests that only FLPs with some active business interests could qualify as "bona fide." Also, the opinion never suggests that a partnership must satisfy a long list of business purposes to qualify as passing the "sham transaction/disguised gift/genuine" test.

(7) Many of the "objective facts" listed to show the existence of "substantial business and other non-tax reasons" would be present in most FLP situations. See the list in Item C.3.b. above. (The one factor that may not ordinarily be present, at least with investment partnerships, is the reference to assets requiring active management.)

(8) Many of the "non-tax business reasons" that the court said were satisfied by the partnership but that could not be satisfied by Mrs. Kimbell's revocable trust could have been satisfied by an appropriately drafted long-term trust arrangement (except the factor of providing creditor protection). That apparently was not important to the court.

(9) John Porter's summary of the "business purpose" discussion: "We should be careful when saying that the 5th Circuit required a "business purpose." I don't think the opinion goes that far, at least the narrow way the IRS traditionally speaks of business purpose. It does appear to require some non-tax purpose (see the language on page 16 which talks about 'business and non-tax reasons'), but I don't see that being much different from the definition of a partnership under 7701(a). Those non-tax reasons are present in almost every case. The interesting thing is the non-tax purposes can include post-death management (which we have always thought was a substantial non-tax reason (See Bishoff)), such as ease in generational transfer of assets (as the court found with respect to the oil and gas interests)."

(10) The requirement of non-tax reasons may be amorphous. A wide variety of estate planning transactions are entered into only because of tax reasons. For example, special provisions inserted into many trusts are included ONLY for tax reasons (provisions to qualify as GRAT, QPRT, QDOT, QSST, NIMCRUT, CLAT, Crummey powers, bypass trusts, etc.).

(11) The opinion's discussion of the bona fide requirement is somewhat similar to the analysis suggested by the ACTEC amicus curiae brief in suggesting that a "sham transaction" standard be applied in determining if a transfer has actually been made, thus satisfying the "bona fide" test. However, the ACTEC brief did not suggest applying a business purpose test, but that the sham transaction standard would weed out abusive situations in which the parties ignore the partnership, especially if the partnership is disregarded by the decedent after creation. Indeed, the ACTEC brief took the position that the "adequate and full consideration" test should be applied objectively, and "subjective criteria such as testamentary intent or the absence of a primary business purposes should not be relevant."

(12) Reports from the oral argument are the Judge Davis asked a number of questions about business purpose. Perhaps the judges were concerned about business purpose, and saw the "bona fide" requirement as the only place to address business purpose, particularly in light of the Fifth Circuit's first opinion in Strangi [293 F.3d 279 (2002)] affirming the Tax Court's initial ruling in the taxpayer's favor regarding the IRS's lack of business purpose attack.

e. <u>Full Consideration Requirement Means "Roughly Equivalent"</u>.

(1) The court's opinion is similar to the <u>Stone</u> case, which held that transfers to a partnership in return for pro rata interests and capital accounts in the partnership would be treated as meeting the full consideration requirement.

(2) The test regarding contributions to partnerships (quoted in Item 5.c. above) would be satisfied in most FLP situations.

(3) The court makes clear that an objective test is applied: "… taxpayer's testamentary or tax-saving motive for a transfer alone does not trigger §2036 recapture if objective facts demonstrate that the transfer was made for a full and adequate consideration." (p.9).

(4) The court does not specifically address the tension between two possible approaches to the full consideration requirement: (1) an "in <u>pari materia</u>" test, which would focus on whether the consideration received is sufficient to avoid a gift for gift tax purposes; and (2) an "equilibrium test," which focuses on not depleting the

gross estate. Arguably, an "equilibrium test" would not be satisfied by the contribution of assets to a partnership, because the gross estate would be lower if the contributor to the partnership were to die the next day. In Wheeler, the court was able to demonstrate that the sale of remainder interest situation satisfied both tests. In Kimbell, the court recited some of its discussion from Wheeler, hinting that an equilibrium test might be applied ("requires only that the sale not deplete the gross estate"), but then interpreted the inquiry as follows: "In other words, the assets the estate receives must be roughly equivalent to the asset it gave up." The opinion's statement of a "test" for adequate consideration regarding partnership contributions is that the "exchange of assets for partnership interests must be roughly equivalent so that the transfer does not deplete the estate."

(5) The application of the "rule" to partnership contributions clearly points out that transfers for pro rata interests in a partnership based on capital accounts will satisfy the full consideration test.

(6) The court's statement of the rules is very similar to the position taken in the ACTEC amicus curiae brief. It concluded that a transfer for interests in an entity that are proportionate in all material economic respects to the capital contributions should be "full consideration." It rejected a strict equilibrium test (i.e., no depletion of the gross estate), because such a test would almost never be satisfied whenever property is transferred to an entity as a capital contribution, irrespective of whether the transferor is a family member.

(7) The court summarily dismissed the "mere recycling" argument that has been adopted by the Tax Court, by saying that a concern that a contribution of assets to an FLP is a "mere paper transaction resulting in a 'recycling of value' is better addressed under the 'bona fide sale' prong of this exception."

f. Insufficient "Control" for Application of §2036 to LLC.

(1) The U.S. Supreme Court in Byrum rejected the government's position that a right to designate should be construed as mere "control." The Supreme court said: The 'control' rationale, urged by the Government and adopted by the dissenting opinion, would create a standard—not specified in the statute—so vague and amorphous as to be impossible of ascertainment in many instances."

(2) A strict control test makes no sense, because many courts have blessed transfers to trusts, with the grantor as trustee with complete control over trust distributions, as long as distributions may be made only under a determinable standard.

(3) The opinion concludes that §2036 does not apply to the LLC because the decedent "did not retain sufficient control" to trigger §2036(a) where the decedent was a 50% member where her son had sole management powers. If the Fifth Circuit was suggesting that a pure control test should be used to gauge whether a decedent has retained a right to designate who can possess or enjoy property, that approach is most suspect. However, perhaps the court was just saying that the decedent had no ability at all to designate who could possess or enjoy property where she was only a 50% member and not the sole manager. Therefore, there was no need to address whether any power at all to designate would rise to the level of a "right to designate," taking into consideration any fiduciary or other limitations on the exercise of that power.

(4) The discussion ameliorates some of the concern that has been raised about Judge Cohen's extremely broad application of the "in conjunction with" language in §2036 in her opinion in Strangi. Her analysis, if pushed to its limits, would suggest that retaining even a 1% limited partnership interest could risk inclusion of the entire partnership contribution because that 1% limited partner, in conjunction with all other partners, could dissolve and liquidate the partnership at any time. The Kimbell decision debunks that theory, indicating that even a 50% member interest in an LLC, where the decedent was not the sole manager, would not cause inclusion under §2036(a)(2).

g. De Minimis Transfers.

(1) The court rejected the government's argument that one factor suggesting that the transfer was not bona fide was because of the de minimis contributions made to the partnership by other partners. "This argument amounts to a restatement of the government's recycling of value argument and does not justify treating the transaction as a sham. We know of no principle of partnership law that would require the minority partner to own a minimum percentage interest in the partnership for the entity to be legitimate and its transfers bona fide."

(2) Another reason suggested for having significant transfers by other partners

is to avoid a "mere recycling" argument where the decedent had an interest in the same pool of assets both before and after the transfer. The Kimbell court totally dismisses the "mere recycling" argument, so that would not be a valid reason to insist on having substantial contributions by other partners if Kimbell is followed.

(3) There is a separate argument by the government to disregard fiduciary limitations on the exercise of a power, to determine whether it rises to the level of a "right to designate," if there are only de minimis other partners to whom a fiduciary duty would be owed. The Kimbell opinion does not address that issue and thus is not a complete repudiation of a possible advantage of having significant contributions by other partners.

D. Appeal of Strangi**.**

In Strangi v. Comm'r, T.C. Memo 2003-145 (May 20, 2003), the court held that partnership assets were included directly in the decedent's estate under Section 2036(a)(1) and 2036 (a)(2). That case involves many of the same issues as the Kimbell case. Strangi has been appealed to the 5th Circuit Court of Appeals. The court stayed the case until the resolution of the Kimbell case. Following the issuance of the Kimbell decision on May 20, 2004, the stay was lifted on May 21. The estate has filed its brief, and ACTEC has filed an amicus curiae brief. There are reports that there have been settlement discussions.

ENDNOTE

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PROPERTY TAX: RECENT DEVELOPMENTS

by John Brusniak, Jr.[1]

United States Supreme Court

FEDERAL TAX INJUNCTION ACT APPLIES ONLY WHEN TAXPAYERS ARE SEEKING TO AVOID PAYING TAXES OR ARE SEEKING RETROACTIVE RELIEF.

Hibbs v. Winn, ___ U.S. ___, 124 S. Ct. 2276 (2004).

Taxpayers sued the Director of the Arizona Department of Revenue alleging that an income-tax credit for payments to provide financial aid to children attending private schools was unconstitutional under the Establishment Clause of the United States Constitution. The lower courts barred the suit under the Tax Injunction Act which prohibits federal courts from restraining "the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."The United States Supreme Court reversed the lower courts' decisions holding that no violation of the statute had occurred since the taxpayers had not sought to enjoin the *assessment* of taxes on themselves. The Court reasoned that the act was intended to bar actions adversely affecting the state's ability to raise revenue, and the relief sought by the taxpayers would in fact *increase* funds available for the public benefit.

Texas Courts of Appeals

TEN PERCENT ANNUAL RESIDENCE HOMESTEAD VALUATION INCREASE APPLIES TO COMBINED VALUE OF LAND AND IMPROVEMENTS.

Bader v. Dallas Central Appraisal District, No. 05-03-01057-CV (Tex.App.–Dallas, July 22, 2004, no pet. h.).(to be published)

Taxpayer sued an appraisal district contending that the district's proposed increase of the taxable value of his residence homestead violated the 10 percent annual "cap" on valuation increases contained in Tex. Tax Code §23.23. Taxpayer argued that the "cap" should have been applied separately to the land and improvements. The court disagreed, ruling that the "cap" was intended to apply to "residential homesteads" as a unit and not to their underlying components taken separately.

IMPROVEMENTS CONSTRUCTED ON EXEMPT GOVERNMENT LAND ARE ALSO EXEMPT FROM TAXATION UNLESS TITLE TO THE IMPROVEMENTS IS CLEARLY VESTED IN THE PRIVATE PARTY.

Travis Central Appraisal District v. Signature Flight Support Corp., No. 03-03-00707-CV (Tex.App.–Austin, July 1, 2004, no pet. h.). (to be published).

Taxpayer constructed a fixed base aircraft operations center on land leased at a municipally owned airport. Appraisal district sought to tax the improvements to the land to the lessee. The lease specifically provided that legal title to the improvements would be vested in the city at the completion of construction. The court held that the improvements were not taxable to the lessee because they had become part of the land and thus belonged to the exempt landowner. It further held that such improvements would be considered as a part of the realty unless there was an understanding between the parties that the improvements were not to become permanently annexed to the land, or unless there was other evidence demonstrating an intent on the part of the private party to keep the improvements as personal property with the right of removal. Because no such evidence existed and because the lessee did not hold equitable title or a beneficial title by which it could have compelled the city to turn over legal title to it, the court held that the city was the owner of both the land and improvements, and as a result the improvements were exempt from taxation.

TAXPAYER'S DUE PROCESS RIGHTS TO NOTICE OF APPRAISED VALUE ARE NOT VIOLATED IF TAXPAYER HAS TIMELY ACTUAL NOTICE OF VALUATION PRIOR TO THE EXPIRATION OF TIME FOR FILING OF A TIMELY PROTEST FOR FAILURE TO DELIVER NOTICE UNDER SECTION 41.411 OF THE TAX CODE.

ABT Galveston Ltd. Partnership v. Galveston Central Appraisal District, 137 S.W.3d 146 (Tex.App.–Houston [1st Dist.] 2004, no pet.).

Taxpayer defaulted on its obligations under a tax abatement agreement and sought to move the abated property out of the state of Texas. The tax assessor threatened to block the removal of the assets from the state, and the taxpayer paid the assessed taxes under protest prior to the delinquency date. Taxpayer claimed that the appraisal district had not informed it in writing of the removal of the exemption or of the appraised value of the property as required by the Texas Tax Code, but conceded that it had been informally notified of the valuations by a third party appraiser for the appraisal district and that it had received a timely tax bill. Taxpayer sued for a refund contending that its due process rights were violated. The court held that no such rights were violated because the taxpayer could have, on a timely basis, availed itself of the remedies for governmental failure to deliver notices provided by Section 41.411 of the Texas Tax Code.

INDIVIDUALLY OWNED TRACTS PARTICIPATING IN A WILDLIFE COOPERATIVE MUST SEPARATELY QUALIFY TO BE ELIGIBLE FOR WILDLIFE VALUATION; COOPERATIVE ACTIVITIES MAY BE USED TO SATISFY INTENSITY REQUIREMENTS, BUT NOT REQUIREMENTS AS TO WHETHER ACTIVITIES CONSTITUTE AGRICULTURE.

Cordillera Ranch, Ltd. v. Kendall County Appraisal District, 136 S.W.3d 249 (Tex. App.-San Antonio 2004, no pet.).

Taxpayers formed a wildlife management cooperative under rules promulgated by the Texas Parks and Wildlife Department and sought open space land valuation. Taxpayers conceded that each individual tract did not meet the statute's requirements that "three of the seven wildlife management activities be performed" on the property, but argued that they should qualify for the valuation if the activities occurred within the boundaries of the cooperative. The court disagreed, finding that the statute specifically required each owner-applicant's land to qualify. It held that any agency rules to the contrary would not be given effect. It held that "the requirement that 'three of seven qualifying activities' requirement must be met to satisfy the agricultural use requirement not the intensity requirement." The Texas Parks & Wildlife guidelines could be used to demonstrate that the property was used to the level of intensity which was required but not to satisfy the underlying proof as to agricultural activity.

TAXPAYERS CHALLENGING CONSTITUTIONALITY OF APPRAISAL DISTRICT CONDUCT NEED NOT EXHAUST ADMINISTRATIVE REMEDIES; TRAVEL TRAILERS DO NOT CONSTITUTE TAXABLE MANUFACTURED HOMES EVEN IF THEY ARE PERMANENTLY AFFIXED TO REALTY; APPRAISAL DISTRICT CANNOT REDEFINE TERMS DEFINED BY THE LEGISLATURE; APPRAISAL DISTRICT MAY NOT CONTEST THE CONSTITUTIONALITY OF A STATUTE UNDER WHICH IT HAS SOUGHT TO APPRAISE PROPERTY.

Rourk v. Cameron Appraisal District*, *135 S.W.3d 285 (Tex. App. - Corpus Christi 2004, pet. filed)

Appraisal district defined the term "manufactured home" as encompassing travel trailers. Plaintiffs filed a class-action lawsuit claiming that the appraisal district's actions violated the constitution. Appraisal district sought dismissal of the lawsuit because some of the plaintiffs had failed to exhaust administrative remedies. The appellate court disagreed, finding that no exhaustion of administrative remedies was required when the constitutionality of an appraisal district's actions was an issue. The court further held that travel trailers are not encompassed within the definition of "manufactured homes" regardless of whether they are affixed to realty or not. The appraisal district could not undertake to redefine legislative terms without unconstitutionally usurping the power of the Texas Legislature and the appraisal district could not contest the constitutionality of the statute since it had availed itself of the statute in attempting to tax the plaintiffs.

CLAIM TO EXCESS PROCEEDS FROM TAX SALE MUST BE FILED WITHIN TWO YEARS OF DATE OF SALE; THE CLAIM NEED NOT BE DETERMINED WITHIN THE TWO YEAR PERIOD

Franks v. Woodville Independent School District , 132 S.W.3d 167 (Tex.App.–Beaumont 2004, no pet.).

Taxpayer's property was sold to satisfy a delinquent tax judgment. Excess proceeds were paid into the registry of the court. Taxpayer filed a claim for disbursal of the excess proceeds within two years of the date of sale, but did not obtain an order from the court ordering disbursement of the funds within the two years. Relying on Section 34.03(b) of the Texas Tax Code which provides that the district clerk shall automatically disburse excess proceeds to the taxing units "if no claimant establishes entitlement to the proceeds" within two years, the district court ordered the excess proceeds distributed to the taxing units. The court of appeals reversed this ruling, noting that Section 34.03 (a) of the Texas Tax Code provides that excess proceeds shall be kept in the registry of the court for two years after the date of the sale "unless otherwise ordered by the court." The appellate court held that this provision superceded the clerk's ministerial function of funds disbursal and required a court ruling on all claims brought within the two year limitations period even if such determinations would be made after the expiration of the two year period.

Texas Attorney General Opinions

A TAXING UNIT WHICH HAS CONTRACTED WITH ANOTHER UNIT TO COLLECT ITS TAXES MAY NOT OFFER AN EARLY PAYMENT DISCOUNT IF THE COLLECTING UNIT DOES NOT OFFER ONE.

Op. Tex. Att'y Gen. GA-0225 (2004).

A taxing unit may not offer an early payment discount to its taxpayers if it has contracted with another taxing unit for tax collections services and the collecting taxing unit does not offer early payment discounts for its own taxes.

A MUNICIPAL TAX FREEZE MAY BE ADOPTED BY EITHER A VOTE OF THE CITY COUNCIL OR BY A VOTE OF THE CITIZENS; ONCE A TAX FREEZE IS ADOPTED BY A CITY, IT MAY NOT BE REPEALED BY VOTE OF THE CITIZENS; A GOVERNMENTAL ENTITY MAY NOT USE A BASE YEAR PRIOR TO THE CURRENT YEAR TO ESTABLISH THE YEAR OF THE FREEZE.

Op. Tex. Att'y Gen. GA-0222 (2004).

A municipality has the option of adopting a tax freeze by vote of its city council or by direct vote of the citizens of the city. Once a freeze is adopted by a city, there is no provision authorizing the removal of the freeze by vote of the citizens. The Constitution does not permit the use of a base year prior to the year of the adoption of the tax freeze.

STATUTORY AMENDMENTS REDEFINING HOMESTEAD EXEMPTION QUALIFICATIONS ARE NOT RETROACTIVE.

Op. Tex. Att'y Gen. GA-0148 (2004).

The legislature adopted restrictions on the qualifications for a residential homestead exemption effective June 18, 2003. Appraisal district sought to impose the restrictions effective as of January 1 of that same year. The attorney general ruled that the new restrictions could not be imposed retroactively without an express indication by the legislature of its intent to make the statute retrospective.

ENDNOTES

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STATE TAX: RECENT TAX CASES AND RULINGS

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The following article provides a summary discussion of various significant Texas tax rulings and cases decided and released since the last publication of the Texas Tax Lawyer. The survey focuses on franchise and sales and use tax cases and rulings and covers the period from March 15, 2004 to August 15, 2004.[2]

During the survey period, there were several cases decided and released by the Third Court of Appeals in Austin, Texas. Three were in the sales and use tax context and only one addressed a franchise tax issue. One of the sales tax cases addressed a very significant issue involving the applicability of use tax to out of state printing charges. Another of the sales tax cases also addressed a significant issue involving the sales tax responsibility of a multi-level marketing company. The franchise tax case provided a holding that generated a compelling dissenting opinion. All of the cases decided by the Third Court of Appeals were decided in favor of the Comptroller. Each of these cases is discussed below.

There were also a number of significant rulings decided and released by the Comptroller that are discussed below. Sales tax rulings within the survey period include issues involving the resale and manufacturing exemptions, real property repair and remodeling services, use tax, refund claims, successor liability and various taxability determinations. Franchise tax rulings include issues involving apportionment, sourcing and refund claims. The vast majority of rulings issued by the Comptroller were decided in favor of the Comptroller.

Sales Tax

Court Decisions

The May Department Stores Company v. Strayhorn, 2004 WL 1573171 (Tex. App.—Austin, July 15, 2004): Out of State Printing Charges Constitute Tangible Personal Property Subject to Texas Use Tax

The Third Court of Appeals in Austin, Texas issued a significant decision in favor of the Comptroller in *The May Department Stores Company v. Strayhorn*, 2004 WL 1573171 (Tex. App.—Austin July 15, 2004). The case involves the applicability of the Texas use tax to printing services provided outside the state and the applicability of the U.S. Supreme Court's decision in *D.H. Holmes Co. v. McNamara, 486 U.S. 24 (1988)* to Texas use tax. In its opinion, the Court of Appeals held that the printing services in that case were subject to use tax. In doing so, the Court resolved in favor of the Comptroller a long-standing dispute regarding the applicability of the U.S. Supreme Court's holding in *D.H. Holmes* to the Texas use tax.

At issue in *The May Department Stores* is the taxation of out-of-state printing services used to produce advertising materials that were mailed to Texas either directly or indirectly to prospective customers and in-state stores and offices. The Comptroller agreed that the bulk paper purchased by May to make the advertising material was not subject to use tax under *Sharp v. Morton Bldgs, Inc.*, 953 S.W.2d 300, 303 (Tex. App. – Austin 1997, pet den'd). However, the Comptroller determined that the printing charges were subject to use tax because, under the Comptroller's long-standing policy, the printing charges constitute the sale of tangible personal property.[3] The Comptroller further determined that May made a taxable use of the printed items in Texas on the authority of its Rule 3.346(b)(3)(A), which states: "Use tax is due on taxable items purchased outside this state by a person engaged in business in this state if the taxable items are delivered at the direction of the purchaser to recipients in Texas designated by the purchaser."

May argued that the Comptroller's Rule 3.346(b)(3)(A) is in conflict with the Texas Tax Code, which does not define a taxable use to include distribution. Alternatively, May argued that Rule 3.346(b)(3)(A) did not apply to the printing charges in this case because the printing services were not distributed to Texas. May further argued that the printing charges were not subject to use tax under the Court's prior holding in *Morton Buildings* because May manufactured the advertising materials from raw materials outside of Texas.

The Court first addressed and rejected May's argument regarding the validity of the Comptroller's Rule 3.346(b)(3)(A). As noted by the Court, the Comptroller amended Rule 3.346 in 1990 to encompass taxable items delivered to Texas residents on the authority of the U.S. Supreme Court's decision in *D.H. Holmes Co.* In that case, the Supreme Court held that the State of Louisiana could impose use tax on the delivery of catalogs printed out of state and then mailed to Louisiana residents. May argued that the Comptroller could not rely on *D.H. Holmes* because the Louisiana use tax statute specifically included "distribution" whereas the Texas use tax statute does not. The Court disagreed. According to the Court, the Supreme Court's analysis did not turn on the question of distribution. Rather, the Supreme Court merely applied the fourpart test articulated in *Complete Auto Transit v. Brady* and determined that the tax was constitutional.

The Court also disagreed with May's argument that Comptroller's Rule 3.346(b)(3)(A) is in conflict with Section 151.011(a) of the Tax Code because that Section does not include "distribution" in the definition of "use." According to the Court, delivery at the direction of the purchaser falls within the definition of "use" in the Tax Code because the Tax Code defines that term to include "the exercise of a right or power incidental to the ownership of tangible personal property over tangible personal property."[4] Accordingly, stated the Court, the Comptroller's Rule 3.346(b)(3)(A) does not conflict with the Tax Code.

The Court next addressed and rejected May's alternative argument to the effect that, because the advertising materials, not printing, were delivered to Texas recipients, Rule 3.346(b)(3)(A) was not applicable to the printing charges in this case. According to the Court, the advertising materials are inextricably intertwined with the printing and, without the printing, the advertising materials would not exist. Thus, the purchase price, stated the Court, becomes the cost of the printing. Accordingly, held the Court, Rule 3.346(b)(3)(A) applies to the printing at issue.

Having determined that Rule 3.346(b)(3)(A) applied to the facts of this case, the Court then proceeded to determine if taxation of the printing met the requirement of Section 151.101(a) and the overall scheme of the Tax Code. The Court noted that the general sales and use tax provisions of the Tax Code define a "sale or purchase" to include "the production, fabrication, processing, printing, or imprinting of tangible personal property for consumers who directly or indirectly furnish the materials used in the production, fabrication, processing, printing, or imprinting" when performed for consideration.[5] The Court held that this provision applies equally to sales and use tax under the Tax Code. On the basis of this statutory language, the Court concluded that the Comptroller's long-standing rule to the effect that the sale or purchase of printing constitutes the sale of tangible personal property was reasonable and a valid interpretation of the use tax provisions.

The Court then considered the applicability of *Morton Buildings*. May argued that the printing charges were not taxable because May manufactured the advertising materials from raw materials out-of-state, and then shipped the advertising materials into Texas. The Court disagreed holding that that the facts in this case were distinguishable from *Morton Buildings*. According to the Court, *Morton Buildings* involved a taxpayer who manufactured building components from raw materials outside of Texas, then shipped the components into the State. The Court in *Morton Buildings* held that the lumber and steel were not subject to tax because the lumber and steel were not used in their raw form in Texas. This case was distinguishable, stated the Court, because the Comptroller sought to tax the transformation services (*i.e.*, the printing) and not the raw materials. While May purchased the raw materials for the advertising material, the printers – not May – transformed the raw materials into advertising materials.

The Court also held that May made a taxable use of the printing services in Texas because (i) May directed either the printer or mailing company in Texas to mail the materials to prospective customers in Texas; (ii) May's expressed purpose for the advertising was to increase sales in Foley's stores and (iii) May took possession of coupons tendered by customers included in the advertising materials in Texas.

Finally, the Court noted that the Texas Legislature's recent amendment to the definition of "use" in Section 151.011 of the Tax Code for use tax purposes supports its holding that May used the printing in Texas. The term "use" was amended in 2003 to include "tangible personal property other than printed material that has been processed, fabricated, or manufactured into other property or attached to or incorporated into other property transported into this state." According to the Court, the fact that the legislature specifically excluded "printed material" from the definition of tangible personal property suggests that the legislature was aware of a prior construction of the term that included printing within the ambit of the use tax.

For the above reasons, the Court upheld the lower Court's summary judgment order granted in favor of the Comptroller.

The Court of Appeals decision in this case deals a significant blow to mass mailing advertisers in Texas. Under the Court's analysis, merely directing that printed material be mailed to in-state residents constitutes a "use" for tax purposes rendering the cost of the printed material subject to Texas use tax. This is a very broad construction of the term "use," that the Comptroller will no doubt seek to apply in other contexts.

As noted by the Court, the definition of "use" for use tax purposes set forth in Section 151.011 was amended in 2003. The amendment effectively overrules *Morton Building*, but carves out an exception for certain "printed material." As currently worded, the exception for printed material is not exactly a model of clarity. However, it appears that the Legislature intended to preserve the Comptroller's position to the effect that raw materials that are incorporated into printed materials that are brought into the state are not considered "used" in Texas for use tax purposes. Oral communications with the Comptroller's Tax Policy Section confirm that this is the Comptroller's current interpretation of the 2003 amendment.

Applying the above rules suggests the following consequence for persons who direct the distribution of out-of-state printed material to in-state residents. The purchase of raw materials outside the state that are incorporated into the printed material remains excluded from Texas use tax under the authority of *Morton Buildings*.[6] The cost of the printing services are subject to use tax. This rule appears applicable to all printing and distribution activities, not just those involving the distribution of advertising materials.

Alpine Industries, Inc. v. Strayhorn, 2004 WL 1573159 (Tex. App.—Austin, July 15, 2004): Sales Tax Assessment Against Multi-Level Marketing Company Upheld

In *Alpine Industries, Inc. v. Strayhorn*, 2004 WL 1573159 (Tex. App.—Austin, July 15, 2004) involves the sales tax obligation of a multi-level marketing company with sales representatives in Texas. Alpine is a Tennessee-based company engaged in the manufacture of air-purification equipment. It sells its equipment in Texas and throughout the U.S. through a system of "independent salespersons." To become a sales person, one is required to pay Alpine a fee on a yearly basis. Each sales person is encouraged to recruit others to join Alpine's network. Alpine provides its independent salespersons with incentives such as automobiles and world travel if his or her recruits are successful and also pays bonuses based on dollar volume of products ordered. Alpine had up to 20,000 persons in Texas registered as independent salespersons for the years at issue, 1994 - 1998.

The Comptroller determined that Alpine was "a multilevel marketing company/direct sales company . . . ." As such, Alpine was required to collect sales tax for its independent distributors under Comptroller Rule 3.286(a)(1)(D). This Rule was issued under Section 151.024 of the Tax Code which provides, "If the Comptroller determines that it is necessary for the efficient administration of this chapter to regard a salesman, representative, peddler, or canvasser as the agent of a dealer, distributor, supervisor, or employer under whom he operates or from whom he obtains the tangible personal property that he sells, whether or not the sale is made on his own behalf or for the dealer, distributor, supervisor, or employer, the Comptroller may so regard the salesman, representative, peddler, or canvasser, and may regard the dealer, distributor, supervisor, or employer as a retailer or seller for the purpose of this chapter."

Alpine first argued that the Comptroller failed to prove as a matter of law that Alpine is a direct sales organization. The Court disagreed. According to the Court, the Comptroller's summary judgment evidence from Alpine's own manual established that Alpine marketed its products through a network of independent sales persons and "encouraged them to sell Alpine products through cold calls, teaser mailing, and person-to-person approaches, among others."

Alpine also argued that its dealers were not "salesmen, representatives, peddlers, or canvassers" for purposes of Rule 3.286(a)(1)(D) or the Tax Code. Rather, Alpine argued that its dealers are "independent contractors." The Court again disagreed. According to the Court, Alpine's dealers function in the same way that salesmen, representatives, peddlers, or canvassers function. The Court noted that Alpine encourages its independent salespersons to hold meetings in their homes to sell company products and recruit new salespersons. The Court also noted that Alpine bases its compensation on the amount of products sold and the prices at which the products are sold. The Court further noted that Alpine's dealers utilize a variety of sales techniques, including cold calls, teaser mailing and person-to-person sales, all at the suggestion of Alpine. The Court therefore held that the Comptroller established that Alpine was a direct sales organization.

The Court rejected Alpine's argument to the effect that the Comptroller's adjustment violated Section 151.024. Alpine argued that Section 151.024 requires an individualized determination that unique tax treatment for different persons is warranted under the Tax Code, which the Comptroller did not do. Alpine further argued that, if the Comptroller is not required to make a determination that treatment of direct sales organizations as retailers is necessary for administrative efficiency, then the Comptroller's Rule constitutes an unlawful delegation of legislative authority. The Court rejected each of these arguments noting in part that, although the legislature requires the Comptroller to determine that treatment of a dealer, distributor, supervisor, or employer as a retailer is necessary for administrative efficiency, the legislature does not require the Comptroller to take particular steps in making this determination. However, according to the Court, the Comptroller produced ample evidence to show that it did in fact determine the Alpine was a direct sales organization and that treatment of Alpine as a retailer under Section 151.024 was necessary for administrative efficiency. For this same reason, the Court rejected Alpine's alternative argument.

The Court then considered and rejected Alpine's final argument concerning the constitutionality of the Comptroller's assessment. Alpine argued that the Comptroller had failed to establish a sufficient nexus between Texas and Alpine's sales activities because Alpine had no inventory, real estate, employees, offices, bank accounts, or other assets in Texas. The Court disagreed noting that the Comptroller had introduced evidence that Alpine maintained a network of up to 20,000 independent salespersons in Texas. The Court also noted that Alpine suggested a variety of sales techniques in its manual for use in selling Alpine's products. Citing to *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987) and *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), the Court held that Alpine's extensive network of salespersons – even though they are independent contactors—establishes a sufficient nexus between Texas and Alpine's sales activities.

The Court also rejected Alpine's attempt to distinguish Tyler Pipe and Scripto on the basis that both *Tyler Pipe* and *Scripto* involved situations where the taxpayers' sales forces helped the taxpayers maintain markets in the taxing states, whereas the Alpine independent distributors were themselves the in-state market. The Court rejected this argument noting a letter from Alpine's president which stated that most of the company's dealers sold the product retail. The Court therefore concluded that the uncontroverted evidence in this case established that a sufficient nexus between Texas and Alpine's sales activities.

As a final matter the Court summarily rejected Alpine's arguments to the effect that the Comptroller's tax violates the due process and equal protection clauses of the United States and Texas Constitutions.

Direct sellers and multi-level marketing companies present interesting constitutional nexus issues. On the one hand, their in-state distributors resemble retailers, which do not generally create nexus for out-of-state suppliers and wholesalers. On the other hand, they resemble in-state sales representatives which generally do. The Comptroller has generally taken the position that direct sellers with in-state distributors have nexus for sales tax purposes, citing to the U.S. Supreme Court's holding in *Scripto*.[7]

Multi-level marketing companies have enjoyed slightly greater success in the franchise tax context. In one hearing, the Comptroller ruled that a multi-level marketing company was not subject to the earned surplus portion of the Franchise Tax by virtue of Public Law 86-272.[8] In an unusual turn of events, the Comptroller disagreed with the ALJ in that ruling, who had initially ruled against the taxpayer on this issue. Unfortunately for multi-level marketing companies, in a later hearing decided by a different ALJ involving a very similar set facts, the Comptroller ruled against the taxpayer on the Public Law 86-272 issue and severely limited the scope of the prior ruling.[9]

Thus, even before this case was decided, the Comptroller had an established a policy of holding direct sellers and multi-level marketing companies with in-state distributors subject to Texas franchise and sales tax obligations. The Court of Appeals' decision in this case will no doubt provide the Comptroller with added boldness in pursuing multi-level marketing companies.

USA Waste Services of Houston, Inc., 2004 WL 524469 (Tex. App.—Austin, March 18, 2004): Steam Cleaning Services Purchased by Waste-Removal Company Do Not Qualify for Sale for Resale Exemption

USA Waste Services of Houston, Inc., 2004 WL 524469 (Tex. App.—Austin, March 18, 2004) addresses the application of the resale exemption to steam cleaning services purchased by a waste removal company. USA Waste is in the business of providing waste removal services for commercial customers. In the course of providing the waste removal services, USA will from time to time spill liquid onto a customer's property. Upon receiving a customer complaint about a spill, USA hires a steam cleaning company to clean up the spill.

Following an audit, the Comptroller assessed sales tax for USA's purchase of steam cleaning services performed on customers' property. USA claimed that the services were exempt from sales tax under the "sale for resale" exemption, which provides an exemption for services where "the buyer intends to transfer the service as an integral part of a taxable service." USA argued that the steam cleaning was an integral part of its waste removal service. The Court disagreed with USA's argument noting that USA's safety manager established that USA did not order steam cleaning every time that a spill occurred and that spills occurred only "sometimes." The Court also rejected USA's assertion that steam cleaning induced its customers to purchase USA's services, noting that one could conclude from the evidence that USA ordered steam cleaning only after a customer complained.

USA also argued that the Comptroller's construction of the resale exemption in this case was inconsistent with its construction of the exemption in other contexts. However, the Court found each of those contexts distinguishable. According to the Court, the steam cleaning services in this case were more analogous to a construction company paying for a plant that it accidentally backed over with one of its trucks. The replacement of the plant is not an integral part of the service, stated the Court, but rather is intended to make the customer whole.

The Court therefore held that the steam cleaning services did not qualify for the sale-forresale exemption.

Resale Exemption Rulings

Hearing No. 43,728 (April 29, 2004): Telephone Equipment Installed in Hotel Guest Rooms Do Not Qualify For Resale Exemption

Hearing No. 43,728 addresses the taxability of a telephone system in a hotel. The telephone system at issue consists of a PBX system (switch equipment, telephones, ACD, interface, etc.) and a voice mail messaging system. The telephones were installed in hotel guest rooms. Hotel guests use the room telephones to place and receive calls from outside the hotel, as well as within the hotel. The telephones are also commonly used by hotel guests to request services from hotel staff and to receive incoming calls transferred by the hotel's front desk.

Throughout the audit period, hotel guests were charged a fee for local and long distance telecommunication services upon placing an outgoing call from a guest room telephone. The hotel would collect and remit sales tax on these telecommunication services. However, the hotel claimed that it was entitled to a refund for sales tax paid on telephone handsets installed in hotel guest rooms under the sale for resale exemption. In support thereof, the hotel argued that care, custody and control of the equipment was transferred to its guests.

In addressing this issue, the ALJ mentioned the 3rd Court of Appeals' 1998 decision in *Sharp v. Clearview Cable TV, Inc.*, 960 SW2d 424 (Tex. App.-Austin 1998, pet. den'd.), in which the Court considered whether a wireless cable television provider was entitled to purchase equipment affixed to the outside of a subscriber's home tax free under the sale for resale exemption. In that case, the Comptroller conceded that the subscriber took custody of the equipment because it was located on the customer's property, but argued that care and control of the equipment was not transferred. The Court disagreed with the Comptroller noting that the subscribers controlled, at all times, the manner in which the outside equipment was used (including programming decisions) and were also contractually obligated to "properly care" for the cable equipment.

According to the ALJ, the facts in this case were "fundamentally different" from those at issue in *Clearview Cable*. In this case, hotel guests must refrain from damaging any property located in the guest rooms, including the telephone equipment because the guests have only a right to occupy the room. According to the ALJ, the burden to care for, clean, and maintain the telephone equipment and to make any necessary repairs falls on the hotel, and not the hotel guests. The hotel retains custody and control of the guest room telephone handsets in this case by virtue of its ownership of the hotel and all tangible personal property located therein. The fact that the equipment is made available to hotel guests for a limited period of time does not place custody and control of the equipment in the guests.

The ALJ continued stating that, even if the sale for resale exemption did apply, intrahotel calls constitute a divergent use of the equipment for which the hotel must accrue and remit use tax on the fair market rental value of the phones for the period of divergent use.

Texas Contractors

Hearing No. 41, 778 (April 20, 2004): Recoating Services for Parking Garages Held Taxable as Real Property Repair and Remodeling Services

In *Hearing No. 41,778*, the Comptroller considered the taxability of services claimed to be nontaxable maintenance services. The taxpayer in this case was a contractor who contracted with a real estate company to recoat three parking garages. The auditor assessed sales tax on these services claiming they were taxable real property repair and remodeling services. The taxpayer countered that the recoating projects represented routine maintenance performed on a scheduled basis to preserve the structure of the garages and were therefore not subject to tax.

The three garages at issue in this ruling were in three separate locations. The taxpayer provided the recoating services for the first location ("Location A") on July 1, 1997. The recoating services for the second location ("Location B") took place on September 1, 1998. The recoating services at the third location ("Location C") occurred on December 1, 1998.

In support of its contention that the services were not taxable, the taxpayer presented a letter from the Vice President of Company C regarding the three parking garages at issue. The letter stated that COMPANY C was a premier real estate management company that had in place routine scheduled maintenance for the three parking garages at issue. The garage at Location A was scheduled to be repainted in September of 2003 under a frequency schedule of every six years. The garage at Location B was scheduled to be repainted in September of 2003 under a frequency schedule of every five years. The garage at Location C was scheduled to be repainted in November of 2004 under a frequency schedule of every six years.

Other evidence established that the garage at Location A had been purchased just before the repainting was performed and furthermore that the repainting of the garage at Location B was needed for insurance purposes.

The ALJ agreed with the Tax Division that the evidence submitted by the taxpayer did not establish that the work performed was either scheduled or periodic.[10] The Comptroller agreed that the taxpayer had established that repainting of the garages was necessary to sustain or support safe, efficient, continuous operations or to prevent the decline, failure, lapse, or deterioration of the improvement. However, the ALJ ruled that the taxpayer failed to substantiate by way of maintenance schedules or work orders or other evidence that the recoating services constituted scheduled, periodic maintenance of real property. Furthermore, stated the ALJ, the garage at Location B was painted on an as-needed basis to obtain insurance coverage. For these reasons, the ALJ denied the taxpayer's contention that the services did not represent taxable real property repair and remodeling services.

Manufacturing Exemption

Hearing No. 43,999 (March 26, 2004): Network Equipment and Electricity Used in Telecommunications Services Held Taxable: Manufacturing and Resale Exemptions Not Applicable

In *Hearing No. 43,999*, the Comptroller ruled that a provider of telecommunications services did not qualify for either the manufacturing or resale exemption on its purchase of network equipment or electricity used to provide certain telecommunications services. The taxpayer in this case provides voice telecommunications, information processing and transmission services within Texas and elsewhere. It utilizes various items of equipment ("Network Equipment") to receive, convert, transmit, amplify and reproduce sound and information. Electrical impulses are involved in the process. The network equipment performs conversions of signals from analog to digital and back to analog.

The taxpayer raised an interesting argument regarding the applicability of the manufacturing exemption. It argued that, following the October 1, 1997 legislative amendment to the exemption, the network equipment qualifies for the manufacturing exemption because the telecommunications services provided by the taxpayer qualify as manufactured "products." The taxpayer further argued that, following the 1997 amendment, the manufacturing exemption is not limited to items of tangible personal property that are manufactured. Alternatively, the taxpayer argued that telecommunications fall within the definition of tangible personal property under Section 151.009 of the Tax Code because they are visible to the senses. Finally, the taxpayer argued that the telecommunication services constitute tangible personal property because they commence with electrical impulses, which are regarded as tangible personal property under the Comptroller's Rule 3.295.

The ALJ considered and rejected the taxpayer's primary argument regarding the significance of the 1997 amendment. The ALJ noted that the purpose for the October 1, 1997 amendment was to respond to Court decisions interpreting the manufacturing exemption to exempt tangible personal property that the Comptroller held to be indirectly involved in the manufacturing process and therefore nonexempt.[11] The ALJ noted that the amendment left undisturbed all other references to tangible personal property in the manufacturing exemption provisions of the Tax Code, which suggested that the Legislature did not intend to broaden the exemption to include intangible products or services. Thus, equipment must be necessary or essential tangible personal property used in the manufacturing, processing or fabrication of tangible personal property for ultimate sale to qualify for the manufacturing exemption.

The ALJ also rejected the taxpayer's alternative argument regarding the manufacturing exemption. After considering the history of the taxability of telecommunications services, the ALJ concluded that telecommunications were legislated to be a service, not tangible personal property. According to the ALJ, telecommunications were legislated as a service regardless of whether technically a telecommunications message is perceptible to the senses. The ALJ also agreed with the Tax Division that, if the Legislature had intended for telecommunications to be considered tangible personal property, no need would have existed for the addition of telecommunications as a taxable service in 1985.

The ALJ likewise rejected the taxpayer's argument that telecommunications signals are effectively electrical impulses, which constitute tangible personal property under the Comptroller's rules. The ALJ noted that the taxpayer in this case sells telecommunications services, not electricity. The ALJ further stated that the network equipment is not made tangible personal property by the involvement of electrical impulses in the process, nor is the network equipment exempt under the manufacturing exemption as equipment that manufactures or processes electricity. Accordingly, the ALJ ruled that, because the taxpayer's network equipment does not produce tangible personal property for ultimate sale, the manufacturing exemption is not available to exempt its network equipment.

The Comptroller also rejected the taxpayer's second contention in this ruling that the electricity used in its telecommunications services qualifies for the resale exemption. The ALJ noted that electricity used in the telecommunications services is not transferred to the taxpayer's subscriber customers. Rather, it is converted by the taxpayer to a signal, which is thereby consumed in providing telecommunications services. Accordingly, the electricity did not qualify for the resale exemption.

Hearing No. 42,955 (April 22, 2004): Certain Items Used in Manufacturing Operation Held Taxable

In *Hearing No. 42,955*, the Comptroller addressed the taxability of several items used by a taxpayer as part of its shrimp processing operations. The taxpayer filed a refund claim claiming that several items used in its operations qualify for the manufacturing exemption. The Comptroller agreed with the taxpayer with respect to some of these items, but not on others.

The taxpayer claimed that the purchase of an ice machine qualified for the manufacturing exemption under Section 151.318(a)(10) because it was "necessary and essential to comply with federal, state, or local laws or rules that establish requirements related to public health." The ice produced by the ice machine was used to keep the shrimp within a certain temperature range as required by federal regulations. The ALJ denied the exemption to the ice machine because the taxpayer did not establish by clear and convincing evidence that it could not secure ice that would comply with the federal regulations from any source other than the ice machine. According to the ALJ, the federal regulations required that the ice comply with certain requirements, but did not require that the ice be produced by the taxpayer's ice machine.

The ALJ agreed with the taxpayer, however, that certain hand cleaner required by state and federal health regulations qualifies for the manufacturing under Section 151.318(a)(10). The facts established that special hand cleaners were required to be used by processing employees under state and federal health regulations.

The ALJ also agreed with the taxpayer that the purchase of certain pumps, piping, motors, switches, and accessories associated with surge tanks qualified for the exemption provided for under Section 151.318(a)(11), which provides an exemption for property installed to "reuse and recycle waste water streams generated within the manufacturing . . . operation."

The ALJ rejected an argument by the Tax Division that the surge tanks and accessories did not qualify for the manufacturing exemption because they were not specifically required by federal regulations. According to the ALJ, these items qualified for the exemption because they were installed to reuse and recycle the water displaced from the chill and thaw tanks used in the taxpayers operations.

The ALJ rejected an argument by the taxpayer that certain piping used to re-circulate water from a surge tank to a flume at a separate "heading" station qualified for the manufacturing exemption. According to the ALJ, the evidence in this case clearly establish that the surge tank and the flume were not a single item of manufacturing equipment, but rather constituted an integrated group of manufacturing and ancillary equipment. As such, the piping was not a component part of a single item of manufacturing equipment as required under Section 151.318(c)(1)(A), but rather constituted a non-exempt intra-plant item of transportation equipment subject to state tax.

Finally, the ALJ rejected the taxpayer's claim that certain steam and pressure washers used to clean the "peeling areas" are exempt under Section 151.318(a)(10). The Comptroller rejected this assertion, noting that only the cleaning of the peeling equipment and not the use of steam and pressure washers was required by the federal regulations.

Hearing No. 42,858 (April 27, 2004): Manufacturing Exemption Held Inapplicable to Certain Refrigeration Units

In *Hearing No. 42,858*, the Comptroller ruled that electricity used to operate certain coolers and freezers does not qualify for the manufacturing exemption. The taxpayer in this ruling purchases frozen and nonfrozen food products from manufacturers for distribution at grocery stores. The products are processed and packaged prior to receipt by the taxpayer. Upon receipt, the taxpayer uses coolers and freezers to lower the temperature of the products to various target levels prior to distribution to its customers. The taxpayer claimed that electricity used to operate these refrigeration units as well as packaging supplies and the costs of repairs and replacement parts for processing equipment are exempt from the State sales tax under the manufacturing exemption.

The ALJ summarily rejected the taxpayer's assertions. Citing to numerous rulings, the ALJ ruled that the processing of food products is complete when the products are packaged by the manufacturer. According to the ALJ, the subsequent lowering of food temperatures during storage by a distributor, prior to resale to a grocery store or restaurant, does not constitute exempt processing under Sections 151.317, 151.318, or the Comptroller's longstanding administrative policy. Accordingly, the taxpayer was not entitled to claim the manufacturing exemption.

Taxability Determinations

Hearing No. 42,539 (June 8, 2004): Skybox Rentals Held Subject to Sales Tax

In *Hearing No. 42,539*, the Comptroller considered the taxability of fees received for the rental of skyboxes. The taxpayer in this case is the owner and operator of a professional basketball team who entered into a license agreement with an unnamed city ("City") for the license of several sky boxes located in a sports facility. The City makes available to the taxpayer and its sublicensees a corresponding number of admission tickets for specified events. The taxpayer enters into sublicense agreements with various third parties under which it receives fees for the use of the sky boxes. The taxpayer remitted sales tax on the face amount of the admission tickets sold to sublicensees. At issue in this hearing is the taxability of the remaining portion of the fee payments.

The taxpayer offered three reasons that this portion of the fees is not subject to Texas sales tax. First, it argued that the fees represent payment for the nontaxable rentals of real property. Second, it argued that the fees represent payment for nontaxable sales of intangible rights. Third, it argued that the fees are exempt from taxation under Section 151.3101 of the Texas Tax Code. The ALJ disagreed with each of these arguments.

With respect to the first argument, the ALJ noted that the Comptroller's policy, as expressed in Tax Policy Letter 9507L1361C01 and Tax Policy Letter 9501L1329E06, is that the charge for the use of a facility to view an amusement is part of the total charge for the amusement service and therefore subject to sales tax. According to the ALJ, this is a reasonable interpretation "based on the obvious conclusion that the only reason for licensing a sky box is [to] be able to view events in the facility." For this reason, the Comptroller rejected the taxpayer's first two arguments.

The ALJ also rejected the taxpayer's third argument. The ALJ ruled that, while fees paid by the taxpayer to the City are exempt from sales tax under Section 151.3101, the sublicense fees paid by the suite holders to the taxpayer are nevertheless subject to tax because each represents fees paid under a separate transaction.

Hearing No. 41,466 (April 14, 2004): Insurance Related Services Held Taxable

In *Hearing No. 41,466*, the Comptroller ruled that certain insurance related services were subject to sales tax. The petitioner in that ruling is an insurance adjusted who measures and documents losses of individual policyholders to assist those policyholders in obtaining fair settlements from their insurance companies. The petitioner argued that its services were not subject to sales tax as "insurance services" in part because they were not performed on behalf of insurance carriers. The ALJ disagreed ruling that, because the services were provided to policyholders and pertained to policies of insurance, they were subject to sales tax.

Letter Ruling 200407710L (July 21, 2004): Bounty Hunter Services Held Taxable

In *Letter Ruling 200407710L*, the Comptroller ruled that the services provided by a bounty hunter are subject to the state sales tax. According to the ruling, a person must be licensed as a private investigator in Texas to provide the services of a bounty hunter. As such, these services are taxable as "security services" under the Texas Tax Code.

Letter Ruling 200406651L (June 1, 2004): Sale of Receivable Held not Taxable as Debt Collection Service

In *Letter Ruling 200406651L*, the Comptroller addressed the taxability of certain debt collection services and ruled that the service is not taxable where it is structured in the form of a sale of the receivables at issue. The ruling addresses three examples under a hypothetical where Company B engages Company A to collect an outstanding $1,000 debt. Under the first example, 60% of the amount collected is remitted to Company B and 40% is retained as compensation by Company A. The Comptroller ruled that the 40% retained by Company A is taxable as a debt collection service. Under the second example, Companies B and A share 60%/40% on the first $700 collected with any additional monies collected going to Company A. The Comptroller ruled that tax is due on 40% of the first $700 plus the additional amount retained by Company A ($200 in the example).

Under the third example, Company A purchased the $1,000 receivable from Company B for $400 and collected $900 from the debtor. Under these facts, the Comptroller ruled that Company A is not performing a debt collection service because it is the owner of the receivable and does not receive any consideration for collecting. However, Company B owes tax on all remaining payments due for the receivables at the time of their sale to Company A under Rule 3.302(c).

This ruling provides an interesting possibility on structuring debt collection services. Rather than structuring debt collection services as such, one might consider structuring the services as a sale of the receivables. This ruling suggests that the Comptroller would not consider the sale taxable. However, the Comptroller has frequently applied the "essence of the transaction" doctrine to re-characterize transactions. It is quite possible that, under certain circumstances, the Comptroller would apply this doctrine to re-characterize a sale of receivables as debt collection services. Any company considering this possibility should probably first obtain a private letter ruling from the Comptroller.

Letter Ruling 200403425L (March 4, 2004): Property Tax Included in Lease Charge of Tangible Personal Property Not Subject to Sales Tax

In *Letter Ruling 200403425L*, the Comptroller ruled that certain property taxes passed to lessees of tangible personal property as additional rent were not subject to sales tax. The taxpayer is a lessor of computer equipment that would add property taxes to the amount of rent owed by the lessees. The taxpayer would perform calculations utilizing actual valuations provided to the county and tax rates for each individual lessee site in order to determine the amount of property tax to bill to a specific client. On these facts, the Comptroller ruled that the taxpayer's methodology amounted to a dollar-for-dollar separately stated reimbursement for property tax paid on the specific equipment being leased under the contract which is not subject to sales and use tax.

Use Tax

Hearing No. 42,035 (May 27, 2004): Morton Buildings Held Inapplicable to Component Parts of Film Projection Systems

Hearing No. 42,035 addresses the applicability of the Third Court of Appeals' holding in Sharp v. Morton Buildings, Inc., 953 S.W.2d 300 (Tex. App.-Austin 1997, pet. den'd) to certain component parts purchased for film projection systems used in Texas. The taxpayer owns and operates movie theaters throughout the U.S. including Texas. It filed a refund request for sales and use taxes paid on the purchase of component parts purchased from out of state manufacturers for film projection systems used in the taxpayer's Texas movie theaters.

The component parts consist of amplifiers, digital sound processors, projectors, and other projector-related components. They were sent directly to a company in California for final assembly into film projection systems, which were then shipped to the taxpayer's theaters in Texas for installation by engineers and electricians. The taxpayer argued that the component parts were not subject to tax under the holding of *Morton Buildings* because they ceased to exist as separate pieces of tangible personal property at the time they were brought into the state.

The ALJ agreed with the Tax Division that the facts of this case were distinguishable from those considered in *Morton Buildings*. According to the ALJ, Morton purchased "raw" materials in the truest sense of that word: lumber, plywood, paint, and steel, all of which were used by Morton to create building components with a different nature in utility. By contrast, the film projection system components purchased by the taxpayer in this case were already manufactured from raw materials and maintained the same nature, utility, and function after being installed in the film projection systems. Accordingly, the ALJ ruled that the assembled components were used by the taxpayer in its Texas theaters and were subject to the State's use tax.

Refund Claims

Hearing No. 42,309 (April 7, 2004): Refund Claim Did Not Operate to Toll Statute of Limitations

In *Hearing No. 42,309*, the Comptroller addressed the question of whether a refund claim submitted by a taxpayer in connection with an ongoing audit had the effect of tolling the statute of limitations with respect to a subsequently filed refund claim. The taxpayer in this case was audited for sales and use tax for the period from June 1, 1992 through May 31, 1996. On June 30, 1998, the taxpayer filed a refund claim covering part of the audit. (October, 1993 to May, 1996). The portion of the refund claim falling within the audit period was processed as part of the audit. Approximately one year later, on June 10, 1999, the Comptroller issued a Texas Notification of Audit Results showing a credit due to the taxpayer. The credit became final on July 11, 1999.

The taxpayer filed a subsequent refund claim that also covered part of the prior audit period. The Comptroller granted only part of the refund claim and denied the remaining portion on the basis that it was barred by the statute of limitations. The taxpayer requested a hearing on the denial claiming that the refund claim was not untimely in part because the original refund claim tolled the statute of limitations, and in part because the second claim was filed within six months of the date the deficiency determination became final. The ALJ disagreed with each of these arguments.

With respect to the first argument, the ALJ ruled that audits do not constitute administrative proceedings that toll the statute of limitations. According to the ALJ, the Tax Code's provision for tolling the statute of limitations while an "administrative proceeding is pending before the Comptroller for a redetermination of the tax liability," clearly contemplates a contested case as defined in the Government Code. Because informal reviews do not constitute contested cases, they do not toll the limitations period.

With respect to the taxpayer's second argument, the ALJ acknowledged that the second refund claim was filed less than six months following the date the deficiency determination became final on July 2, 1999. The ALJ also noted that the Tax Code does not require that the Comptroller's determination in a "deficiency determination" in fact be a deficiency and recognized that many audits result in credits rather than tax amounts due. As such, the second refund claim would be timely under Section 111.104(c), unless limited by Section 111.104(d) which limits the refund claim to the amount of tax "found due" in the deficiency determination. According to the ALJ, this statutory provision has been interpreted by the Comptroller to limit the transactions that fall within the six month provision of Section 111.104 to "all transactions that are included in the deficiency determination." Under this authority, the second refund claim was not timely under the six month provision of Section 111.104 because the transactions that made up the second refund claim were not included in the deficiency determination.

Hearing No. 43,726 (June 8, 2004): Refund Claim for Items not Included in a Prior Deficiency Determination Held Barred by Statute of Limitations

In *Hearing No. 43,726*, the Comptroller ruled that a taxpayer's claim for refund was barred by the statute of limitations notwithstanding that it was filed within six months from the date that a prior deficiency determination became final. The taxpayer was audited for sales and use tax compliance for the period from June 1, 1996 through December 31, 1998. The Comptroller issued a Texas Notification of Audit Results that became final April 7, 2002. On September 6, 2002, the taxpayer filed a refund claim for the audit. The Comptroller denied the refund claim in part on the basis of the statute of limitations.

The ALJ agreed with the Tax Division that the refund claim was barred by the statute of limitations. The ALJ noted that Section 111.104(c)(3) provides that a refund claim must be filed "before the expiration of the applicable limitation period. . . .or before the expiration of six months after a jeopardy or deficiency determination becomes final, whichever period expires later." The Tax Division argued that the refund claim was subject to Section 111.104(d), which limits the refund claim to the amount of tax "found due" in the deficiency determination. The ALJ agreed that this limitation precluded the refund claim in this case because the transactions that made up the denied items in the refund claim were not included in the deficiency determination.

Successor Liability

Hearing No. 43,978 (May 5, 2004): Successor Liability Upheld Against Purchaser of Restaurant

In *Hearing No. 43,978*, the Comptroller upheld the imposition of successor liability for unpaid sales tax against the purchaser of a café. Under the terms of the contract the taxpayer agreed to pay an unspecified amount for the restaurant's equipment and inventory, as well as the right to continue operating the restaurant in the same location using the same trade name. The ALJ ruled that the Tax Division had established a prima facie case for successor liability under Section 111.020 of the Tax Code by showing that the taxpayer had purchased the predecessor's equipment and inventory, as well as the right to continue operating the restaurant in the same location using the same trade name. Moreover, the taxpayer presented no controverting evidence to refute the Tax Division's position. As such, the taxpayer was liable for the predecessor's sales tax liability under Section 111.020 of the Tax Code.

Hearing No. 43,660 (April 26, 2004): Successor Liability Upheld in Acquisition of Convenience Store

In *Hearing No. 43,660*, the Comptroller considered the applicability of successor liability to the purchaser of a convenience store and ruled that the new owner could in fact be held liable for his predecessor's unpaid sales tax liability. The purchaser contracted to purchase equipment and inventory previously used in the operation of a convenience store by the seller. The contract provided that the seller was responsible for all sales tax due through the date of sale. No amount of the purchase price was specifically allocated to good will. In addition, the seller did not purchase the trade name under which the seller operated the convenience store business. The convenience store reopened under a new name within a few days after consummation of the transaction and continued to operate at the same location.

The ALJ ruled that location and inventory are the "vital ingredients" in establishing successor liability for a convenience store. The ALJ noted that, in this case, location remained the same and the purchaser acquired the entire sellable inventory. The ALJ also found it noteworthy that the purchaser had acquired various items of equipment that made the store profitable and essentially continued to operate the same business as before, subject only to an insignificant interruption. These facts were sufficient to establish successor liability, according to the ALJ.

The ALJ rejected the purchaser's argument to the effect that successor liability should not apply because it did not purchase the seller's good will. According to the ALJ, the fact that good will is not purchased, where none is apparent, does not prevent a purchaser from qualifying as a successor under Section 111.020. The ALJ also commented that the agreement between the parties allocating sales tax liability did not operate to absolve the purchaser from liability under Section 111.020.

The ALJ distinguished the facts of this case from those at issue in *Hearing No. 40,162* (2002) in which the Comptroller ruled that successor liability did not apply to the purchaser of used equipment already in place in restaurant premises. According to the ALJ, unlike the decision in *Hearing No. 40,162*, the transaction in this case involved the transfer of inventory on hand. The ALJ also noted that, unlike the purchaser in *Hearing No. 40,162*, the purchaser in this case was not established in the convenience store business at the time of the purchase. For this reason, the transaction could not be viewed, as it was in *Hearing No. 40,162*, as an expansion of a business with existing and independently developed good will. These facts distinguished Hearing No. 40,162 and rendered its ruling inapplicable.

For these reasons, the ALJ upheld the imposition of successor liability.

Franchise Tax

Anderson-Clayton Bros. Funeral Home, Inc. et al. v. Comptroller of Public Accounts, 2004 Tex. App. LEXIS 7168 (Tex. App. – Austin 2004, no pet h.): Investment Income of Grantor Trust is Sourced to Location of Trust, Despite Flow-Through Nature of Income For Federal Tax Purposes

As this publication goes to print, the Texas Court of Appeals issued an opinion involving the Texas franchise tax in the case of *Anderson-Clayton Bros. Funeral Home, Inc. et al. v. Comptroller of Public Accounts*, 2004 Tex. App. LEXIS 7168 (Tex. App. – Austin 2004, no pet h.) that triggered a compelling dissenting opinion from Justice David Puryear. The case addresses the proper sourcing of revenues generated by a grantor trust for purposes of apportioning the earned surplus portion of the franchise tax. The Court held that the investment income of a grantor trust should be sourced by viewing the trust as the payor for purposes of apportioning the earned surplus portion of the Texas franchise tax. This applies notwithstanding that the trust's income flows through to the grantor for both federal income tax and taxable earned surplus purposes.

The taxpayers consist of a group of affiliated funeral homes that sell prepaid funeral services. As required under state law, the proceeds from the prepaid services are placed in certain trusts that invest the proceeds and accumulate earnings. The trusts are treated as grantor trusts for federal income tax purposes. For the period at issue, the investment earnings of the trusts were derived from certain out-of-state corporations.

The taxpayers properly included income of the trusts in their taxable earned surplus. However, they maintained that, under Section 171.1121(b) of the Texas Tax Code, the investment proceeds should be sourced by treating the corporate payors as the relevant payors and not the trusts. Following this argument to a logical conclusion would of course mean that proceeds would be sourced out-of-state.

The Court disagreed with the funeral homes, focusing its analysis on two key terms in Section 171.1121(b). Section 171.1121(b) states, "Except as otherwise provided by this section, a corporation shall use the same accounting methods to apportion taxable earned surplus as used in computing reportable federal taxable income." According to the Court, the term "accounting methods" as contemplated by the franchise tax statute relates primarily to the timing of revenue and income recognition. The term "apportion" refers to the apportionment provisions in Section 171.106. The Court did not find that either of these terms supported the taxpayers' argument.

The Court offered its own interpretation of Section 171.1121(b). According to the Court, this section merely requires corporations to apply the same accounting method (e.g., the installment method, the percentage of completion method) for purposes of calculating both reportable federal taxable income and the "gross receipts" used in the apportionment factor of Section 171.106. The Legislature's evident intent for doing so, stated the Court, stems from the fact that both "gross receipts" used in the earned surplus apportionment factor and the taxable earned surplus that is being apportioned are derived from items reportable on the corporation's federal income tax return.

The Court then considered where the income at issue should be sourced. The Comptroller argued that, because Section 171.1121(b) provides no guidance for determining the location of the payor for apportionment purposes, it could use its own method for making that determination. The Court held that, because ultimately the trusts pay income to the funeral homes earned from their investments, the Comptroller's determination that the trusts should be considered the payors was reasonable. Moreover, because the trusts were domiciled in Texas, under the "location of the payor" rule, the investment income was properly characterized as Texas receipts for apportionment purposes.

Justice David Puryear, issued the dissenting opinion. Justice Puryear disagreed with the majority's characterization of the trusts as "payors" generating income from business done in Texas. Justice Puryear argued that the majority's interpretation of Section 171.1121(b) is flawed in two respects: (1) it renders subsection (b) of section 171.1121 redundant of subsection (a), and ignores the meaning of the term "apportion."

According to Justice Puryear, subsection (a) of Section 171.1121 directs taxpayers to do precisely what the majority interepreted subsection (b) to do. He noted that subsection (a) provides that gross receipts mean all revenue reportable by a corporation on its federal tax return.[12] In addition, taxable earned surplus is determined by adjusting the amount of a corporate taxpayer's reportable federal taxable income under Section 171.110(a) of the Tax Code. And gross receipts do not include revenues that are not included in taxable earned surplus under Section 171.1121(a). Collectively, these provisions require that gross receipts be calculated consistently with taxable earned surplus. This is spelled out in subsection (a), not subsection (b).

Justice Puryear also cited to the definition of "apportion" in Blacks Law Dictionary in concluding that the Tax Code requires that federal accounting methods be used in determining to whom investment income should be attributed. Justice Puryear continued stating that nothing in Section 1121 or elsewhere in the Franchise Tax Act supports the Comptroller's contention that the term apportion means to calculate gross receipts consistently with taxable earned surplus. Justice Puryear further noted that, under federal law, the trusts at issue in this case are treated as grantor trusts whose income flows through to the grantors. Applying this federal accounting method to the facts of this case, as Section 171.1121(b) requires, stated Justice Puryear, means that the corporations in this case should be treated as the payors for purposes of the location of the payor rule.

Justice Puryear continued stating that, even if he were to agree that the Tax Code does not require the Comptroller to apply the federal method of treating grantor trusts as flow-through trusts rather than payors, he would still hold that the trusts cannot be characterized as the payors for purposes of the location of the payor rule. This is because the trusts do not generate the investment earnings and have no discretion as to how or when the earnings should be paid.

Justice Puryear appears to have the stronger argument in this case. The majority has succeeded in creating precisely the kind of inconsistency that it claims the Legislature sought to avoid in Section 171.1121(b). The fact that the Legislature intended to require taxpayers to use the same method of accounting for purposes of calculating both reportable federal taxable income and the "gross receipts" used in the apportionment factor of Section 171.106, as determined by the Court, suggests that the Legislature sought consistency between these two concepts. By upholding the Comptroller's sourcing rule, the Court has effectively established two different (and inconsistent) rules for sourcing the same item of income for purposes of the earned surplus portion of the franchise tax. Assuming the Court's characterization of Legislative intent is correct, it seems questionable that the Legislature would have intended such result.

Furthermore, the Court's comment that trust income can be properly sourced to the trusts in this case because the trusts ultimately pay income to the funeral homes earned from their investments overlooks a fundamental characteristic of grantor trusts. Specifically, this reasoning overlooks the fact that trust income is included in the grantor's income for earned surplus purposes, not because of any actual payments made to the grantor, but merely because of the flow-through nature of grantor trusts. The Court's holding effectively requires the presumption of a hypothetical payment from the trust to the grantor in applying the sourcing rules.

Hearing No. 41,675 (June 10, 2004): Caution! Do Not Overpay Tax With Delinquent Returns: Refund Claim Held Barred By Statute of Limitations

Hearing No. 41,675 provides a stark reminder of how quickly and easily the statute of limitations can whipsaw taxpayers who files late returns. The taxpayer in this case filed franchise tax returns for the 1993 through 1997 report years in response to investigative efforts by the Comptroller's Business Activity Research Team. The returns were filed on May 12, 2000 and were based on tentative information. At the time the returns were filed, the taxpayer remitted a payment that purposefully exceeded the amount of tax liability calculated on the basis of the tentative information in order to have the excess available to offset interest and any liability for succeeding report years. The taxpayer thereafter filed a claim for refund on the overpayment. The Comptroller denied the claim on the basis of the statute of limitations.

On appeal, an administrative law judge upheld the denial. The ALJ noted that Section 111.104 requires that a refund claim be filed before the expiration of the applicable limitations period provided in Chapter 111 or before the expiration of six months after a jeopardy or deficiency determination becomes final, whichever expires later. According to the ALJ, the statute of limitations under Chapter 111 had already expired for all but the last year at the time the claim for refund was filed. In addition, delinquency notices issued by the Comptroller advising the taxpayer of its filing delinquencies and of impending corporate forfeiture did not constitute jeopardy or deficiency determinations and therefore the 6-month period for filing a refund claim did not apply.

Significantly, the operation of the 6-month period for filing refund claims under Section 111.104 provides yet another reason to use the Comptroller's voluntarily disclosure program to report and remit tax to the State. Taxpayers who voluntarily disclose and pay tax under the Comptroller's voluntary disclosure program limit their exposure to liability to four years and also avoid the imposition of penalties and interest. In addition, the Comptroller will generally allow taxpayers to correct amounts reported under the VDA program and obtain a refund of overpayments within a few months of the voluntary disclosure.

Hearing No. 43,513 (May 13, 2004): Sale of Subscriber List Held Apportionable to Texas

Hearing No. 43,513 considers the apportionability of gain from the sale of a subscriber list for Texas franchise tax purposes. The taxpayer is a direct marketer of personal computers and a provider of a nationwide Internet service. The Internet provider service features electronic mail as well as Internet access to a wide array of information resources, including news, entertainment, education, etc. and is referred to as "Internet.Net."

In October 1999, the taxpayer entered into an agreement with a third party ("Internet Corporation") for the sale of the Internet.net subscriber list. The taxpayer argued that gain from the sale of the subscriber list should be allocated to South Dakota, the state of its commercial domicile rather than Texas.

The ALJ disagreed and cited several key factors that support its conclusion. First, Internet.net was not operated as a separate legal entity, but rather was operated as a segment of the taxpayer's business. Second, the taxpayer sold only the subscriber list and not the entire Internet.net business segment. Third, the taxpayer continued to provide Internet service to Internet.net customers in Texas.

The ALJ also found noteworthy a representation made by the taxpayer to the Securities and Exchange Commission in which the taxpayer stated that the agreement with the Internet Corporation was "intended to accelerate [the] distribution of each company's products and services . . . ." According to the ALJ, this statement as well as common sense led to the conclusion that the taxpayer's decision to provide Internet services was perfectly tailored to and designed to enhance its existing business of manufacturing and selling personal computers. Thus, income received from the sale to Internet Corporation was directly related to the taxpayer's activities in Texas.

Under these facts, the ALJ ruled that the taxpayer had failed to rebut the presumption that gain from the sale of the Internet.net subscriber list was unitary and therefore apportionable to the taxpayer's Texas operations.

Hearing No. 43,575 (April 16, 2004): Gain on Sale of Stock Acquired in Demutualization of Insurer Held Apportionable to Texas Under *Allied Signal*

In a case of first impression, the Comptroller ruled that gain from the sale of stock acquired from a demutualizing insurance company was apportionable to Texas. The Petitioner in this case held an insurance policy with Company A on the life of a key officer, who was also the Petitioner's majority shareholder. In 1999, the insurance company went through a demutualization process wherein it was transformed from a mutual life insurance company (i.e., owned by its voting policyholders) to a life insurance company with common shares owned by its shareholders. As a policyholder, Petitioner received shares of stock in Company B and cash during the demutualization process. In the same year, Petitioner sold the Company B stock at a gain.

Petitioner contended that gain from the sale of the Company B stock was not includable in its Texas franchise tax because the gain constitutes non-unitary income. The taxpayer argued that the gain was not unitary because (i) it had insufficient unitary connection with Texas; (ii) the three unities test (centralized management, functional integration, and economies of scale) have not been met; and (iii) the stock was held as an investment. The ALJ disagreed with the Petitioner.

In arriving at its conclusion, the ALJ stated that, while the three unities test provides indicia as to the existence of unitary business, it is not the exclusive test in determining the existence of unitary business under the United States Constitution. Quoting the Supreme Court's holding in Allied Signal, the ALJ ruled that "what is required instead is that the capital transaction serve an operational rather than an investment function."[13] The ALJ also agreed with the Tax Division that, because Petitioner would not have held the stock but for the existence of the insurance policy, the focus in applying this standard should be on the insurance policy rather than on the stock itself.

Having determined that the focus should be on the insurance policy, the ALJ then considered whether the insurance policy served an operational function or was a passive investment unrelated to Petitioner's activity carried out in Texas. The ALJ noted that the insurance policy purchased protected Petitioner and its entire business operation against risk that may potentially arise from the death of a key officer. Under these circumstances, ruled the ALJ, the insurance policy clearly served a purpose related to Petitioner's manufacturing operation.

The Comptroller's decision in this case effectively establishes a per se rule that any income attributable to a company's key man insurance policy represents unitary income for apportionment purposes. However, query whether this same rule should apply to appreciation that occurs after the date the investment ceases to be held in the form of a key man insurance policy. For example, if the Petitioner in this case had instead held the stock for two years following the insurer's demutualization during which time the stock doubled in value, the subsequent appreciation should not automatically fall under the Comptroller's new per se rule. Those facts would provide a strong basis for distinguishing the Comptroller's ruling in this case, even assuming that this ruling represents a proper interpretation of the Texas Tax Code and the U.S. Constitution.

Hearing No. 41,115 (April 16, 2004): Receipts From Television Programming Service Are Sourced to Texas as Proceeds From the Use of a License Rather than From the Sale of a Service

In *Hearing No. 41,115*, the Comptroller determined that revenues derived from the performance of television network programming services were apportionable to Texas as proceeds for the use of a license rather than for the provision of services. The Petitioner in this case is a national television network programming provider with nexus in Texas. It provides its programming services to third party cable system operators and multi-channel video programming distributors, referred to as "affiliates, via satellite.

At issue in this ruling was whether proceeds received from affiliates constitute proceeds for the use of a license or for the provision of a service. Under the Tax Code and the Comptroller's Rules, receipts from the performance of services are generally sourced to the point at which the services are performed, whereas receipts from the use of a license are sourced to the location where the licensed is used. Petitioner argued that the receipts in dispute result from labor-intensive network programming services, all of which are performed in New York. In support of its argument, Petitioner cited to the Austin Court of Appeals decision in *Westcott Communications, Inc. v. Strayhorn*, 104 S.W.3d 141 (Tex. App.—Austin 2003, pet. denied), which held that receipts from educational and training programming services originating in Texas and provided via satellite to customers for viewing outside of Texas represent receipts for the performance of a service and not for the right to view the programming.

The ALJ disagreed with Petitioner's argument. The ALJ ruled that *Westcott* was not controlling in this case in part because, unlike in *Westcott*, the explicit contract language at issue in this case facially reflects the grant of a license and identifies the involved receipts as license 23 fees.[14] According to the ALJ, the contracts in this case clearly contemplate the payment to Petitioner for the right to distribute entertainment programming. The ALJ also found persuasive case law in Michigan holding that payment by cable operators for network programming represent royalties and not compensation for the provision of services.

The ALJ therefore ruled that the fees paid to Petitioner represent fees for the use of a license that were properly sourced to Texas.

Hearing No. 43,183 (Jan. 16, 2004): Limitations Period for Refund Claims Applies Even Where Taxpayer Not Subject to Franchise Tax

Hearing No. 43,183 addresses the applicability of the statute of limitations to a refund claim filed after the Comptroller determined that a taxpayer did not have nexus with the State. The Claimant in this ruling filed Texas franchise tax reports and paid franchise tax for report years 1998 through 2000. It later submitted a Texas Nexus Questionnaire to the Comptroller's Business Activity Research Team after which the BART determined that Claimant did not have nexus with Texas for franchise tax purposes. Thereafter, on December 12, 2002, Claimant filed a refund claim seeking a refund of franchise tax previously paid for the 1998, 1999 and 2000 report years. The Comptroller denied Claimant's refund claim for the 1998 report year.

On appeal, the Claimant acknowledged that a refund claim must generally be filed within four years from the date the tax is due and payable under Section 111.104(b) of the Texas Tax Code. However, Claimant argued that the statute of limitations never commenced to run because no franchise tax was ever "due and payable."

The ALJ rejected Claimant's argument. The ALJ noted that under the long-settled common law of Texas, taxes voluntarily paid may not be recovered even where the tax is illegal, absent fraud, express or implied duress or mutual mistake of law. According to the ALJ, Claimant's franchise tax payment for 1998 was purely voluntary and therefore subject to the voluntary payment rule. The ALJ also agreed with an argument by the Tax Division to the effect that construing the "due and payable" clause to mean that the statute does not run at all if the tax is not "due and payable" would render limitations meaningless for all refund claims. As a final matter, the ALJ noted that even claims for refund of illegal fees or taxes paid involuntarily or under duress have been held subject to the applicable statute of limitations or the equitable doctrine of laches.

Accordingly, the ALJ ruled that the denial of the refund claim on the basis of the limitations period should be upheld.

Hearing No. 42,311 (Jan 26, 2004): Sourcing Receipts Attributable to Goods Originating in Mexico to Texas Under "Throwback" Rule Did Not Violate U.S. Constitution

Hearing No. 42,311 presents the interesting issue involving the applicability of the "Import-Export Clause" of the U.S. Constitution to the throw-back rule in the Texas Tax Code. With predictability, the ALJ in this case ruled that the throwback rule as applied under the facts of this case did not violate the Import-Export Clause. The ALJ also ruled that the receipts attributable to the sale of goods in this case were properly sourced to Texas under the "throwback" rule in the Texas Tax Code.

The Claimant in this case is headquartered in Wisconsin and is engaged in the design, development, manufacture and sale of "locksets" to automobile manufacturers. The actual assembly of the locksets is performed by a Mexican subsidiary. After assembly in Mexico, the goods are shipped to a leased facility in Texas where they are stored for three to five days and thereafter delivered to customer auto assembly plants in Texas and elsewhere. According to Claimant, the reason for maintaining the Texas facility is due to federal restrictions imposed on Mexican trucking companies within the United States. Claimant argued that receipts from the sale of locksets shipped outside of Texas could not be sourced to Texas under the throw-back provision. Claimant initially treated these receipts as Texas receipts on its Texas franchise tax returns, but later filed a claim for refund, which was denied and at issue in this hearing.

The throw-back rule is set forth in Section 171.1032(a)(1) of the Tax Code. It states that, for earned surplus purposes, the sale of tangible personal property shipped from Texas to a purchaser in another state in which the seller is not subject to any tax on, or measured by, net income, without regard to whether the tax is imposed is included in Texas receipts for apportionment purposes. Claimant argued that the locksets should not be considered as shipped from Texas for purposes of the throw-back rule. According to Claimant, the goods originated in Mexico and experienced only necessary delays in transit at Claimant's Texas facility, prior to being shipped out-of-state. Claimant further argued that treating the sales at issue as Texas receipts under the throw-back rule would violate the Import-Export Clause of the United States Constitution, which prohibits a State from laying "any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection laws . . . ."

After consideration of applicable Texas and federal authority, the ALJ disagreed with Claimant's assertion regarding the constitutionality of the throw-back rule in this case. In addressing first whether the franchise tax is an "impost" or "duty" for purposes of the Import- Export Clause, the ALJ noted that the franchise tax is clearly neither a transit fee nor a direct tax on the locksets. In addition, the ALJ concluded that inclusion of receipts from the shipment of locksets in the computation of Claimant's franchise tax obligation does not contravene the underlying "Import-Export Clause policies" identified in U.S. Supreme Court cases. Finally, the ALJ noted that Claimant had failed to produce precedent supporting its position that the Import- Export policies should be applied to the lockset receipts included in Texas (throwback) receipts, rather than to the tax itself.

Having determined that no prohibited "impost" or "duty" had been assessed, the ALJ then considered whether the receipts could be properly sourced to Texas under the throw-back provision. In addressing this issue, the ALJ considered the threshold question to be "whether the locksets were in the import stream of commerce during the time they were at Claimant's Texas Facility." The ALJ identified a number of facts suggesting that the goods were not in a 25 "continuous stream of commerce" while in Texas, including: (i) two or three trucks per day arrived daily at Claimant's Texas facility carrying pallets loaded with packaged and labeled locksets for more than one of Claimant's customers; (ii) the pallets were not immediately loaded onto United States carriers for shipment to Claimant's customers, but were rather unloaded and stored at Claimant's facility in separate racks specific to Claimant's customers; (iii) the locksets were stored at Claimant's facility for three to five days and were released to Claimant's customers, via their United States common carriers pursuant to orders on a first-in, first-out basis; bills of lading indicated the goods were shipped FOB, Texas Facility; and (iv) shortly after loading the lockset pallets on the United States carriers, Claimant electronically issued an advance shipping notice, which effectively served as an invoice or bill. The ALJ acknowledged that "a delay in transit solely for the purpose of transferring goods from Mexican carriers to United States carriers would not affect the continuity of transit." However, more was occurring during the stoppage in this case.

The ALJ also rejected a separate argument by the taxpayer that the Federal Trade Zone also provided a source of immunity for the locksets. Accordingly, the Comptroller ruled that Claimant had failed to establish its entitlement to a refund in this case. 305362

ENDNOTES

1 *Meadows, Owens, Collier, Reed, Cousins & Blau, LLP.*

2 The cases discussed in this article do not represent a comprehensive coverage of all court cases and rulings. Only those that the author considered significant are included herein.

3 *See Hearing No. 27,942* (Feb. 18, 1993).

4 Citing former Texas Tax Code § 151.011(a).

5 Tex. Tax Code § 151.005(4).

6 Given the ambiguity of the 2003 amendment to Section 151.011 of the Texas Tax Code, a private letter ruling to this effect would be advisable.

7 *See, e.g.*, Priv. Ltr. Rul. 9705477L, 9803418L

8 *See Hearing No. 38,070* (Nov. 15, 2000).

9 *See Hearing No. 40,927* (Oct. 21, 2002); *see also Amway Corporation v. Dep't of Treasury*, 438 N.W.2d 904 (Mich. Ct. App. 1989).

10 Citing Comptroller Rule 3.357, the ALJ noted that "maintenance" is excluded from the definition of the taxable real property repair and remodeling services and is defined as "scheduled, periodic work necessary to sustain or support safe, efficient, continuous operations, or to prevent the decline, failure, lapse, or deterioration of the improvement." The term "scheduled" means "anticipated and designated to occur within a given period of time or production level." The term "periodic" is defined as "ongoing or continual or at least occurring at intervals of time or production which are generally predictable."

11 *See Sharp v. Tyler Pipe Industries, Inc.*, 919 S.W.2d 157 (Tex. App.-Austin 1996, writ den'd); *Sharp v. Chevron Chemical Company*, 924 S.W.2d 429 (Tex. App.-Austin 1996, writ den'd).

12 Subsection (a) of Section 171.1121 states in relevant part, "For purposes of this section, 'gross receipts' means all revenues reportable by a corporation on its federal tax return, without deduction for the cost of property sold, materials used, labor performed, or other costs incurred, unless otherwise specifically provided in this chapter. 'Gross receipts' does not include revenues that are not included in taxable earned surplus."

13 *See Allied Signal, Inc v. Director, Division of Taxation*, 112 S.Ct. 2251, 2263 (1992).

14 The contract between Petitioner and the affiliates stated that "a non-exclusive license and right to distribute and exhibit" was granted with respect to the programming services provided by Petitioner. The contract also provided for the payment of a "license fee."

STATE TAX: RECENT DEVELOPMENTS

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Most states rely principally on the following taxes: sales and use tax, property tax, business taxes and personal income tax. Texas is one of seven states[2] that does not have a personal income tax, and thus Texas relies more heavily than most on its sales and use tax and property tax, and to a lesser extent on other state-level taxes, which include the franchise tax, oil and gas production taxes, occupation taxes, cigarette tax, cigar and tobacco products tax, motor fuel taxes, mixed beverage tax, inheritance tax, and hotel occupancy tax.

Several emerging trends have created a political consensus that the Texas tax system is in need of reform. First, the growth in state-level taxes has not kept pace with the growth in state spending requirements. Second, the franchise tax base has been eroded by planning techniques, such as the "Delaware sub" and "Geoffreys" structures discussed infra, which have not been challenged by the Comptroller of Public Accounts of the State of Texas (the **"Comptroller"**).[3] Finally, and revisiting a long-standing problem, the State is providing an ever-decreasing portion of the total funding to local school districts. In 1997, then-Governor Bush stated a goal of increasing the state's share of school funding from approximately 46 percent to 60 percent.[4] Instead, this number has decreased to around 36 percent today, the lowest level since Texas began studying education reform in 1984.[5] This has put a strain on the local property tax system to generate funds to pay for the remainder of school costs, and as a result, property owners have seen substantial increases in school district property tax rates. In fact, as this article goes to press, a case challenging the constitutionality of the school finance system is being tried in a Travis County District Court.[6] The increase in school district property tax rates, in particular, has led to significant pressure on legislators from their constituents for reform.[7]

The consensus for reform reflects four general themes: (1) school district property tax rates, presently capped at $1.50 per $100 valuation (exclusive of certain debt service requirements), should be reduced and the cap lowered; (2) additional state-level funding must be earmarked for education to lower school district property tax rates and increase school district spending; (3) the tax system should be made more equitable by imposing tax on unincorporated businesses that do not presently pay franchise tax, most of which are believed to be in the service sector; and (4) the tax system should not include a personal income tax.

The school finance reform debate encompasses revenue and expenditure issues both large and small: From whom will the tax be collected, and in what form and amount? Should the State shift the relative incidence of the tax burden among different groups, e.g., consumer vs. business or among different industries? What total funding increases are necessary, and how can existing and additional funds be spent most effectively? To what extent should school district property tax rates be reduced?

The remainder of this article focuses on one piece of the puzzle - a summary of the array of tax proposals impacting businesses that have received serious consideration in the reform process.

Franchise Tax Reform Proposals

There is a broad consensus that the franchise tax should be reformed to capture those businesses escaping the system through the so-called "Delaware Sub" structure, a tax avoidance technique that filters ownership of Texas operations through limited partnerships and out-of-state holding companies to eliminate virtually any franchise tax.[8] Beyond that, many legislators and state officials are urging the extension of the franchise tax (or some other broad-based business tax) to unincorporated businesses such as partnerships, which currently are not subject to the franchise tax.[9]

A fundamental issue in this debate is whether the Texas Constitution precludes a tax on unincorporated entities such as partnerships that are owned by natural persons. Article 8, section 24(a) of the Texas Constitution provides:

> A general law enacted by the legislature that imposes a tax on the net incomes of natural persons, *including a person's share of partnership and unincorporated association income*, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax. The referendum must specify the rate of the tax that will apply to taxable income as defined by law. (Emphasis added.)

Professional services industry representatives generally assert that this provision prohibits the imposition of an income tax (and a franchise tax based on income) on any partnership entity having natural persons as partners.[10] Some legislators, however, believe that this provision should be construed pursuant to the entity theory of partnerships, especially with respect to partnerships affording some form of limited liability protection.[11] Pursuant to the entity theory, some legislators maintain that an income tax could be imposed at the partnership level without voter approval, even where natural persons own partnership interests.[12]

Against this backdrop, a number of legislative bills and proposals have been introduced in recent years aimed at broadening the existing franchise tax to apply to additional business entities. During the 1997 regular session, the House Select Committee on Revenue & Public Education Funding reported out C.S.H.B. 4, which would have extended the franchise tax to most non-corporate businesses. The bill would have included in the franchise tax base any compensation paid to an officer, director, or owner of greater than 0.1 percent of an entity. "Owner" was defined to include "a shareholder, an income or equity partner of a partnership, and an owner of equity in any other taxable entity." For entities with 35 or fewer owners, up to $100,000 in compensation was excludible for each "owner." The provisions of C.S.H.B. 4 made its effectiveness contingent on the passage of various amendments to the Texas Constitution, including (i) an amendment to article 8, section 1(c) authorizing the legislature to "impose privilege or franchise taxes measured by the income or taxable capital of a corporation, partnership, or business entity other than a sole proprietorship"; and (ii) a new article 8, subsection 24(k), which modified the constitutional limitation on personal income taxes quoted *supra* by specifying that "[t]his section does not apply to a privilege or franchise measured by the income of a corporation, partnership, or other entity, other than a sole proprietorship."

More recently, two approaches have been discussed as potential means for subjecting partnership income to the existing franchise tax: an entity-level approach and a nexus approach. First, H.B. 3146 illustrates an entity-level approach taken by the House in the 2003 Regular Session. That Bill proposed an entity-level tax on all limited liability entities; its provisions excluded a natural person's share of income from the entity's taxable income.[13] H.B. 3146 also disallowed deductions for all payments of management fees, interest, and royalties to related parties to address the so-called "Geoffreys" structures.[14]

Second, amendments to H.B. 2425 approved by the Senate Finance Committee (but subsequently removed by the full Senate) endorsed a nexus approach for taxing partnership income by ensuring that all direct and indirect corporate and limited liability company partners in partnerships doing business in Texas were subject to the tax. Under this plan, ownership of a limited partner interest would constitute "doing business" or nexus in Texas, effectively overruling Comptroller's Franchise Tax Rule 34 Tex. Admin. Code § 3.546(c)(12)(B), which provides that a foreign corporation that is a limited partner in a limited partnership is not doing business in Texas. With respect to "Geoffreys" structures, the proposal contained less draconian expense disallowance provisions than H.B. 3146, disallowing deductions for payments of management fees, interest, and royalties to related parties only if such payments are not made pursuant to arm's length terms.

New Taxes

Modified Value Added (Business Activity) Taxes. A number of proposals would eliminate the existing franchise tax in favor of a new tax. One proposed new tax was a modified value added, or "business activity," tax. A business activity tax proposed by Lieutenant Governor Dewhurst, for example, would start with the sum of taxable income plus wages and salaries reported pursuant to Internal Revenue Service Form 940, the sum of which would then be multiplied by the taxpayer's Texas apportionment factor (computed the same as the existing Texas franchise tax single factor gross receipts formula). This apportioned tax base would then be reduced by a $250,000 standard deduction before being multiplied by a tax rate of 1.9 percent. Various alternatives to the Lieutenant Governor's plan have been discussed, including the following two alternatives in lieu of the $250,000 standard deduction and 1.9 percent tax rate: (i) allow a deduction of the greater of $20,000 per Texas employee or $250,000, with a 2.5 percent tax rate; or (ii) allow a deduction of the greater of $30,000 per Texas employee or $250,000, with a 3.75 percent tax rate.[15]

Business activity taxes have been criticized for a number of reasons. The most frequently voiced criticism is that a business activity tax is inequitable, since it is effectively based on gross receipts for some taxpayers and on net income for others. In addition, a business activity tax would be unfair to businesses operating at low profit margins or at a loss; these businesses would not have the wherewithal to pay the tax.

Critics also assert that a business activity tax would be harmful to economic development in Texas. By not allowing a deduction from the tax base for employee compensation, the business activity tax would discourage Texas job growth and would be a disincentive to locating or expanding businesses in Texas. In addition, a business activity tax would result in businesses incurring an even greater percentage share of the state and local tax burden in Texas, when businesses' share of the state and local tax burden in Texas already exceeds the national average. As evidence of these economic concerns, critics cite the Michigan Legislature's decision to phase out its business activity tax (referred to as the Single Business Tax), due to its negative economic consequences.

Nevertheless, some commentators assert that a business activity tax may be preferable to a reformed franchise tax because it would be more efficient in taxing all forms of business, simpler to administer, and would generate more stable revenues.[16]

Payroll Taxes. During the 2004 Special Session, the House Select Committee on Public School Finance approved a bill that contained a payroll tax, which found relatively broad support among the business community but was opposed by the Governor.[17] The payroll tax would have replaced the existing franchise tax and been imposed on all employers (regardless of business entity form) at the lesser of (i) 1.25 percent of the wages paid to an employee; or (ii) $500 per employee.[18]

Business License Fee Proposal. A business license fee plan also was proposed to replace the existing franchise tax. This plan, also known as the "Texas Business Permit Proposal," would require all Texas business entities (regardless of form) to pay a graduated tax on gross receipts.[19] The plan proposed two alternative rate structures; the higher of the two structures would have imposed the license fee at a rate of .40 percent up to 1 percent, subject to a maximum amount of $500,000.[20]

Sales and Use Tax Reform Proposals

A number of proposals sought to expand the sales and use tax base and/or increase the sales and use tax rate, including the imposition of sales and use tax on professional services. Certain of these proposals coupled modification to the sales tax with franchise tax reform or new business activity taxes.

Expansion of the sales tax base and rate increases engender various economic concerns. The imposition of a sales tax on professional services presents serious issues, including the following:

1. Extension of the tax to services puts Texas-based providers at a substantial competitive disadvantage, particularly when competing for business on a regional or national basis. Irrespective of whether the tax is imposed at the location where the services are performed or at the service benefit location, the tax discriminates against Texas firms in favor of out-of-state firms with a resulting loss of business by Texas firms and loss of jobs by Texas workers.

2. The extension of the tax to services will increase the cost of doing business in Texas and thereby cause manufacturing and other businesses to consider locating and/or expanding facilities in other states where such taxes are not imposed. This increased cost of doing business will fall heavily on small and emerging businesses that cannot hire full-time personnel to perform these services and therefore must secure the services from third parties.

3. The tax on services produces an unacceptable level of "pyramiding" in that it is incurred in large part by businesses that in turn sell products subject to tax. Therefore, the

tax imposition increases the cost of the products, which in turn are again subject to tax when sold at retail.

4. Sales and use taxes are not deductible taxes for federal income tax purposes.[21] Therefore, expansion of the tax base to services will result in replacement of deductible property taxes by non-deductible sales and use taxes. This will increase the overall federal tax burden borne by Texans under current law.

5. Multistate users of services will face sourcing and nexus rules that present numerous compliance problems, in addition to competitive issues. Intrastate compliance issues and competitive disadvantages similarly exist by virtue of local, county, transit authority and special district sales taxes.

6. There are numerous timing issues regarding services performed over substantial periods.

Comprehensive Tax Plans

The Greater Houston Partnership proposed a two-step solution. The first step would be to increase school funding and raise revenues in the short-term by (i) increasing the state sales tax and motor vehicle tax rates by one percent; (ii) increasing the cigarette taxes by $1 per package; (iii) allowing video lottery terminals at racetracks; (iv) increasing occupation and business filing fees; and (v) closing the "Delaware sub" loophole. As part of the first step: (i) the entire state and local system would be subjected to "sunset" on December 31, 2007; and (ii) the State leadership would appoint a task force to evaluate long-term restructuring of the Texas tax system prior to the 2007 regular legislative session. If adopted, this plan likely would focus attention on the role of the personal income tax as a part of a restructured tax system.

Several "basket tax" proposals also are being considered. A typical plan of this type proposes a tax based on the lesser of (i) a payroll tax and (ii) a modified value-added tax with the portions of the tax base allocable to individual owners excluded from taxation to comply with Texas Constitution article 8, section 24(a); these would be subject to a minimum tax based on the business license fee plan, discussed above.[22] The scope of potential exemptions from a "basket tax" has not been completely determined. However, the following exemptions have been discussed preliminarily:

- Entities exempt from the current franchise tax, including partnerships owned ultimately by entities exempt from the current franchise tax;

- Real estate investment trusts and qualified REIT subsidiaries, as defined by Internal Revenue Code section 856, and partnerships owned by real estate investment trusts or qualified REIT subsidiaries;

- Partnerships owned by family members and/or certain nonprofits;

- Self-insurance trusts created under Texas Insurance Code art. 21.49-4;

- "Publicly traded partnerships" as defined by Internal Revenue Code section 7704(b), which meet the gross income requirements of Internal Revenue Code section 7704(c)(2), and lower tier partnerships owned directly or indirectly by publicly traded partnerships;

- "Investment partnerships," meaning partnerships that receive substantially all of their income from passive investments in certain securities.

Conclusion

In the near future, the Legislature may enact structural changes to the Texas state and local tax system that could have long-term economic effects on businesses and individuals. It is critical that Texas businesses fully understand these proposals and their ramifications and provide constructive input to their elected representatives.

ENDNOTES

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2 The seven states are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. A comparison of state personal income taxes is available at <http://www.taxadmin.org/fta/rate/ind_inc.html>.

3 *See* Comptroller Report on Methods of Franchise Tax Avoidance, STAR Accession No. 9606338L, June 1996.

4 *See* Legislative Budget Board, *Fiscal Size-Up 2004-05*, Table 89, at 189, <http://www.lbb.state.tx.us/Fiscal_Size-up/Fiscal_Size-up_2004-2005_1203.pdf>; Molly Ivins, *Texas Legislature Busy Reversing Course from Bush Era*, CONTRA COSTA TIMES, April 10, 2001, *available at* <http://www.commondreams.org/views01/0410-06.htm>.

5 *Id*.

6 *See* West Orange-Cove Consolidated Independent School District, et al. v. Alanis, et al., Cause No. GV-100528, (Dist. Ct. Travis County, filed April 2001).

7 *See* George S. Christian, *Legislative and Political News Update*, March 16, 2003, <http://www.texasbusinesslaw.org/legupdate/FoodForThought.htm>.

8 In one iteration of the technique, a corporation doing business in Texas and paying the franchise tax forms two Delaware limited liability company subsidiaries (disregarded for federal tax purposes), which in turn form a limited partnership in which one of the LLCs that is domiciled strictly out-of-state owns a 99% or greater limited partner interest, and the other LLC hold the remaining interest as a general partner. The corporation pushes its business assets down to the partnership, which becomes the operating entity in Texas. If structured correctly, the corporation's Texas business activities attributable to the limited partner's interest will escape the franchise tax because under long-standing Comptroller policy, (i) owning a limited partner interest in a Texas limited partnership does not subject the out-of-state LLC to the franchise tax and (ii) any distributions from the out-of-state LLC to the corporate parent will be treated as non-Texas receipts for apportionment purposes based on Texas' "location of payor" rule for sourcing dividends and interest. For examples of authorities confirming this tax treatment, see Texas Comptroller's Letter Rulings 9110L1229D08 (October 23, 1991); 9202L1231C02 (February 24, 1992); 9210L1262G04 (October 9, 1992).

9 *See* George S. Christian, *Legislative and Political News Update*, April 19, 2003, <http://www.texasbusinesslaw.org/legupdate/TheLickLog.htm>.

10 *See* Gary Susswein, *Reform of business tax likely doomed*, Austin American-Statesman, May 24, 2003, *available at* <http://www.ttara.org/Join/News/media/media_news/news_AAS_5_24_03.htm>.

11 *See, e.g.*, Texas Society of Certified Public Accountants, *Special Session Update*, May 12, 2004, *available at* <http://www.tscpa.org/gvtaffairs/specialsession/ssweeklyupdate0512.asp>.

12 *See, e.g.*, Tex. H.B. 3146, 78th Leg., R.S. (2003)("H.B. 3146").

13 *Id.*

14 *Id.* The name derives from Geoffrey, Inc. v. South Car. Tax Comm'n, 313 S.C. 15, 437 S.E.2d 13 (1993), cert. denied, 114 S.Ct. 550, a seminal case testing the validity of a common tax avoidance structure that uses licensing payments to out-of-state intangibles holding companies to reduce the income tax base of in-state affiliates.

15 However, these two alternative deductions may violate the Commerce Clause of the United States Constitution based on an argument that they impermissibly discriminate against interstate commerce by granting preferential treatment to in-state investment or activity. *See* Charolotte Cuno, et al. v. DaimlerChrysler, Inc., et al., 2004 FED App. 0293P (6th Cir. September 2, 2004).

16 *See, e.g.*, George R. Zodrow, *An Economic Evaluation of Alternative Sources of Tax Revenue for the State of Texas, available at* <http://www.capitol.state.tx.us/psf/Reports/GRZ_TX_Rev_Options_03-09-04.pdf>.

17 Tex. C.S.H.B. 1, 78th Leg., 4th Spec. Sess. (2004); *See* Janet Elliott and Clay Robison, *School finance plans disintegrate*, Houston Chronicle, May 4, 2004, <http://www.chron.com/cs/CDA/ssistory.mpl/topstory/2547457>.

18 Tex. C.S.H.B. 1, 78th Leg., 4th Spec. Sess. (2004). Similar payroll taxes are imposed in Nevada and Oregon (the Oregon payroll tax is imposed on a local option basis).

19 *See* Joint Select Committee on Public School Finance, December 4, 2003 Meeting Agenda, Materials from Steve Lankford, Testimony – Texas Business Permit Option, <http://www.capitol.state.tx.us/psf/12_04_03/Steve%20Lankford%202.pdf>.

20 *Id.*

21 However, pending federal legislation would allow taxpayers a federal income tax deduction for the greater of state income taxes paid or approximate sales and use taxes paid. *See* American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. §501.

22 *See Wake Everyone When You're Ready*, Texas Weekly, July 19, 2004, *available at* <http://www.investintexasschools.org/press/news_articles/2004/july/pdfs/everyone.pdf>.

CIVIL TAX CONTROVERSY: RECENT DEVELOPMENTS

by Mark P. Thomas[1]

1. **Civil fraud penalty not imposed even though the taxpayer was convicted of willfully filing false tax returns.**

Kemp v. Commissioner, T.C. Memo. 2004-153, 2004 WL 1435482 (U.S. Tax Ct.).

This case is a good example of what the government must prove in order to establish fraud and how difficult that burden can be even if the facts surrounding the taxpayer are less than ideal. *Kemp* involves a taxpayer who operated a sole proprietorship, Southeast Trust Investment Management ("Southeast Trust"). Southeast Trust was a registered investment adviser with the SEC that managed an investment portfolio consisting of, among other things, employee benefit accounts. The taxpayer apparently had the habit of depositing a portion of the management fees he received from Southeast Trust into CDs, municipal bonds, and a cash management fund.

While operating Southeast Trust, the taxpayer also worked as a senior vice president for another investment company, First Tennessee Investment Management ("First Tennessee"). The taxpayer worked at First Tennessee from 1983 to 1993 when he was fired for violating bank and corporate policies. Specifically, the taxpayer was alleged to have misappropriated approximately $28,000 from First Tennessee.

Things began going downhill for the taxpayer. During the summer of 1994, the taxpayer's 1992 income tax return was selected for examination. Shortly after the audit was initiated, the taxpayer inexplicably began amending his 1989 through 1993 income tax returns; all of those amended returns were filed by April 1996 and resulted in increases of taxable income of $102,506, $134,859, $173,817, $191,595, and $63,628, respectively. In 1996, the taxpayer was indicted for bank fraud, mail fraud, money laundering, and willfully filing false tax returns. The taxpayer was ultimately convicted of filing false tax returns for his 1989 through 1992 tax years, but was acquitted of the bank fraud, mail fraud, and money laundering charges.

Notices of deficiency asserting the fraud penalty under I.R.C. § 6663 for the taxpayer's 1989 through 1993 tax years were issued; the taxpayer ultimately filed petitions with the Tax Court to contest the deficiencies asserted with respect to his 1991 through 1993 tax years. At trial, the taxpayer argued that he did not intend to evade tax and believed that he was entitled to defer a portion of the underreported income as funds were set aside (i.e., the Southeast Trust management fees that were placed in CDs, municipal bonds, and a cash management fund) to satisfy reserve requirements of Southeast Trust; the taxpayer contended that when the funds were no longer needed to meet reserve requirements, they would be reported as income.

The Tax Court determined that the Commissioner did not meet his burden to sustain the fraud penalty, noting that although the taxpayer's conviction was a badge of fraud that estopped him from contesting that he intentionally filed false 1991 and 1992 returns and that an underpayment existed for those years, the government cannot rely solely on the conviction to presume or impute fraud. Rather, the Tax Court stated that fraud must be established by some independent evidence and found that the Commissioner did not introduce any witnesses or sufficient evidence to establish that any portion of the underreported income was attributable to fraud. The Tax Court was also somewhat critical of the Commissioner's approach at trial, noting his focus on the taxpayer's criminal indictment for bank fraud (he was acquitted of that charge) and the surprising failure to question either the taxpayer or his accountant regarding the portion of the underreported income that was not explained by the informal reserve account. The Tax Court concluded its analysis by noting that the typical indicia of fraud were not present as the taxpayer maintained adequate records, made all pertinent information available to the IRS, and cooperated with the IRS' investigation.

2. Attorney-client privilege upheld in tax shelter arena.

United States v. BDO Seidman, LLP, 2004 WL 1470034 (N.D. Ill), 94 A.F.T.R. 2d 2004-5066, 2004-2 USTC 50,288.

BDO Seidman, LLP ("BDO") claimed attorney-privilege and work product protections with respect to 110 documents that the government sought the production of. The documents consisted of three broad classes that included (i) legal advice reflected in memoranda from outside counsel for BDO, (ii) legal advice reflected in documents other than memoranda from outside counsel for BDO, and (iii) communications with BDO in-house counsel. The documents were produced to the court for an *in camera* review.

With respect to the legal memoranda, the court found that those communications were privileged as they were prepared in "direct response to a BDO inquiry for … legal advice and based on confidential facts provided by BDO to its outside counsel" regarding various Internal Revenue Code provisions and regulations. The court found that the same analysis applied to the documents other than legal memoranda (e.g., e-mails, faxes, letters, and other correspondence), which were covered by the attorney-client privilege if their purpose was to seek or provide legal advice. Although not all of the documents comprising the second class were deemed to be privileged, the court found that documents seeking or providing legal advice in connection with (i) BDO's obligations under the Internal Revenue Code, (ii) IRS investigations, audits, and potential litigation, (iii) legal and regulatory ramifications of particular transactions, (iv) an arbitration matter involving BDO, and (v) a lawsuit threatened by a former BDO client were privileged.

The court also found that communications with BDO's in-house counsel were protected and noted the presumption that a lawyer working in the legal department is giving legal advice rather than business advice. Specifically, (i) documents reflecting communications between BDO employees and BDO's general counsel regarding various transactions and the application of the tax shelter list maintenance and registration rules and (ii) documents reflecting communications to or from BDO's in-house lawyers regarding various agreements were found to be privileged.

Finally, the court found six documents to be protected under the work product doctrine as they were determined to have been created in anticipation of litigation. After reviewing the documents, the court was able to dismiss the government's argument that BDO changed the description of these documents on its privilege log to show that the documents were created after BDO subjectively anticipated litigation.

The government made two arguments to combat BDO's privilege claims with respect to communications involving outside counsel. First, the government argued that the advice provided by the legal memoranda was unprivileged business advice. The government cited *United States v. KPMG LLP*, 316 F. Supp. 2d 30 (D.D.C. 2004), where it was found that opinion letters by a certain law firm (that law firm also served BDO) may not be privileged as the law firm appeared to be an "orchestrated extension" of KPMG LLP's "marketing machine." The government also cited *Denney v. Jenkens & Gilchrist*, 2004 WL 936843 (S.D.N.Y. April 30, 2004), where accounting firms (including BDO) and the law firm who wrote the underlying tax opinion letters were alleged to be co-promoters of tax shelters. The court discounted the facts that were alleged through the citation of those two cases by noting that opinion letters written by BDO's outside counsel to its clients were not enough, standing alone, to support a conclusion that BDO and its outside law firms were co-promoters. Furthermore, the court determined that mere allegations could not be relied upon and pointed out that none of the law firms serving as BDO's outside counsel were the subject of the allegations of the *Denney* case.

Second, the government argued that the crime-fraud exception voided BDO's claims of attorney-client privilege. The court had serious doubts about this argument and said so; it ultimately concluded that the government's claims were based on "speculation and innuendo." Based on its review of the documents, the court was reluctant to infer that the purpose of BDO's quest for legal advice was to allow it to perpetrate a crime or fraud given the "uncertain and complex nature of the Internal Revenue Code and the regulations" that inherently require legal advice. Additionally, the court concluded that any finding of mutual fraud in the *Denney* case had no bearing on BDO's communications with its outside counsel given that none of the law firms serving as its outside counsel were identified in that case.

3. Underlying, self-assessed tax liabilities may be challenged at CDP hearing.

Montgomery v. Commissioner, 122 T.C. No. 1 (2004).

In *Montgomery*, the taxpayers filed a timely joint income tax return for the 2000 tax year that reported tax due in the amount of $194,637 that could not be paid. A Final Notice of Intent to Levy was issued; the taxpayers timely filed a Request for a Collection Due Process Hearing on Form 12153. In their Request, the taxpayers stated their intention to file an amended income tax return for 2000 that would reflect a refund and suggested alternatives to enforced collection.

On July 2, 2002, the Appeals Officer wrote to the taxpayers to schedule their hearing for July 25, 2002; the Appeals Officer's letter stated that since the taxpayers had not received a notice of deficiency and did not otherwise have an opportunity to dispute the underlying tax liability, the amount of tax due could be discussed at the hearing. On July 22, 2002, the parties had a telephone conversation where the taxpayers' advisor explained that their tax liability had been overstated due to a misapplication of complex statutory provisions and that an amended return would be filed. However, no deadline was set for filing the amended return.

The July 25, 2002 hearing was not held and, without any further communication between the parties, the Appeals Officer issued a Notice of Determination Concerning Collection Action(s) Under Section 6320 and/or 6330 on September 26, 2002. The Notice of Determination stated that although the taxpayers had indicated that they would file an amended return, it had not been filed within a reasonable time. On October 11, 2002, the taxpayers filed their amended return for 2000, which reflected a refund of $519,087. The taxpayers next filed a timely Petition for Lien or Levy Action Under Section 6320 and/or 6330, the sole issue being raised was a challenge to the amount of the underlying tax liability for 2000. After filing its Answer, the Commissioner filed a Motion for Summary Judgment to sustain the Notice of Determination on the ground that the tax liability in question was "self-assessed." The Taxpayer's filed an Objection.

Applying a plain-language method of construction to I.R.C. § 6330(c)(2)(B), the Tax Court held that the taxpayers may challenge the existence or amount of their self-assessed "underlying tax liability" as they had neither received a notice of deficiency nor had they received an opportunity to dispute the liability. The Tax Court was not persuaded by the Commissioner's argument (i.e., it is "nonsensical" to allow a taxpayer to argue against an amount that was self-reported under penalty of perjury) that the term "underlying tax liability," which was not defined in the statute or the legislative history, referred only to liabilities asserted by the IRS that differed from a taxpayer's self-assessed amounts. The Tax Court also found Treas. Reg. § 301.6330-1(e), which states that a taxpayer may "raise challenges to the existence or amount of the tax liability specified in the CDP Notice," to be unpersuasive as this interpretive regulation did not expressly bar a taxpayer from challenging the amount or existence of a self-assessed tax liability. Thus, the Tax Court concluded that the term "underlying tax liability" could include amounts that were self-assessed, amounts that were assessed following the issuance of a notice of deficiency, or a combination of both. Finally, the Tax Court found that the taxpayers had not had an opportunity to dispute their self-assessed tax liability and stated that the right to make such a challenge was not "nonsensical" given the complexity of the tax laws and the resulting likelihood of taxpayer errors.

It is somewhat unclear as to how far *Montgomery* can be relied upon due to its facts that beg for equity. For example, in a concurring opinion, Judge Marvel raised serious doubts whether the taxpayers ever received the hearing mandated by I.R.C. § 6330 and argued that the Commissioner's motion should be denied on that ground alone. Judge Marvel also indicated that procrastinating taxpayers who seek to rely solely on their announced intention to file an amended return should not take solace from the majority opinion as, by comparison, the taxpayers in *Montgomery* had well-documented intentions to file an amended return and substantial reasons for doing so.

Judge Goeke, in a separate concurring opinion, takes Judge Marvel's warning a step further by noting that "if petitioners had been given a reasonable opportunity to challenge the amount of their underlying liability during the hearing process (e.g., by filing an amended return) and they had failed to do so, then we should not review the underlying tax liability because it was not properly raised at the hearing, but in this case they were not given the opportunity to challenge their underlying liability, so the hearing was inadequate." Judge Goeke also issued another reminder: The majority opinion did not imply that the Tax Court had the authority to order a refund.

4. **<u>Non-electing spouse may intervene in stand-alone proceeding to support innocent spouse's claim for relief from joint and several liability on a joint return.</u>**

Van Arsdalen v. Commissioner, 123 T.C. No. 7 (2004).

It is probably not uncommon for innocent spouse relief to be denied as a result of the vindictive testimony of the non-electing former spouse. *Van Arsdalen*, however, involved a supporting non-electing former spouse. In *Van Arsdalen*, the Commissioner filed a Notice of Filing Petition and Right to Intervene with the Tax Court that stated the taxpayer's former husband had the right to intervene "for the sole purpose of challenging petitioner's entitlement to relief from joint and several liability." The taxpayer moved to strike the Commissioner's notice on the ground that it misinterpreted Tax Court Rule 325(b) to the extent it permitted her former husband to intervene only for the purpose of challenging her entitlement to innocent spouse relief. Subsequently, taxpayer's former husband filed a Notice of Intervention in order to offer evidence in support of her claim for equitable relief under I.R.C. § 6015(f).

The taxpayer's motion to strike was granted and the Tax Court concluded that the non-electing spouse could also intervene for the purpose of supporting an innocent spouse's claim for relief. The Tax Court noted that there was no direct support in the plain language of I.R.C. § 6015 or the legislative history that prevented the non-electing spouse from supporting the requested innocent spouse relief. The Tax Court further reasoned that since I.R.C. § 6015 was enacted to provide taxpayer relief, it was certain that Congress did not intend for relief to be denied where otherwise warranted.

5. **<u>Taxpayer's individual tax return must provide the clue to the omitted income in order to prevent the application of the six-year statute of limitation for assessment</u>.**

The Connell Business Company, et al. v. Commissioner, T.C. Memo. 2004-131, 2004 WL 1194626, 87 T.C.M. (CCH) 1384 (2004).

The petitioners in this case included two individual taxpayers (a husband and wife) (the "Petitioners") and four trusts. The Petitioners and the trusts appear to have timely filed their income tax returns for 1995, 1996, 1997, and 1998, the years at issue. One trust's returns for 1995 and 1996 identified the Petitioners as beneficiaries while another reported "distributions" to each of the Petitioners in 1996. However, the opinion states that the Petitioners' returns "made no reference to the petitioner trusts or in any way indicated that petitioners were associated with, beneficiaries of, or recipients of income from, the petitioner trusts." Furthermore, with respect to the income that was reported by the Petitioners in 1996 from one of the trusts, the opinion notes that their individual returns contained no information suggesting that a specific trust was the source of the income.

Notices of deficiency were issued on August 2, 2001, to the Petitioners and the trusts for 1995, 1996, 1997, and 1998. Petitions in response to all of the notices of deficiency were timely filed with the Tax Court on October 31, 2001. However, due to delays in the mail resulting from anthrax contamination, the petitions did not reach the Tax Court until December 5, 2001. Thus, the deficiencies and penalties were erroneously assessed; however, after service of the petitions was received, "most of the assessments" were abated.

The Petitioners argued that the Commissioner was barred from assessing deficiencies for the 1995 and 1996 tax years because the notices of deficiency were mailed more than three years from the dates the returns for those years were filed. To combat this statute of limitation defense, the Commissioner argued that the six-year statute of limitation applied because the Petitioners omitted gross income in excess of 25% of the amounts stated on those returns. The Petitioners answered that the gross income omitted from their returns should be disregarded for purposes of the 25% test because the omitted income was adequately disclosed by virtue of being reported on the trusts' returns.

The Petitioners cited several cases to support their argument that the Tax Court should look beyond their individual returns to the trusts' returns and, when they are all taken together, both sets of returns adequately disclosed the omitted income. The Tax Court reviewed the cases cited by the Petitioners and rejected their argument noting that, without exception, the cited cases involved individual income tax returns containing some reference to a separate document from which the omission of income could be ascertained. Thus, the Tax Court held that because the Petitioners' returns made no reference to the trusts or the trusts' returns, they could not rely on the trusts' returns to establish that adequate disclosure of any item of gross income had been made. Additionally, the Tax Court found that the Commissioner had met his burden of proof due to the fact that the Petitioners conceded that an amount of income exceeding 25% of their reported gross income had been omitted in the 1995 and 1996 tax years. Finally, the Tax Court summarily dismissed the Petitioners' estoppel, admission, and *res judicata* arguments that were based on the Commissioner's abatement of the prematurely assessed deficiencies.

6. **The IRS' "return" of an offer in compromise was held to be an abuse of discretion.**

Chavez v. United States, 2004 WL 1124914 (W.D. Tex. 2004), 93 A.F.T.R. 2d 2004-2386.

It seems that it is becoming more difficult to get an offer in compromise processed by the IRS. For example, the IRS frequently "returns" offers as nonprocessable instead of "rejecting" them on their merits, which leaves the taxpayer with no administrative appeal rights. Often, the only option is to start the process over again by submitting another offer. This case will hopefully serve as a reminder to the IRS of its own mandate to negotiate and explore the potential for compromise and that it cannot construe Internal Revenue Manual provisions to confer obligations on taxpayers that are not specifically authorized by statute.

The taxpayer in *Chavez* proposed to compromise I.R.C. § 6672 trust fund recovery penalties assessed against him due to the failure of his trucking company, E-C Trucking, Inc., to pay employment taxes. It is important to note that E-C Trucking, Inc. was no longer a going-concern at the time of the offer. The taxpayer submitted his offer, based on promoting "effective tax administration," during the collection due process proceedings.

A settlement officer notified the taxpayer that the IRS would be unable to consider the merits of his offer because he was not current on employment tax deposits for his remaining business that was still a going-concern, Chavez Trucking, Inc. Relying on provisions contained in the Internal Revenue Manual, the settlement officer determined the taxpayer's offer to not be processable under current IRS policies and procedures, i.e., Chavez Trucking, Inc. must demonstrate current compliance for two consecutive quarters before an offer could be considered. The taxpayer was allowed the opportunity to make another proposal within one week.

Receiving no proposal, Appeals issued its final Notice of Determination Concerning Collection Action(s) Under Section 6320 and/or 6330 to uphold the proposed enforced collection actions; the stated basis for its determination was the fact that Chavez Trucking, Inc. continued to accrue additional tax liabilities. Thus, Appeals ruled that the taxpayer's offer "could not be considered at this time." The taxpayer's offer was therefore "returned" unprocessed. Appeals further advised that the "expectation of compliance is a Service-wide requirement for consideration of all offers in compromise." The taxpayer sought judicial review in federal district court, complaining that the IRS' refusal to accept his offer was an abuse of discretion in violation of I.R.C. § 6330(d)(1)(b) and I.R.C. § 6320(c). The taxpayer sought an order requiring the IRS to accept his offer.

The court acknowledged jurisdiction and began by describing the abuse of discretion standard by which the IRS' determination would be judged. The court noted that discretionary determinations are to be sustained unless they are proven to be unreasonable, arbitrary, or capricious. The court further stated that only clearly improper agency actions would be considered an abuse of discretion and that decisions must not be based upon invidious or legally improper criteria.

The court then analyzed the provisions governing offers, I.R.C. § 7122 and its counterpart, Treas. Reg. § 301.7122-1, which detail the statutory standards and procedures for the acceptance or rejection of an offer in compromise. The court noted that once an offer is accepted for processing, the IRS must make a fact-specific determination of whether to accept or reject it. *See* Treas. Reg. § 301.7122-1(d)(2) and (c)(1). "An offer will be returned as nonprocessable only when (1) the case for which an offer is submitted to resolve has been referred to the Department of Justice for prosecution, (2) the offer contains insufficient information on which to make a determination and the taxpayer does not timely provide required information, and (3) the offer was interposed solely to delay collection efforts or was otherwise nonprocessable." Treas. Reg. § 301.7122-1(d)(2).

The court held that the only legal basis for the IRS to return the offer would have been if it were "otherwise nonprocessable," and that upon reviewing the evidence, the IRS had returned the offer for noncompliance based on guidelines found in the Internal Revenue Manual requiring compliance by in-business taxpayers for two consecutive quarters. Since that requirement was not found in the relevant statute and regulations, the court held that the IRS' reliance on Internal Revenue Manual procedures was an abuse of discretion because "no degree of deference is afforded the procedures contained within the Internal Revenue Manual," which confers no rights or obligations on taxpayers. Thus, the court concluded that the provisions of the Internal Revenue Manual are intended only to aid in the internal administration of the IRS and do not have the force and effect of law.

As further justification for its holding, the court pointed out that noncompliance is a ground for "rejection" of the subject offer pursuant to Treas. Reg. § 301.7122-1(b)(3)(iii), and that this ground for rejection mirrors the "return" standard set forth in the Internal Revenue Manual. The court therefore concluded the following:

> If such a return were permissible, it would appear to preempt the fact-specific determination required by section 301.7122-1(c), couching the response as a return rather than a rejection. It is not apparent how such a piecemeal approach would facilitate compromise, whereas the evident goal of section 301.7122-1 is to facilitate compromise where practicable. This provision has been construed as "imply[ing] a mandate to negotiate, to make the effort, to explore the potential for compromise before deciding unilaterally whether or not to refer." [Citation omitted.] As such, the rejection would be characterized as clearly improper and thus an abuse of discretion.

The court did not order the IRS to accept the taxpayer's offer, but gave the taxpayer the option of having his offer remanded to the IRS for full consideration (knowing that if his company was not in compliance, the IRS would likely reject his offer), or show cause as to how the court may order the IRS to accept the offer.

ENDNOTE

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TAX-EXEMPT ORGANIZATIONS: RECENT DEVELOPMENTS

by Tyree Collier

The following is a summary of selected current developments in the law applicable to tax-exempt organizations, prepared by Tyree Collier.[1] Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "Code").[2]

A. LITIGATION

1. King Foundation Litigation. The office of the Texas Attorney General and a new board of directors obtained a $20 million judgment (including $14 million in exemplary damages) against former officers and directors of the Carl B. and Florence E. King Foundation of Dallas. The basis for the suit was to recover excessive compensation and other Foundation funds that had been used for the payment of personal expenses. The total compensation of the Foundation's former CEO, Carl L. Yeckel, in recent years approached, and in at least one year exceeded, $1 million per year. The foundation's net assets during recent years totaled approximately $40 to $50 million.

2. Class-Action Lawsuits filed against 501(c)(3) hospitals. In June, 2004, several plaintiffs attorneys announced they had filed class-action lawsuits against 501(c)(3) hospitals and healthcare systems in several states and that more such lawsuits would be forthcoming. As of mid-August, more than thirty 501(c)(3) hospitals and health systems had been sued in nineteen states. In Texas, suits have been filed against East Texas Medical Center and against the Baylor Healthcare System and its Baylor University Medical Center.

   The petitions allege primarily that the hospitals are subject to community obligations as a result of their federal and state tax exemptions and their receipt of charitable contributions and that the hospitals have failed to live up to those obligations because of the way they charge uninsured patients. The petitions allege that the hospitals charge unreasonable amounts for services provided to the uninsured, which often includes lower-income people, and that the hospitals harass those uninsured persons who are unable to pay their hospital bills. Each petition sets out at least one specific situation where such overcharges and harassment purportedly occurred.

   As a general matter, individuals ordinarily do not have standing to try to enforce any obligations a 501(c)(3) organization has to the state or federal governments as a result of its tax-exempt status. Moreover, while an organization that is a "charity" under the common law has an obligation to operate for charitable purposes, the state attorney general is the representative of the public for the purpose of enforcing that obligation. Persons other than the state attorney general rarely have standing to enforce that obligation.

   The lawsuits also assert that the hospitals' billing practices are illegal because the uninsured patients are charged much more than insured patients for the same services and much more than the actual cost of those services. Those types of allegations, of course, are not specific to nonprofit hospitals. As a result, petitions were also filed against HCA and other for-profit hospitals in Nevada and Florida starting in early August. While it is easy to say that the lawsuits appear to be without merit, the primary plaintiff's attorneys involved in these cases are veterans of state tobacco litigation with significant resources and historical successes. Thus, the cases are not being taken lightly. In fact, one Mississippi hospital had already entered into a settlement agreement as of mid-August, albeit one that does not appear to involve a significant monetary payment. All the petitions against the 501(c)(3) hospitals and certain plaintiff press releases can be found at their web site www.nfplitigation.com.

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

1. Congressional Hearings. Several House and Senate committees held hearings over the Summer to discuss and consider issues relevant to nonprofit and tax-exempt organizations. On the House side, the most prominent hearing was a June 22, 2004 hearing held by Oversight Subcommittee of the House Ways and Means Committee to address hospital billing practices and the requirements for charitable hospitals to maintain tax-exempt status. That hearing was announced as the "first in a series of hearings on tax exemption issues." Among the highlights of the hearing was testimony from Harvard professor Nancy M. Kane that up to 75% of charitable hospitals enjoyed tax benefits in excess of the average cost of the charity care they provide to the community, depending on how the costs of bad debts are factored into the analysis.

   The Senate Finance Committee also held a June 22 hearing and one-upped the House Ways and Means Committee by releasing a "white paper" on June 21 setting forth numerous measures to be considered for potentially revamping the requirements for tax exemptions and the way nonprofit organizations are taxed and governed. The most important proposals from the "white paper" are summarized in the next section below. Service personnel testified at the hearing about a variety of abuses of exempt organizations in recent years. Chairman Grassley (R - Iowa) announced at the hearing that he is working closely with ranking Democrat Max Baucus (Mont.) and that he intends to introduce comprehensive reform legislation this Fall.

The Senate Finance Committee followed up its June 22 hearing with a July 22 "roundtable" discussion. The July 22 event included submissions from both the AICPA and the ABA Section of Taxation, which urged the committee to consider the costs and burdens proposed changes could impose on the many exempt organizations that do not abuse their exemption privileges. As the AICPA stated, "[t]he vast majority of exempt organizations and their executives carry out their exempt purposes faithfully."

2. Senate Finance Committee "White Paper". On June 21, 2004, the Senate Finance Committee released a "white paper" setting forth potential proposals for revamping federal tax exemption laws. As of August 10, Chairman Grassley maintained that "[t]he closer we look at charities in our Finance Committee, the stronger the case gets for meaningful legislative reforms ...." While it is possible that the most sweeping and controversial proposals will not be enacted, the sheer number of proposals and their variety is compelling. It is fair to say that if all the proposals would be enacted, the changes to federal tax exemption law could be even more profound than the changes enacted in The Tax Reform Act of 1969, when the private foundation excise tax provisions of Chapter 42 were added to the Internal Revenue Code. The most significant proposals in the "white paper" are the following:

   A. Five-Year Review. Exempt organizations would be required to re-apply for exemption every 5 years, although the Service could choose to simply accept the exempt status without reviewing the new exemption materials.

   B. Donor-Advised Funds. Revisions to the rules for donor-advised funds would include: (i) contributions other than cash and marketable securities must be sold within one year; (ii) no grants made to non-operating private foundations or individuals; (iii) advisers would have to guarantee their recommendations would result in no private benefit; (iv) there would be new aggregate and individual fund payout requirements; and (v) certain expense limitations would be imposed.

   C. Supporting Organizations. The "operated in connection with" relationship would be eliminated.

   D. Credit Counseling Organizations. Significant limits would be placed on income generation and benefits to insiders.

   E. Tax Shelter Accommodators. Accommodating listed or reported tax shelters would result in revocation of exemption.

   F. Public Charity Self-Dealing Rules. The self-dealing rules of Section 4941 would be applied to public charities also, using a new definition of disqualified person for both private foundations and public charities that includes both the existing Section 4946 definition and the existing Section 4958 definition.

   G. Chapter 42 Excise Taxes. Most excise taxes under Chapter 42 would be increased.

   H. Compensation Limitations. The following limitations would apply to compensation paid by exempt organizations: (i) no compensation could be paid for serving as a trustee of a non-operating private foundation (alternatively, a statutorily set de minimus amount of compensation could be paid); (ii) all compensation of disqualified persons would be limited to comparable government pay; (iii) compensation of anyone above $200,000 would trigger additional filing requirements; and (iv) compensation of any disqualified person above $75,000 would trigger additional filing requirements.

   I. Private Foundation Expense Reforms. New limits applicable to certain private foundation expenses would include: (i) administration expenses of more than 10% of total expenses would trigger additional filing requirements; (ii) administration expenses of more than 35% of total expenses would not be qualifying distributions; (iii) no grants could be made to donor advised funds; and (iv) expenses for travel, meals, and lodging would be limited to U.S. government per diem rates or other published rates.

   J. Public Charity Expense Reforms. Public charity expenses for travel, meals, and lodging would be limited to U.S. government per diem rates (or other published rates) unless the organization's Board approves the excess and such approval is disclosed on the Form 990.

   K. Improved Reporting. Reporting changes would include (i) an independent auditor must review Form 990; (ii) all exempt organizations with $250,000 or more of gross receipts must have audited Financial Statements; (iii) exempt organizations with gross income between $100,000 and $250,000 must have Financial Statements reviewed by accountants; and (iv) Form 990 would be enhanced to provide increased information.

   L. Increased Public Disclosure. Increases in public disclosure would include: (i) financial statements would be available to the public; (ii) Form 990-T would be available to the public; (iii) tax returns of affiliates would be available to the public; (iv) exempt organizations with web sites would have to post on the web site all documents that are required to be available to the public; and (v) final Service audit determinations would be disclosed without redaction.

   M. Board Improvements. Board improvements would include (i) all exempt organizations must adopt a compliance program; (ii) no more than one exempt organization board member could be compensated by the exempt organization; (iii) the compensated board member could not be the Chair or Treasurer; and (iv) the Service would have the power to remove board members.

N. Investment Restrictions. The prudent investor rule, which already applies to most Texas trusts, would be made applicable to all exempt organizations.

3. Review of Exempt Organizations' Compensation Practices. The Service announced earlier this year an enforcement initiative aimed at identifying and halting perceived abuses by exempt organizations that award and pay excessive compensation to officers and directors. Early mentions of the project indicated the Service would focus on executives being paid $1 million or more by exempt organizations. On August 10, 2004, the Service issued a news release (IR-2004-106) announcing that it has identified nearly 2,000 exempt organizations that it intends to contact and in some cases audit regarding the compensation paid by such organizations. The news release adds that one area of focus will be individuals who are highly compensated in comparison to the assets and gross receipts of their organization. Another area of focus will be on loans between exempt organizations and their officers and directors, along with other transactions involving insiders.

4. Ancillary Joint Venture Revenue Ruling. In Revenue Ruling 2004-51, released May 6, 2004, the Service acknowledged that a joint venture between an exempt organization and a for-profit partner can serve an exempt purpose even if the venture's board is elected one-half by each partner. The ruling provides a single fact pattern and holds that (i) it does not endanger the exempt status of the nonprofit partner, because the activity is not "substantial," and (ii) it does not result in UBIT because the venture was substantially related to the exempt purposes of the nonprofit. The exempt organization involved was a university that already provided teacher training on its campus. The university entered into the venture to provide interactive video teacher training at off-campus locations. The for-profit partner was a perfect fit because it specialized in conducting interactive video training. While the governing board of the venture was elected half by the university and half by the for-profit partner, the university retained the exclusive right to determine curriculum, materials, and instructors, and to set standards for successful completion of a course. The for-profit partner, on the other hand, had the right to determine off-site locations and to select all non-instructor personnel. While the ruling's acceptance of a 50/50 governing board is helpful, nonprofits should remain cautious in using 50/50 boards because the ruling approves such a board under a scenario where all the important decisions regarding the educational program were reserved to the exempt organization and not to that 50/50 board.

5. Credit Counseling Organizations. The Service has been increasingly critical of tax-exempt credit counseling organizations and is actively auditing such organizations with the intention of revoking the exemptions of many such organizations. On July 13, 2004, the Chief Counsel's Office issued an in-depth memorandum outlining the issues the IRS has with many such organizations. The memorandum explains that early credit counseling organizations were granted exemptions in the 1960's because those organizations operated primarily to educate consumers about credit-related issues. Many of today's credit counseling organizations, however, are primarily engaged in commercial debt-management activities for which they are compensated. Based on public criticism, it appears that many of today's organizations have a reputation for taking advantage of the consumers they are supposed to be helping, although it is not yet clear how many of the worst offenders are in fact tax-exempt organizations.

ENDNOTES

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2 The term "Service" refers to the Internal Revenue Service.

NON-COMPETITION AGREEMENTS COMBINED WITH REDEMPTIONS CAN TRIGGER THE APPLICATION OF INTERNAL REVENUE CODE SECTION 197

Jeff S. Blumenthal and Mitchell A. Tiras[1]

1. Introduction

Before the enactment of Section[2] 197 in 1993, taxpayers and the Internal Revenue Service ("**IRS**") engaged in numerous disputes regarding whether the amortization of intangible property for federal tax purposes was appropriate and, if so, the manner in which such amortization could be claimed. The United States Supreme Court even weighed in on the issue and, in a 1993 case, made clear that taxpayers bore a significant burden in proving their entitlement to amortization deductions related to intangibles. Later in 1993, Congress stepped in to significantly reduce the uncertainty surrounding the amortization of intangibles and adopted a uniform federal tax amortization standard for most intangibles. When applicable, Section 197 requires a taxpayer to amortize the adjusted basis of its intangible asset ratably over a 15-year period beginning with the first day of the month in which such intangible was acquired.[3]

Although certain intangibles need not be acquired in connection with an acquisition of an interest in a trade or business for Section 197 to apply to them, a covenant not to compete must be acquired in such a fashion for Section 197 to apply. An acquisition of an interest in a trade or business is typically thought of as a purchase of all (or substantially all) of the business assets from another party or the acquisition (whether taxable, tax-free or a combination thereof) of all of a target corporation's stock. In 2003, however, the United

States Court of Appeals for the Ninth Circuit, in *Frontier Chevrolet Co. v. Commissioner*,[4] held that a redemption by a corporation of a certain portion of its stock was treated as an acquisition of an interest in a trade or business for purposes of Section 197 and that, as a consequence, a covenant not to compete entered into by such corporation in connection with the redemption was subject to amortization under Section 197. The *Frontier Chevrolet* case and some associated issues are described below.

2. Brief summary of the facts of *Frontier Chevrolet*

Frontier Chevrolet Company ("**Frontier**") was a corporation engaged in the trade or business of selling and servicing automobiles. In 1987, Roundtree Automotive Group, Inc. ("**Roundtree**"), a corporation engaged in the trade or business of purchasing and operating automobile dealerships and providing related consulting services, acquired all of the outstanding Frontier stock. Shortly after the acquisition, Dennis Menholt ("**Menholt**"), a long-term employee of Frontier, became executive manager of Roundtree and, over the next seven years, he acquired twenty-five percent of the outstanding Frontier shares. As a result, Roundtree owned seventy-five percent of Frontier's shares and Menholt owned the remaining twenty-five percent.

Effective August 1, 1994, Frontier and Roundtree entered into an agreement pursuant to which Frontier would acquire all of its shares owned by Roundtree, with such acquisition qualifying as a redemption within the meaning of Section 302(b)(3). As a consequence of the redemption of all of Frontier's stock owned by Roundtree, Menholt became the sole shareholder of Frontier.

Roundtree, Frontier and Frank Stinson, the President of Roundtree ("**Stinson**"), entered into a non-competition agreement ("**Covenant**") effective August 1, 1994 in connection with the redemption of Frontier's stock owned by Roundtree. The purpose of the Covenant was to induce Frontier to consummate the redemption and, as part of the agreement, Roundtree and Stinson agreed not to compete with the Frontier auto dealership for five years. Frontier agreed to pay Roundtree and Stinson $22,000 per month during the five-year term as consideration for complying with the restrictions set forth in the Covenant.

To fund the acquisition of its shares from Roundtree, Frontier was required to borrow from an unrelated party, which caused it to be highly leveraged. In fact, Frontier failed to meet certain minimum working capital requirements imposed by its franchisor and had to obtain a waiver of such requirements to continue holding its franchise. Furthermore, Roundtree and Stinson had the ability and knowledge to be able to compete (absent the Covenant) with Frontier in the agreed-to geographical area. Thus, the Covenant was the only mechanism by which Frontier could protect its business from competition by Roundtree and Stinson and, without the Covenant, Frontier may not have been able to raise capital or repay its loan.

On its federal income tax returns for 1994 through 1996, Frontier amortized its payments made pursuant to the Covenant over the fifteen-year period as provided by Section 197. In 1999, however, Frontier filed a claim for refund for 1995 and 1996, contending that its Covenant payments should be amortized over the life of the Covenant (i.e., five years). The IRS issued a deficiency notice to Frontier, which filed a petition with the Tax Court. The IRS and Frontier stipulated that the only issue to be decided by the court was whether Frontier was required to amortize the Covenant payments in accordance with Section 197. The court also acknowledged that the case before it was the first occasion it had to consider the relationship of the requirements of Section 197 and a covenant not to compete. Before examining the holding and rationale of the Tax Court and the Ninth Circuit Court of Appeals, however, a brief summary of the law in effect before the enactment of Section 197 is in order.

3. Treatment of non-compete agreements as a result of enactment of Section 197

Before the enactment of Section 197, a taxpayer was generally able to amortize the cost or other basis of intangible property used in a trade or business or held for the production of income if the property had a limited life that could be determined with reasonable accuracy. Accordingly, a taxpayer was allowed to amortize payments made pursuant to a covenant not to compete entered into in connection with the acquisition of an interest in a trade or business over the term of the covenant, provided that the term was for a definite, limited amount of time. Conversely, where the benefits of the covenant were of indefinite duration, a taxpayer could not deduct amounts paid pursuant to such covenant. The IRS often challenged taxpayers' assertions that they were entitled to any amortization deductions for certain intangibles and asserted (for example) that the property at issue did not have a limited life and, thus, could not be subject to amortization. In *Newark Morning Ledger Co. v. United States*,[5] the United States Supreme Court addressed the controversial issue of amortizing intangible property and affirmed that a taxpayer may properly claim amortization deductions where the taxpayer can prove that the property at issue (i) can be valued and (ii) has a limited useful life that can be determined with reasonable accuracy. The Court characterized the taxpayer's burden of proof in such a case as "substantial" and stated that such burden "often will prove too great to bear."[6]

In adopting Section 197, Congress acknowledged that the IRS challenged many taxpayers' claims of amortization of intangible property and made clear in the legislative history to Section 197 that it had great concern over the significant backlog of cases in audit and litigation.[7] As a result, Congress urged the IRS "in the strongest possible terms" to expedite its settlement of cases regarding the amortization of intangibles.[8]

The intent of Section 197 was to eliminate significant controversy regarding the amortization of acquired intangible assets by specifying a single method and period for recovering the cost of most acquired intangibles.[9] Section 197(d) identifies those intangibles to which Section 197 applies, such as goodwill, going concern value, workforce in place, and franchises, trademarks and trade names (as well as covenants not to compete, as described below). Section 197(e) identifies those intangibles to which Section 197 does not apply, such as an interest in a corporation, partnership, trust or estate.

With respect to a covenant not to compete, Section 197(d)(1)(E) provides that Section 197 applies to such a covenant (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or substantial portion thereof). For this purpose, the legislative history and the regulations to Section 197 provide that an interest in a trade or business includes not only the assets of a trade or business, but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business.[10]

4. Holding and Rationale of the Tax Court and Ninth Circuit

As stated above, Frontier entered into the Covenant "in connection with"[11] the stock sale agreement. Frontier contended, however, that it did not acquire an interest in a trade or business pursuant to the stock sale agreement because it was engaged in exactly the same trade or business both before and after the acquisition and it acquired no other assets. Frontier further contended that, because it did not acquire any interest in a trade or business, the Covenant could not constitute a Section 197 intangible and, thus, Frontier should be permitted to amortize the payments made pursuant to the Covenant over its life (i.e., sixty months).

The Tax Court reviewed the definition of "acquisition" in Black's Law Dictionary, and noted that it was defined as "[T]he gaining of possession or control over something" and "[S]omething acquired." In addition, the Tax Court noted that the term "redemption" is defined as "[T]he act or an instance of reclaiming or regaining possession by paying a specific price." Based in part on these definitions, the Tax Court concluded that the redemption was an "acquisition" within the meaning of Section 197 because Frontier received seventy-five percent of its stock as a result of the transaction with Roundtree.

The Tax Court then cited the legislative history of Section 197 for the proposition that an interest in a trade or business includes not only the direct acquisition of the assets of the trade or business but also the acquisition of stock in a corporation that is engaged in a trade or business.[12] When Frontier acquired the stock pursuant to the stock sale agreement, it indirectly acquired an interest (in the form of stock) in a corporation engaged in a trade or business.

Frontier then contended that Section 197 may apply if it had acquired a new trade or business, but that Section 197 does not apply because it merely continued its own existing business. The Tax Court stated that neither Section 197 nor its legislative history required the acquisition of a "new" trade or business for Section 197 to apply. Thus, the Tax Court held that Frontier acquired an "interest in a trade or business" within the meaning of Section 197 when it redeemed its stock from Roundtree and was required to amortize the Covenant over a fifteen year period.

The Ninth Circuit affirmed the Tax Court's holding and noted that Frontier acquired possession and control over seventy-five percent of its own stock and that the effect of the transaction was to transfer ownership of Frontier from one shareholder to another. In other words, Menholt, who previously owned twenty-five percent of the shares of Frontier, became the sole shareholder due to the redemption transaction.

It should be noted that the Ninth Circuit did not state whether the deemed transfer of control (i.e., more than fifty percent) of Frontier stock was a factor in its decision. The court did make clear in a footnote[13] that it only addressed the issue of whether the redemption of seventy-five percent of a taxpayer's stock constitutes an indirect acquisition of an interest in a trade or business for purposes of Section 197. In that footnote, the court stated that it was not addressing the issue of whether all stock redemptions made in connection with an execution of a covenant not to compete would constitute an acquisition of an interest in a trade or business with the meaning of Section 197. The court's rather narrow holding thus leaves unanswered the question of whether a redemption of a minority shareholder (e.g., a twenty-five percent shareholder) would have yielded the same result.

The court almost certainly would have come to the same conclusion had the redeemed shareholder held more than seventy-five percent of the taxpayer's stock, but would it have also done so if the redeemed shareholder held 50.1 percent of such stock? What if the redeemed shareholder owned forty-nine percent and held an in-the-money option to acquire 1.1 percent of the shares of the taxpayer's stock? What if the redeemed shareholder owned twenty-five percent and the remaining seventy-five percent was owned by millions of public shareholders? Presumably the Ninth Circuit would have come to the same conclusion if the redeemed shareholder owned 50.1 percent of the corporation's shares but, in other cases, it would have looked to all of the facts and circumstances to determine whether the redeemed shareholder effectively controlled the corporation, which determination may include (for example) the application of Section 318(a)(4) to attribute any options owned by a person to the ownership of the stock. It is unclear whether this type of attribution would apply in this situation.

5. Planning Opportunities

When a corporation redeems a shareholder's stock and that shareholder will continue to provide services to the corporation, it should consider entering into an employment agreement or consulting arrangement with the former shareholder. An agreement requiring the shareholder to perform services or provide property or its use to the corporation does not have substantially the same effect as a covenant not to compete to the extent that the amount paid under the agreement represents reasonable compensation for the services actually rendered or for the property or use of the property actually provided.[14] On the other hand, an arrangement that requires the former owner of a direct or indirect interest in a trade or business to continue to perform services (or to provide property or the use of property) that benefits the trade or business is considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner exceeds reasonable compensation for the services actually rendered (or for the property or use of property actually provided).[15]

Assuming that the selling shareholder is paid reasonable compensation for work performed, payments under an employment agreement or consulting arrangement should not be treated as payments for a covenant not to compete (which may otherwise cause such payments to be subject to Section 197). As long as the compensation under such agreement is reasonable for the services to be performed, such payments would not be considered to be an arrangement that has substantially the same effect as a covenant not to compete and would be deductible when paid or incurred. The redeemed shareholder, however, may prefer to be compensated pursuant to a covenant not to compete agreement instead of an employment or consulting arrangement so as to avoid the taxes associated with self-employment income, as payments for a non-compete agreement are not self-employment income absent a consulting arrangement.[16] This may be a negotiated item in a transaction taking into account the potential tax consequences to all affected parties.

6. Conclusion

Section 197(d)(1)(E) confirms that a covenant not to compete entered into in connection with an acquisition of an interest in a trade or business must be amortized over a fifteen year period. The Treasury Regulations[17] also confirm that the "acquisition of an interest in a trade or business" may take the form of a redemption in addition to a typical purchase of a business. It is not clear, however, what level of redemption in comparison to the remaining outstanding shares of a corporation would constitute the "acquisition of an interest in a trade or business." Presumably, the redemption would need to constitute the purchase of more than fifty percent of the stock of a corporation before a related covenant not to compete would be treated as a "Section 197 intangible" pursuant to Section 197(d)(1)(E). If the redeemed shareholder will continue to provide services to the acquiring taxpayer, it may be beneficial to enter into an employment or consulting arrangement with the redeemed shareholder. Payments made for actual services rendered will be deductible when paid or incurred and would not be required to be amortized over a fifteen year period under Section 197.

ENDNOTES

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2 References to "Section" herein are to the sections contained in the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. Section" are to the Treasury regulations promulgated pursuant to the Internal Revenue Code.

3 Section 197(a); Treas. Reg. Section 1.197-2(f)(1).

4 329 F.3d 1131 (9th Cir. 2003), affirming 116 T.C. 289 (2001).

5 113 S.Ct. 1670, 123 L.Ed.2d 288 (April 20, 1993).

6 123 L.Ed.2d 288 at 306.

7 P.L. 103-66, page 777.

8 Id.

9 P.L. 103-66, page 760.

10 P.L. 103-66, page 764; Treas. Reg. Section 1.197-2(b)(9).

11 In a recent case, *Chief Industries, Inc. and Subsidiaries v. Commissioner*, T.C. Memo 2004-45, the Tax Court considered the issue whether payments made to settle outstanding obligations under an employment agreement were deductible when such payments were made simultaneously with the reacquisition of the employee's stock. In this case, the Tax Court held that even though the transactions were close in proximity, the settlement of the employment agreement claims did not produce a significant long-term benefit and were not "in connection with" or related to the redemption. Thus, the settlement payment was deductible when paid.

12 Treas. Reg. Section 1.197-2(b)(9) provides that "an acquisition may be made in the form of an asset acquisition (including a qualified stock purchase that is treated as a purchase of assets under Section 338), *a stock acquisition or redemption, and the acquisition or redemption of a partnership interest*. [emphasis added]. Treasury Regulation Section 1.197-2(b)(9) was adopted after the transaction at issue occurred.

13 See footnote 2 of the Ninth Circuit's opinion.

14 Treas. Reg. Section 1.197-2(b)(9). Note that the same principle applies whether the taxpayer acquires stock of another corporation (whether or not a Section 338 election is made), redeems its own stock, acquires assets, acquires a partnership interest or (if the taxpayer is a partnership) redeems a partnership interest. *Id*.

15 P.L. 103-66, p. 765.

16 *Barrett v. Commissioner*, 58 T.C. 84 (1972).

17 Treas. Reg. Section 1.197-2(b)(9).

UNCERTAINTY: THE CLOUDY AND EXPENSIVE FUTURE OF STOCK OPTIONS

by Sanjeev Ayyar[1]

The Financial Accounting Standards Board ("FASB") has issued a proposed amendment to Statement of Financial Accounting Standard No.123 regarding the accounting treatment of equity compensation. This proposal is particularly noteworthy because it proposes to mandate expensing of stock options, even for small nonpublic companies. As a practical matter, the stock option expensing requirement will cause companies to reassess the value and structure of any stock option plan, Employee Stock Purchase Plan ("ESPP") or other equity-based compensation arrangement they may have. Stock option expensing would encompass ESPPs, and likely cause changes to those that offer employees a discounted stock price (i.e. 85% of the market price). Without a doubt, this change is extremely controversial.

<u>Congressional Action on Stock Option Expensing</u>

On July 20, 2004, the House of Representatives passed H.R. 3574, the Stock Option Accounting Reform Act by nearly a 3 to 1 margin (312 to 111). Of note, the bill exempts private companies until three years after they go public in addition to limiting mandatory expensing only to the top five executives of a company. It is not clear whether or not this legislative momentum will carry over to the Senate, although the ranking Republican and Democrat on the Senate Banking Committee have publicly stated their opposition to H.R. 3574.[2]

<u>Major Planning Considerations</u>

Stock option expensing under the proposed amendment means moving away from the intrinsic value method of measuring stock options to a fair value method of valuation. Under the current intrinsic value method of valuing stock options, the only "intrinsic" value would be the spread between the option price and the current fair market value of the stock. Because most stock option grants would be at the current stock's fair market value, there would be no stock option expense (the intrinsic value would be zero). Under the intrinsic valuation method, there is no accounting expense due to the fact that the option to buy the stock over time is worth something more than zero. However, investors could still measure in some way the value of these grants because the issuance of stock options would be reflected through the dilution of the company's earnings per share.

The fair value method of valuation would be required under the proposed FASB draft. Essentially, this means that grants at fair market value would still have some value and thus would have to be expensed by the company. While the idea of valuing options and making financial statements more transparent and complete is attractive in theory, there are several practical barriers.

First and foremost, valuation will be difficult for small companies and nonpublic companies. Option valuation is one of the most complex areas of corporate finance. While the proposed statement approves of the Black-Scholes model of option valuation, it prefers a "lattice" model instead. Both valuation methods have significant shortcomings. Black-Scholes in its simplest form uses five inputs: the current stock price, the strike price of the option, the stock's volatility, the risk-free rate, and the length of the option. The Black-Scholes formula depends heavily upon historical volatility. This is not necessarily reflective of the future value of the company's stock. Further, Black-Scholes in its simplest form does not take into account dividends and assumes that options are European options (that is, only exercisable at one-time which is upon expiration). Later iterations of the formula do take into account other factors, but it makes the model more complicated.

The lattice model of valuation that is preferred by FASB is even more complex. Simply put, these valuation methods are not easily done in-house, especially for companies that cannot afford to pay for such valuation expertise. The result is that the cost of using outside valuation consultants for stock options must be anticipated and budgeted by companies with respect to any and all grants of stock options. Further, these valuation models introduce a great deal of subjective judgment in the case of small and nonpublic companies. It is questionable whether or not financial statements of such entities really should be treated the same as the Microsofts and Amazons of the world.

Second, companies must review whether or not their ESPPs are still worth doing. Currently, many ESPPs discount stock within their plans. This discount will have to show up as an accounting expense as well as under the FASB amendment. While promoting broad-based employee ownership is a valid concern, it must be considered in light of a financial hit that will be taken on their accounting statements. It is very likely that companies will consider reducing or eliminating any discount as well as examining whether to continue to allow a look-back provision.

In summary, stock options and ESPPs will be carefully examined in light of the FASB amendment, especially if Senate opposition does not materialize. The FASB amendment has the potential to introduce a lot of subjectivity in financial statements because of the difficulty of valuing stock options. It is likely that restricted stock might become popular in light of the administrative burden of stock option grants. Companies should examine their motivations for offering equity-based compensation.

ENDNOTE

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TAX CONSIDERATIONS FOR THE FOREIGN CORPORATE CLIENT

Martin M. Van Brauman[1]

I. INTRODUCTION

The following article is drawn from a number of actual situations in which foreign clients wanted to acquire U.S. real property or an exiting business, or to import goods into the U.S. market. Since the majority of U.S. tax provisions for inbound transactions are concerned with U.S. real property, this article emphasizes those provisions.

Foreign enterprises, wanting to expand into the U.S. market and perhaps to purchase U.S. real property for its business use or for investment, face many decisions. The first decision may be with respect to the entity structure in the U.S. and its ownership entity based upon treaty concerns. The foreign corporation may operate simply as a U.S. branch, or may form a limited liability company, a foreign or domestic partnership, a domestic subsidiary, or some hybrid entity combination. The final decisions should result from a facts and circumstances analysis based upon the nature of the business, the types of property involved and the investment objectives of the foreign client.

Considerations of the foreign tax laws, the U.S. federal tax laws, the local state tax laws and any applicable income tax treaty must be reviewed. The foreign tax laws and any applicable tax treaty will influence the foreign ownership structure. Because of the vast scope of such a cross-border study, this paper is limited to the U.S. tax portion of this analysis and the effectively connected U.S. trade or business.

For U.S. tax purposes, a foreign business entity engaged in a U.S. trade or business is characterized under U.S. entity tax characterization rules.[2] In determining the U.S. tax status, reference to foreign business enterprise laws is required. Certain foreign entities are classified as "per se" corporations based on the foreign incorporation statutes of the foreign country and thus can only be treated as corporations for U.S. tax purposes.[3] If they are not a "per se" corporation, a choice of entity selection as a partnership or a disregarded entity is available under U.S. tax law. If the foreign law status is different for the entity, a hybrid entity may be created, which may allow for certain tax planning situations.

The use of hybrid entities has become a major planning consideration in cross-border structures. A hybrid entity is an entity that is a fiscally transparent or disregarded entity under U.S. tax law, but treated as a corporation under foreign tax law. A reverse hybrid entity is an entity that is a corporation under U.S. tax law, but is treated as fiscally transparent or disregarded entity under foreign law.

The tax considerations for the foreign corporate client can fill multiple volumes of tax treatises. To limit the scope of this paper, the focus is to present a few of the tax issues that must be addressed for the foreign client, beginning business operations in the U.S. with primary emphasis in the investment in business properties. Along with selecting the type of permanent establishment for U.S. jurisdiction, the foreign client must decide upon the extent of effectively connected U.S. trade or business. These decisions will dictate the impact of various tax provisions, such as the branch profits tax. Running throughout all of these considerations is whether there is a U.S. income tax treaty with the foreign corporation's resident country that will effect the application of many tax statutes and influence the entity structure to minimize the tax liabilities for all tax jurisdictions.

Foreign entities may use debt to finance operations, purchase assets, reinvest liquid assets and meet the working capital requirements of its U.S. activities. In the use of debt in the capital structure of U.S. operations, foreign entities must be careful to avoid debt-equity re-determinations, earnings stripping provisions and anti-conduit rules. Conversely, when funding U.S. operations with interest at below-market rates, the Internal Revenue Service (the "Service") may impute additional interest payments and impose additional withholding tax under I.R.C. § 881.

Also, consideration must be given to any U.S. income that is not effectively connected with the conduct of a trade or business within the U.S. A foreign corporation is exempt from tax on U.S. source interest on banking and similar deposits provided that the interest income is not effectively connected with U.S. business.[4] Further exemptions are provided for portfolio interest from certain debt instruments within the U.S.[5] If a foreign corporation has an office or other fixed place of business in the U.S., the income may be attributable as effectively connected. Thus, any business venture in the U.S. must be careful to avoid changing the status of any tax-exempt interest income that the foreign parent corporation may be receiving.

If the foreign client is bringing a goods or services business venture to the U.S., an analysis needs to be made whether any real property ownership should be part of the business entity or a separate investment vehicle that may lease the business property to the operating entity. If substantial real estate acquisitions are contemplated with the buying and selling of the various properties at different times, separate real estate should be held in separate U.S. corporations to allow foreign investors to buy and sell properties without incurring the second level of U.S. tax by a deemed dividend on the sale proceeds of the U.S. real property interests. Only the unique facts of the foreign client's situation can determine the most beneficial relationship and structure.

The acquisition of U.S. real estate, whether for business use or investment, brings into play the U.S. real property interest provisions in the Internal Revenue Code (the "Code") and Treasury Regulations (the "Regulations").[6] Foreign investors may begin to acquire U.S. real property interests through a foreign corporation, which may buy into an existing real estate partnership or form a partnership structure to own the real property. The foreign corporation will discover that it must file a special tax return and is subject to the branch profits tax. How can it avoid this situation? Subsequently, the foreign corporation may want to repatriate its real estate profits from the U.S. How can it avoid taxable gain on the distribution? The following discussions will highlight some of these issues for the effectively connected U.S. trade or business of a foreign corporate client.

II. EFFECTIVELY CONNECTED U.S. TRADE OR BUSINESS

Whether a foreign corporation conducts business and investments in the U.S. as a branch or through a disregarded entity, the tax treatment is the same as a branch enterprise. Income and deductions of a U.S disregarded entity are treated as the income and deductions of the foreign owner. Operating through a disregarded limited liability company would provide liability protection with a state law recognized entity.

The U.S. imposes tax on foreign entities engaged in a trade or business in the U.S. and on U.S. investment income of foreign entities. A 30 percent withholding tax is imposed at the source on income that is not connected with a U.S. business and is treated as U.S. investment type income.[7] Whereas, a foreign corporation engaged in a trade or business within the U.S. is taxable under the standard U.S. corporate income tax provisions on its taxable income that is effectively connected with the conduct of the trade or business in the U.S.[8]

If a foreign corporation is a partner in a U.S. or foreign partnership, the foreign corporation is considered engaged in a U.S. trade or business if the partnership is engaged in the U.S.[9] The source of income of a partnership is passed through to the foreign partners.[10] To the extent the partnership has U.S. source income; the foreign partners will be subject to U.S. tax on their distributive share. Foreign and domestic partnerships are required to withhold U.S. tax with respect to the partnership's effectively connected income that is allocable under section 704 to foreign partners.[11]

Branch-level Taxation

The U.S. imposes a branch profits tax on the branch income of a foreign corporation on income derived in the U.S.[12] The branch profits tax is a tax on the deemed profits distributed, if the branch were treated as a U.S. corporation. In addition to the U.S. corporate income tax, the branch profits tax imposes a 30 percent tax on the "dividend equivalent amount," regardless of whether or not there is repatriation outside of the U.S.[13]

The dividend equivalent amount is the foreign corporation's effectively connected earnings and profits, subject to certain adjustments.[14] This E & P amount is reduced by the increase in U.S. net equity during the tax year, or increased by the decrease in net equity.[15]

Thus, many foreign corporations conduct their operations in the U.S. with a domestic corporation to avoid the branch profits tax on deemed "dividends." However, an actual dividend paid by a domestic corporation to a foreign shareholder is subject to withholding tax at the source but only when actually (or constructively) paid,[16] which is subject to the discretion and the timing decision of the domestic corporation.

The branch profits tax, as with any withholding tax on dividends paid by a domestic corporation to a foreign shareholder, would be modified if the foreign corporation is a qualified resident of a foreign country that has an income tax treaty with the U.S.[17] Treaty provisions would substitute the treaty rate for the 30 percent rate of the branch profits tax.[18]

If the foreign owner is not in a treaty country with the U.S., a foreign third country corporation in a U.S. treaty country may be placed between the ultimate foreign owner and the U.S. corporation. However, the "limitation on benefits" articles in the applicable income tax treaty may limit the treaty benefits, flowing to the ultimate foreign owner.

Earnings Stripping

The double taxation of dividend income creates an incentive for using debt capital rather than equity capital to fund U.S. operations. The use of debt in the capital structure of a U.S. company can be advantageous with a return of capital through principal payments being nontaxable, instead of an investment return through dividends, and interest being deductible by the U.S. corporation. Under most U.S. tax treaties, interest income, flowing to a foreign entity, is exempt from withholding tax or greatly reduced. Usually, the treaty rate is lower for interest income than for dividends.

A foreign owner that loans funds to its U.S. subsidiary and receives interest payments is subject to the 30 percent U.S. withholding tax at the source unless reduced by treaty. The interest payments are a deductible ordinary expense to the U.S. payor. With reduced treaty rates for withholding, "earnings" may escape the U.S. tax base when such earnings are deductible as "excess" interest expense by the U.S. payor and the earnings are subject to a reduced withholding tax rate. To avoid earnings stripping situations, U.S. tax provisions impose a limitation on the amount of deductible interest expense.[19]

A limitation on the payor's interest expense deduction is imposed if (1) the payor has excess interest expense for the taxable year and (2) the ratio of debt to equity of the corporation exceeds 1.5 to 1.[20] The corporation has excess interest expense to the extent of its net interest expense over 50 percent of its adjusted taxable income.[21] The limitation is imposed if interest is paid to a related person and no U.S. tax is imposed with respect to the receipt of such interest.[22] The limitation is reduced if the interest paid to the foreign recipient is partially subject to U.S. income tax.[23]

The provision is not a re-characterization of debt as equity, but rather a current disallowance and deferral of part of the corporation's interest deduction. The rules prevent the domestic corporation from taking a current deduction for the interest expense, which otherwise would reduce the corporation's current taxable income. The limitation applies to exempt, related-person interest expense paid or accrued, directly or indirectly, by a domestic corporation,[24] or paid or accrued by a foreign corporation with income, gain, or loss effectively connected with the conduct of a trade or business in the U.S.[25]

Generally, the limitation does not apply when a corporation pays interest to a third party, unless there is a "back-to-back loan" situation. If a corporation pays interest to an unrelated party that owes a debt to a person related to the corporation, a back-to-back loan would result in application of the limitation under section 163(j).[26] The Service follows the principles set forth in Rev. Rul. 84-152,[27] Rev. Rul. 84-153[28] and Rev. Rul. 87-89[29] for back-to-back loans,[30] which are discussed under the "anti-conduit" rules. Based upon the revenue rulings, back-to-back loans that have no substance are collapsed, the third party intermediary is ignored and the loan is treated as a direct loan to a related party.[31] The revenue rulings are supplemented by the anti-conduit regulations under section 7701(l).

Anti-Conduit Rules

Congress under section 7701(l) permitted the Service to prescribe regulations re-characterizing any multi-party financing transaction as a transaction directly among any two or more of such parties where the Service determines that such re-characterization is appropriate to prevent avoidance of any tax. Under this substance-over-form doctrine, the intermediary is ignored as a mere "conduit" for the received payments and is denied the treaty benefits that would flow as being treated as the recipient of the payments.[32]

For a conduit situation to exist, the interest recipient must fail to exercise complete dominion and control over the interest payments and must have an obligation to transmit the payment to another.[33] Also, there must be no valid business reason for the multiple party arrangements, except to obtain the benefits of an exemption established by U.S. treaty.[34]

The regulations under section 7701(l) permit the Service for purposes of sections 871, 881, 884(f)(1)(A) and 1441/2 to disregard one or more intermediate financing entities.[35] The regulations target the avoidance of U.S. withholding tax through the use by a non-treaty country resident of a treaty-country intermediary to receive U.S.-source interest, dividends, royalties, or other non-trade or business income at reduced rates granted under a U.S. tax treaty with the intermediary's country of residence.

The regulations determine who is the beneficial owner of the income with respect to a particular financing arrangement.[36] The financing entity, who is the beneficial owner of the income, is entitled to claim the benefits of any income tax treaty that reduces the amount of tax imposed by section 881 on that income.[37] A conduit entity is the agent of the financing entity and cannot claim the treaty benefits to reduce the amount of tax under section 881 on the payments made pursuant to the financing arrangement.[38]

An intermediate entity is a conduit entity with respect to a financing arrangement[39] if (1) the participation of the intermediate entity reduces the section 881 tax, (2) the participation of the intermediate entity is pursuant to a tax avoidance plan and (3) either the intermediate entity is related[40] to the financing entity or the financed entity, or the intermediate entity, would not have participated on substantially the same terms[41] but for the fact that the financing entity engaged in the financing transaction[42] with the intermediate entity.[43] If the participation of a conduit financing arrangement is disregarded, payments made by the financed entity are characterized by reference to the character, such as interest or rent, of the payments made to the financing entity.[44]

A tax avoidance plan is a plan one of the principal purposes of which is the avoidance of tax imposed by section 881.[45] Avoidance of the section 881 tax may be one of the principal purposes for such a plan even though it is outweighed by other purposes, together or separately.[46] The only relevant purposes are those pertaining to the participation of the intermediate entity in the financing arrangement and not those pertaining to the existence of the financing arrangement as a whole.[47]

Below Market Interest Rates

If interest is nominal or zero on intercompany loans between a foreign-controlled U.S. corporation ("FCC") and its foreign related corporation ("FRC")[48] the Service may impute interest under section 482 to the FRC, subject to the withholding tax on the deemed interest income.[49] The withholding tax on the deemed interest income may result in a corresponding interest expense deduction to the FCC.[50]

For example, assume that a FRC in a non-U.S. tax treaty country sold inventory to its FCC on an open account payable basis. The FCC, not paying the balance in the account, carried an account balance over several years. The Service may imputed interest on these account balances under section 482, utilizing the Federal short-term[51] interest rate as specified in I.R.C. § 1274(d). The taxpayer may be allowed a deduction for interest expense under I.R.C. § 163 for the interest imputed on the loan.[52] Interest may be imputed on intercompany loans between FCC and FRC based upon the Third Circuit's decision in *Tate & Lyle, Inc. v. Commissioner*[53] and the matching regulations[54] under I.R.C. § 267.

Under section 163, a taxpayer is allowed to deduct interest paid or accrued within the taxable year on indebtedness. However, taxpayers are required to defer the deduction for the interest payable to related persons,[55] until the interest income is includible in the related person's gross income.[56] With this matching principle of I.R.C. § 267(a)(2), interest deductions are to be matched with the interest income for related persons, when the payor is an accrual basis taxpayer and the payee is a cash basis taxpayer.

The purpose of section 267(a)(2) is to require related U.S. persons to use the same accounting method in related transactions to prevent the allowance of a deduction without the corresponding inclusion in income.[57] Section 267(a)(3) provides that the "Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person."

Personal Property

When a foreign corporation sells an investment asset or a personal asset, the income or gain is subject to U.S. tax if the income or gain is effectively connected to a U.S. trade or business. Generally, foreign source income will not be income effectively connected to a U.S. trade or business.[58] Foreign source income will be effectively connected if the income meets the asset use test, business activities test, or is subject to the force of attraction principle.[59] If a foreign corporation has an office or other fixed place of business in the U.S. to which the foreign source income is attributable, foreign source income may be effectively connected.[60]

Income from the sale or exchange outside of the U.S. of inventory property through a U.S. office or other fixed place of business would be foreign source effectively connected income.[61] If inventory property is sold for use, consumption or disposition outside the U.S. and an office or fixed place of business of the foreign corporation outside the U.S. materially participates in the sale, then the foreign source income is not effectively connected.

U.S. Real Property Interests

The term "U.S. real property interest" is defined by the Code as (1) an interest in real property located in the U.S. or Virgin Islands and (2) any interest in any domestic corporation unless the taxpayer establishes that such corporation was at no time a U.S. real property holding corporation during the 5-year period ending on the disposition date of such interest.[62] An interest in real property includes fee ownership and co-ownership of land or improvements on land, leaseholds of land or improvements on land, options to acquire land or improvements on land, and options to acquire leaseholds of land or improvements on land.[63] Under the Regulations, the term is expanded to include any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, the real property.[64]

Also, the term "U.S. real property" includes personal property associated with the use of real property, which includes movable walls, furnishings and other personal property associated with the use of the real property.[65] Personal property associated with the use of the real property will be treated as real property upon its disposition, regardless of whether it is disposed of concurrently with the disposition of the real property with which it is associated.[66] However, associated personal property will not be treated as real property if the personal property is disposed of either more than one year before or more than one year after the disposition of the associated real property and no right in the real property is reacquired during that one-year period, or the personal property and the associated real property are separately sold within a 90-day period to persons that are related neither to the transferor nor to one another, and the transferor has no reason to know that the buyers are related persons or intend to re-associate the two properties within one year of the sale of the personal property.[67]

A foreign corporation directly owning U.S. real property is subject to taxation on the net income from the property after deductions, if the ownership and maintenance of the property constitutes a U.S. trade or business. With effectively connected U.S. trade or business income from the property, a foreign corporation is permitted deductions for depreciation, interest, repairs, maintenance, real property taxes and other business expenses.

If the income is not effectively connected to a U.S. trade or business, the foreign corporation is subject to the 30 percent gross basis tax on the "gross income" from the property. Even if the real property is under a "net lease" in which the lessee pays the rent, as well as real estate taxes, repairs, operating expenses and insurance, the 30 percent gross basis tax on "rent" includes the net rent and the amounts paid by the lessee that constitute lessor expenses such as taxes and repairs.[68] Thus, the expenses of the lessor under a gross lease paid by the lessee are additional rental income to the foreign person and subject to the 30 percent tax.

Whether a foreign corporation's ownership and maintenance of U.S. real property constitute a U.S. trade or business, the courts and the Service have held that considerable, continuous and regular activity with respect to the property is a trade or business, but the mere receipt of rental income and payment of expenses is not sufficient.[69] An election is available to the foreign corporation to treat the income from the non-business U.S. real property as income effectively connected to a U.S. trade or business and subject to regular taxation.[70]

Thus, foreign persons should elect to treat income-producing U.S. real estate activities as a U.S. business and eliminate the need to engage in a fact-based inquiry as to whether the activities are continuous, regular and substantial to constitute a trade or business. The foreign corporation must attach a statement to the U.S. return, providing a list of the real property, the extent of ownership, location, a description of improvements and information of any previous elections.[71] Also, the foreign corporation must provide any withholding agent or payer a Form W-8ECI to claim an exemption from the 30 percent gross basis withholding tax.[72] However, any gain on the disposition of the U.S. real property will be subject to regular taxation whether or not the election is made.

III. DOMESTICATIONS

Upon entering the U.S. market for the first time, foreign investors may acquire U.S. real estate through a foreign corporation. The foreign parent corporation may use a foreign subsidiary in a low-tax jurisdiction to allow deferral from home country taxation. Such low-tax jurisdictions tend to be non-U.S. treaty countries. Using a foreign corporation in a tax haven with bearer share certificates provides the foreign investor with a great degree of home country anonymity. The foreign corporation may buy into an existing real estate partnership or form a partnership structure to own the real property. Usually, a foreign corporation owns the real estate in a U.S. limited partnership, in which the foreign corporation would hold a 99 percent limited partnership interest and a 100 percent interest in the 1 percent general partner, a single-member limited liability company.

The foreign corporation, filing a Form 1120-F[73] in the United States for its U.S. real property earnings, may want to simplify its U.S. tax filings and to avoid the branch profits tax and any unwanted disposition of a U.S. real property interest with any change in stock ownership. Normally, the taxable earnings represent distributions from an ownership in a U.S. limited partnership and a limited liability company, through which the foreign corporation conducts a U.S. trade or business in U.S. real estate.

A foreign corporation that is a member of a partnership engaged in a U.S. trade or business is treated as being engaged in a U.S. trade or business.[74] A foreign corporation engaged in trade or business within the U.S. is taxable on the effectively connected income (net of the deductions properly allocated and apportioned to such income) at regular graduated rates under I.R.C. § 882. Also, a foreign corporation with a U.S. trade or business is subject to the U.S. branch profits tax under section 884. By using a domestic corporation to hold the U.S. real estate, as opposed to a foreign corporation, avoids the branch profits tax.

A possible solution to the above situation is the domestication of the foreign corporation to avoid being subject to the applications of section 882 and the branch profits tax. The domestication of the foreign corporation is nontaxable as an "F" reorganization, but is subject to sections 897 and 884. Section 897 could trigger the reorganization as a taxable event by a disposition of a U.S. real property interest. The reorganization could increase the transferor's dividend equivalent amount and trigger a branch profits tax liability under section 884.

Inbound F Reorganization

A foreign corporation can be domesticated through an inbound "F" reorganization as a U.S. corporation. A change of domicile for a foreign corporation, pursuant to a state domestication statute, will be treated as a reorganization under section 368(a)(1)(F).[75] A change of corporate domicile is the most common "F" reorganization. The domestication of an existing foreign corporation for U.S. purposes would have no impact on the foreign corporation for foreign commercial law and tax law purposes in the foreign country.

Following its domestication in the U.S., the corporation is a domestic corporation for all purposes of the Code. The dual resident corporation is not considered to have two classes of stock outstanding solely because the corporation continues to be registered as a corporation in a foreign country and does not liquidate.[76]

After the domestication, the dual resident entity possesses the same assets and liabilities as before the domestication and continues its previous business without interruption and the shareholder's proprietary interest does not change.[77] The foreign corporation would be continuing its historic business and the same shareholders would hold ownership through the domesticated entity for U.S. tax purposes. In an inbound "F" reorganization, the taxable year for U.S. tax purposes of the foreign transferor corporation will end with the close of the date of the transfer and the taxable year of the acquiring domestic corporation will end with the close of the date on which the transferor's taxable year would have ended but for the occurrence of the reorganization.[78]

For U.S. tax purposes, the actual form of the transaction does not matter. Regardless of the form of the transaction and the treatment under state corporate laws, the transaction is viewed for U.S. tax regulations purposes as a deemed asset transfer in which there is: (1) the transfer of assets by the foreign corporation in exchange for stock of the domestic corporation and its assumption of liabilities; (2) followed by the distribution by the foreign corporation of the stock of the domestic corporation to the foreign corporation's shareholders; and (3) the exchange by the foreign corporation's shareholders of their stock in exchange for the stock of the domestic corporation.[79]

For U.S. nonrecognition purposes, an "F" reorganization is treated as (1) a section 361(a) transfer of assets from the acquired foreign corporation to the acquiring domestic corporation, (2) a section 361(c) distribution by the acquired foreign corporation of the stock in the acquiring domestic corporation and (3) a section 354 exchange by the shareholder of stock in the acquired foreign corporation for stock in the acquiring domestic corporation.[80] Section 361 and section 354 provide the transferor corporation and the shareholder of the transferor corporation, respectively, with nonrecognition treatment in a section 368 reorganization, unless overridden by the operation of certain other Code sections. A carryover basis in the contributed assets results under section 362(b).

The "F" is the only reorganization in which both carryovers and carrybacks are permitted.[81] Under section 1.381(b)-1(a)(2), "the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization." Under the section 382 limitation provisions, the term "equity structure shift" means any reorganization within the meaning of section 368, except a section 368(a)(1)(F) reorganization.[82]

If a shareholder of the foreign corporation is a U.S. shareholder, the shareholder must include any "all earnings and profits amount" in income as a dividend.[83] With the domestication qualifying as an "F" reorganization, the U.S. shareholders would be required to include in gross income any "all earnings and profits amount" of the foreign corporation not previously distributed to the domestic shareholder and subject to tax in the U.S.[84] If we assume that there are no U.S. shareholders, there would not be any earnings and profits to create a section 367(b) problem with earnings and profits being deemed as section 1248 dividends. Of course, the branch profits tax under section 884 may create a dividend equivalent amount.

Section 354(a)(1) provides nonrecognition to the shareholder, subject to sections 367(b),[85] 1246, and 1291 for U.S. shareholders.[86] However, we are assuming that there are no U.S. shareholders. If a foreign corporation transfers its assets to a domestic corporation, in exchange for stock under a "F" reorganization, nonrecognition treatment occurs under section 361(a), subject to sections 897 (U.S. real property interest) and 884 (branch profits tax if engaged in a U.S. trade or business) for foreign shareholders.

After the domestication, the dual resident corporation (referred to as "DRC") is treated as a domestic corporation for all purposes of the Internal Revenue Code. The foreign corporation has the option to liquidate in the foreign jurisdiction or to maintain its dual resident status. Sections 882 and 884 no longer apply after the reorganization date, but DRC is subject to the normal tax provisions of a domestic U.S. corporation. The dual domestication is nontaxable as an "F" reorganization, but subject to sections 897 and 884.

Section 897(e) Nonrecognition

Under section 354(a), no gain or loss is recognized if stock or securities in a corporation that is a party to a reorganization are, in pursuance of the reorganization plan, exchanged solely for stock or securities in the corporation or in another corporation that is a party to the reorganization. Section 897(a) provides that the disposition of a U.S. real property interest by a foreign corporation is taxable as effectively connected income under section 882(a)(1). If there are U.S. real property interests, section 897(e)(1) may deny nonrecognition treatment to the transferor corporation. Gain is recognized by a foreign corporation on the distribution of a U.S. real property interest, unless nonrecognition is provided in regulations prescribed by the Secretary pursuant to the authority of section 897(e)(2).[87]

Under the regulations, the corporation may avoid recognizing gain if it (1) receives stock in a U.S. real property holding corporation immediately after the exchange, (2) would be subject to U.S. taxation upon an immediate sale of the stock received and (3) reports certain information to the Service.[88] The foreign transferor must comply with certain filing requirements and attach to its U.S. tax return for the year of transfer a document setting forth information on the section 897 transfer.[89]

The term "United States real property holding corporation" means any corporation if the fair market value of its U.S. real property interests equal or exceed 50 percent of all assets.[90] A domestic or a foreign corporation may be a U.S. real property holding corporation.[91] Assets held by a partnership are treated as held proportionately by its partners.[92]

Section 897(e) may cause an exchange to be taxable if a treaty provision would protect the foreign shareholder from U.S. tax on a later sale of the stock of the domestic corporation. If a foreign corporation is under a treaty obligation of the U.S. and is entitled to nondiscriminatory treatment with respect to its U.S. real property interest, the foreign corporation may make an election to be treated as a domestic corporation for purposes of sections 897, 1445 and 6039C.[93]

Section 897(e)(1) generally allows a nonrecognition provision to apply if a foreign person exchanges a U.S. real property interest for an interest that would be subject to U.S. taxation if sold. For the exchange to be tax-free, the domestic corporation must be a U.S. real property holding corporation immediately after the exchange.[94]

Under Temp. Treas. Reg. § 1.897-6T(a)(1) as modified by Notice 99-43, a foreign taxpayer will not recognize gain under section 897(a) for a stock exchange under section 354(a) in certain "F" reorganizations.[95] For purposes of section 897(a) and (e), the final regulations under section 897(e) will provide that the stock received in a section 368(a)(1)(F) reorganization, qualifying for nonrecognition pursuant to section 354(a), will constitute the same interest in the corporation whose stock was exchanged for purposes of determining whether the interest received is a U.S. real property interest under section 897(c)(1)(A)(ii).

The exception will apply when the taxpayer receives stock in the corporation that is substantially identical to the shares exchanged, possessing the same dividend rights, voting power, liquidation preferences, and convertibility as the shares exchanged without any additional rights or obligations.[96] Also, Notice 99-43 modifies the regulations to require that the determination of whether the interest received in the exchange is a U.S. real property interest under section 897(c)(1)(A)(ii) will include the period prior to the exchange.[97]

Section 897 could trigger the reorganization as a taxable event. However, the nonrecognition provision would apply under section 897(e) for the F reorganization, but the foreign corporation would need to attach to its U.S. tax return for the year of domestication a document setting forth information on the reorganization.

Avoiding a Branch Profits Tax Disposition

In addition to the tax imposed by section 882,[98] a branch profits tax is imposed on any foreign corporation and is equal to 30 percent of the dividend equivalent amount unless reduced by treaty. The term "dividend equivalent amount" means the foreign corporation's effectively connected earnings and profits adjusted by increases or decreases in U.S. net equity. Thus, it is a tax on a foreign corporation's after-tax U.S. earnings that are not reinvested in the corporation's U.S. business.

The principle purpose of section 884 is to equalize the tax treatment between U.S. branches and subsidiaries of foreign corporations. If the foreign client were a foreign corporation in non-treaty country, there would be no reduction in the 30 percent branch profit tax. The branch profit tax is eliminated after the reorganization, since DRC is a U.S. corporation that is not subject to the tax. However, any future dividends paid by DRC to the non-treaty shareholders are subject to a 30 percent U.S. withholding tax under section 1442(a).

If a foreign corporation engaged in a U.S. trade or business transfers its U.S. assets to a domestic corporation in an exchange for stock, the reduction in the foreign corporation's U.S. net equity would cause an increase in the transferor's dividend equivalent amount and trigger branch profits tax liability under section 884(a).[99] The transfer ends the deferral of the transferor's branch profits tax liability to the extent of non-previously taxed effectively connected earnings and profits.

The regulations contain an exception for a transfer of stock of the transferee by the transferor in a section 368(a)(1)(F) reorganization.[100] A section 884 disposition does not include a transfer of stock of the transferee by the transferor in a section 332(b) complete liquidation of a subsidiary or an "F" reorganization.[101] Any other transfer that qualifies for non-recognition of gain or loss is treated as a disposition for purposes of section 884 unless the Service has published guidance for an exception.[102]

The domestic transferee corporation DRC must file Form 8848 if U.S. assets are transferred to it from a foreign corporation in a transaction described in section 381(a) and if the foreign corporation was engaged in the conduct of a U.S. trade or business immediately prior to the section 381(a) transaction.[103] Form 8848 is the consent to extend the time to assess the branch profits tax under regulations sections 1.884-2T(a) and -2T(c) and replaced Form 2045 outlined in regulations 1.884-2T(c)(2)(iii).

Form 8848 is attached to the corporation's income tax return for the tax year of the reorganization. The taxpayer must consent to extend the time to assess to a date not earlier than the close of the 6th tax year following the year of the reorganization. Also, Form 8848 requires that the corporate officers have, by resolution of its board of directors, been authorized to execute Form 8848 and its terms and a copy must be attached of the minutes of its board of directors evidencing the authorization and that the terms of this Form 8848 have been included in its corporate minutes.

The foreign corporation's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits generally carry over to the transferee domestic corporation.[104] Section 1.884-2T(c)(4) provides for the reduction of any dividend equivalent amount of the transferor during the year ending with the reorganization against the carryover amount.

The reorganization could increase the transferor's dividend equivalent amount and could trigger a branch profits tax liability under section 884. For the nontaxable exception to apply for the "F" reorganization, the foreign corporation is required to attach a Form 8848 to its corporate income tax return for the year of domestication that extends the statute of limitations for the branch profits tax liability.

IV. PURGING REAL PROPERTY INTERESTS

The typical situation may represent a foreign corporation that owns 100 percent of a domestic corporation. The domestic corporation holds an interest in a domestic partnership, owning U.S. real estate. The domestic corporation may also hold cash and notes receivables. The domestic corporation is a "U. S. real property holding corporation" by definition under I.R.C. § 897. The foreign parent corporation wants to repatriate its profits from the U.S. on the real estate. For such situations, separate real estate should be held in separate U.S. corporations to allow foreign investors to buy and sell properties without incurring the second level of U.S. tax by a deemed dividend on the sale proceeds of the U.S. real property interests, while the continuing domestic corporation holds other real property interests.

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") revised the taxation of gain from the disposition of U.S. real estate by nonresident alien individuals and foreign corporations. The purpose of this section is to address the tax consequences of a complete liquidation of a U.S. real property holding corporation with respect to the issues concerning the "U. S. real property interest" status and the potential gain on the liquidating distribution to the foreign corporate shareholder.

The domestic corporation should sell its entire partnership interest. By the end of the tax year, the domestic corporation's only asset will be cash. The domestic corporation then should file a final federal income tax return and distribute all of its cash to its foreign stockholder. There should be gain by the foreign parent corporation on its investment in the domestic corporation.

In order to consider the U.S. tax consequences of such actions, the statutory status of the events must be reviewed with respect to the definitions of a U.S. real property interest and a U.S. real property holding corporation. Then, the purge rules for U.S. real property interests and the effect of a subsidiary liquidation into a foreign parent must be considered.

U.S. Real Property Interest

A stock interest held by a foreign person or foreign corporation in a domestic corporation may be treated as a "U.S. real property interest" that may accelerate tax liabilities. Section 897(a)(1) may cause a foreign person or corporation to be taxed on a disposition of a U.S. real property interest by treating certain gain or loss as effectively connected with the conduct of a U.S. trade or business. Such an effectively connected gain or loss is taken into account in determining the foreign taxpayer's tax under section 871(b)(1) or 882(a)(1). A foreign corporation may pay tax on the net gains from U.S. real property dispositions under § 882(a)(1) at the top rate for § 11.

Section 897(a)(1) does not require that gain or loss be recognized, but that gain or loss "shall be taken into account" as if the taxpayer were engaged in a U.S. trade or business and the gain or loss were effectively connected with such trade or business. However, sections 897(d), (e) and (j) do trigger the recognition of gains (not losses) to transactions involving a "U.S. real property interest" with respect to distributions, redemptions, reorganizations and capital contributions.

Also, section 897(g) uses a "look-through" rule to apply section 897(a) to the portion of the gain or loss on the disposition of an interest in a partnership, trust, or estate attributable to a U.S. real property interest. Under section 897(g), the amount received by a foreign corporation in exchange for all or part of its interest in a partnership, trust, or estate to the extent attributable to U.S real property interests will be considered as an amount received from the sale of such property in the U.S.

The term "U.S. real property interest" means (1) an interest in real property located in the U.S. or Virgin Islands and (2) any interest in any domestic corporation unless the taxpayer establishes that such corporation was at no time a U.S. real property holding corporation during the 5-year period ("look-back rule") ending on the disposition date of such interest.[105] An interest in real property includes fee ownership and co-ownership of land or improvements on land, leaseholds of land or improvements on land, options to acquire land or improvements on land, and options to acquire leaseholds of land or improvements on land.[106] The term "domestic corporation" has the same meaning as set forth in sections 7701(a)(3) and (4) and 301.7701-5. For purposes of sections 897 and 6039C, it includes a foreign corporation electing to be treated as a domestic corporation under section 897(i).[107] A corporation's status as a U.S. real property holding corporation generally taints the stock interests in the corporation for shareholders, who are either nonresident alien individuals or foreign corporations.

Additionally, a "U.S. real property interest" can refer to an interest in a foreign corporation that elects under section 897(i) to be treated as a domestic corporation and that is, or was, a U.S. real property holding corporation.[108] If a foreign corporation holds a U.S. real property interest and under any treaty obligation of the United States the foreign corporation is entitled to nondiscriminatory treatment with respect to that interest, the corporation may elect to be treated as a domestic corporation for purposes of sections 897, 1445 and 6039C.[109]

The term "U.S. real property interest" has a different application for a domestic corporation that is determining whether it would be treated as a U.S. real property holding corporation. The stock of a foreign corporation cannot be a U.S. real property interest in the hands of a foreign person or foreign corporation, but only the stock of a domestic corporation can be a U.S. real property interest under section 897(a)(1). In determining whether the domestic corporation may be a U.S. real property holding corporation, its interest in any corporation, foreign or domestic, may be a U.S. real property interest. Section 897(c)(2) pertains to "any corporation." Section 897(a)(1) may apply to the stock of a foreign corporation that elects to be treated as a domestic corporation under section 897(i). For purposes of section 897(a)(1), only stock of a domestic corporation can be a U.S. real property interest.[110]

If the foreign corporation is a U.S. real property holding corporation, any of its stock held by another corporation is a U.S. real property interest for purposes of determining the status of that other corporation. The value of that interest is used to test whether the other corporation is a U.S. real property holding corporation.[111] The primary significance of a foreign corporation's status as a U.S. real property holding corporation is that an interest in the foreign corporation held by a domestic corporate shareholder may make the corporate shareholder itself a U.S. real property holding corporation. The treatment of a foreign corporation as a U.S. real property holding corporation for determining the status of a corporate shareholder applies to any multi-tier corporate chain.[112]

Further, the term, "U.S. real property interest," can refer to a publicly traded interest in a partnership or trust held by a greater-than-5-percent owner.[113] Such an interest in a publicly traded partnership or trust would constitute a U.S. real property interest, if the entity holds assets that would cause it to be classified as a U.S. real property holding corporation if it were a corporation.[114] Similarly, a publicly traded stock may be treated as a U.S. real property interest for a greater-than-5-percent owner.[115]

U.S. Real Property Holding Corporation

A U.S. real property holding corporation is any corporation in which the fair market value of its U.S. real property equals or exceeds one half of all of its real property and business assets. Under the Code, the term "U.S. real property holding corporation" means any corporation if the fair market value of its U.S. real property interests equal or exceed 50 percent of the fair market value of (1) its U.S. real property interests, (2) its interests in real property located outside the U.S. and (3) any other of its assets which are used or held for use in a trade or business.[116] The mathematical definition applies to certain assets of the corporation and may ignore other assets.

If the fair market value of the assets cannot be determined with certainty, the Regulations allow a presumption based upon the book value of the assets. The Regulations provide an alternative test based upon the total book value of the U.S. real property interests being 25 percent or less of the book value of the aggregate of the assets.[117] If there is difficulty in determining fair market value, the presumption moves away from fair market value but reduces the 50 percent threshold to 25 percent in the Regulations.

"Book value" for assets directly owned by the corporation means the value listed in the financial accounting records in accordance with U.S. generally accepted accounting principles.[118] "Book value" for assets held by another entity and imputed to the corporation means the corporation's share of the value listed in the financial accounting records of the other entity in accordance with U.S. generally accepted accounting principles.[119] The Regulations do not require a corporation or the other entity to keep its books in accordance with U.S. generally accepted accounting principles, but they must determine the book value of the particular assets in accordance with these principles.[120]

Also, the definition takes into account certain assets held by partnerships, trusts and estates in which the corporation has an interest.[121] Assets held by a partnership, trust, or estate are treated as held proportionately by its partners or beneficiaries.[122] A chain rule applies if the domestic corporation owns an interest in a partnership, trust, or estate that owns an interest in another entity. The Regulations attributes assets successively upward through the ownership chain.[123] The Regulations treat a domestic corporation as owning its share of the assets of a partnership, trust, or estate, but does not include its interest in the entity as an asset for purposes of the 50 percent or more test.[124]

The U.S. real property holding corporation determination takes into account its proportionate share of real estate and business assets held through a controlled domestic or foreign corporation.[125] If a corporation holds a controlling interest in a second corporation, the first corporation is treated as holding a portion of the assets of the second corporation equal to the percentage of the fair market value of the stock of the second corporation held by the first for purposes of determining a U.S. real property holding corporation.[126]

In determining the threshold of a U.S. real property holding corporation under the 50 percent or more test, the "other assets used or held for use in a trade or business" would include inventory, depreciable property, goodwill, intangible property, cash, securities, stock and receivables of all kinds to the extent such assets are used or held for use in the corporation's trade or business.[127] An asset is used or held for use in an entity's trade or business if it is under the principles of section 1.864-4(c)(2)("asset-use test") held in a direct relationship to the trade or business.[128] The net result is that the definition of a U.S. real property holding corporation takes into account certain assets and may ignore other assets.

A note receivable arising from that trade or business would be an asset held in a direct relationship to the trade or business.[129] However, there is a special rule concerning liquid assets, such as cash. Under the Regulations, the amount of cash that is presumed to be used or held for use in a trade or business may be up to 5 percent of the fair market value of the other assets used or held for use in the trade or business.[130] Cash held to meet the present needs of the business would be held in a direct relationship to that business and constitute assets used or held for use in the trade or business.[131] Cash held to provide for the future expansion of the corporation into a new trade or business is not necessary for the present needs of the business and is not held in a direct relationship to the business and does not constitute assets used or held for use in the trade or business.[132] Thus, excessive cash would be ignored for the 50 percent or more test.

Generally, interests in a U.S. real property holding corporation are U.S. real property interests for the 5 years following an "applicable determination date."[133] If a corporation is a U.S. real property holding corporation on such a date, interests in the corporation are U.S. real property interests for the subsequent 5 years.[134]

Whether a corporation is a U.S. real property holding corporation is determined as of four different determination dates: (1) last day of the corporation's taxable year, (2) the acquisition date of any U.S. real property interest, (3) the disposal date of an interest in real property located outside the U.S. or other business assets and (4) such changes in items 2 and 3 as they relate to the assets held proportionately through an entity owned by the corporation.[135] Although the Regulations require testing for U.S. real property holding corporation status only on certain dates, the corporation may determine its status upon acquiring or disposing of any assets.[136]

The Regulations list certain transactions that may occur without triggering a determination date.[137] Additionally, a corporation does not have to test for status as a U.S. real property holding corporation during the first 120 days after the later of the date of incorporation or it first acquired a shareholder.[138] Also, no determination of status is required during a 12-month period beginning with the date of the adoption of a plan of complete liquidation by the corporation and ending with the distribution of assets.[139]

Purge Rule For U.S. Real Property Interest

A corporation's status as a U.S. real property holding corporation may end at any time, if less than 50 percent of certain assets consist of U.S. real property interests.[140] A domestic corporation that determines that it is not a U.S. real property holding corporation may attach to its income tax return for that year a statement informing the I.R.S. of its determination.[141] If the corporation voluntarily provides such notice, the corporation must submit a supplemental statement if such corporation independently determined whether or not an interest in a second corporation is a U.S. real property interest.[142]

Upon the termination of the U.S. real property holding corporation status, interests in the corporation generally continue to be U.S. real property interests for the next 5 years.[143] After 5 years, interests in the corporation cease to be treated as U.S. real property interests unless subsequent transactions cause the fair market value of the corporation's U.S. real property interests to equal or exceed the 50 percent threshold.

Section 897(a) provides that the disposition of a U.S. real property interest by a foreign corporation is taxable as effectively connected income under section 882(a)(1). Section 897 would apply only if there is a transfer or distribution by foreign persons of a U.S. real property interest. Section 11 simply taxes the domestic corporation on all its recognized gains.[144]

However, a special "purge" rule allows interests in a corporation to lose their status as U.S. real property interests immediately before the end of the 5-year period.[145] Section 897(a) does not apply when a domestic corporation sells its U.S. real property interest. The corporation's stock ceases to be a U.S. real property interest, if the domestic corporation disposes of all its U.S. real property interests in taxable sales.[146] Thus, section 897(a) does not apply if the corporation has "purged" its stock of the taint as a U.S. real property interest.

As stated, a corporation may purge itself by disposing of all of its U.S. real property interests in transactions in which gain is recognized. Essentially, the corporation must have sold all of the U.S. real property interests held while the taxpayer was a shareholder during the prior five years. Under the Code and Regulations, the term U.S. real property interest does not include any interest in a corporation if (1) as of the date of the disposition of such interest, such corporation did not hold any U.S. real property interests, and (2) all of the U.S. real property interests held by such corporation at any time during the 5-year period ending on the date of the disposition of such interest were disposed of in transactions in which the full amount of the gain was recognized (or ceased to be U.S. real property interests by reason of taxable dispositions of ownership in partnerships or controlled corporations).[147]

Further, a corporation that holds interests in another U.S. real property holding corporation, or a partnership holding U.S. real property, can meet the purge rule if the other corporation, or partnership, sells all of its U.S. real property interests (or sells the partnership interest) held during the defined period in transactions in which all gain is recognized.[148]

The domestic corporation has been a U. S. real property holding corporation by definition under I.R.C. § 897. If the domestic corporation sells all of its real property interests in taxable transactions, the domestic corporation will cease to be a U.S. real property holding corporation and a U.S. real property interest prior to the end of the 5-year period.

Parent/Subsidiary Liquidation

In a domestic context, the liquidation of a domestic corporation into its 80 percent or more (by vote and value) corporate shareholder would qualify under section 332 as a nontaxable event at both the shareholder and subsidiary levels. An 80 percent or more shareholder that is a foreign corporation would qualify for nonrecognition treatment under section 332. Section 337(a) provides that a liquidating corporation recognizes no gain or loss on the distribution of property to an 80 percent domestic or foreign corporate shareholder, unless overridden by section 367.

With a foreign parent corporation, a section 332 liquidation would be subject to sections 897 and 367 and their underlying Regulations. Section 897 applies to transfers and distributions by foreign persons of U.S. real property interests, including the stock of a U.S. real property holding corporation. Even if the liquidating domestic subsidiary is a U.S. real property holding corporation, section 897 does not apply at the subsidiary level with a domestic entity. Of course, the example in this situation assumes that the domestic corporation will no longer be a U.S. real property holding corporation and will purge its U.S. real property interest before the time of liquidation.

Generally, section 367 requires a liquidating domestic corporation to recognize gain on the distribution of its appreciated assets to a foreign person. Except as otherwise provided in the Regulations, gain results under section 367(e)(2), which overrides the nonrecognition sections of 337(a) and 337(b)(1). A distributing corporation must recognize gain on each item of property that has a fair market value in excess of its adjusted basis.[149] The intent of the provision is to impose an immediate corporate tax on the distribution of all appreciated assets that would not be subject to U.S. taxation if subsequently sold by the foreign corporate shareholder.[150]

Section 367(a)(6) does allow the Regulations to exempt any transaction from section 367(a)(1) application. A domestic corporation may avoid gain recognition on the distribution of U.S. real property interests and certain U.S. trade or business assets, if the U.S. can tax any gain recognized later by the foreign corporation that is still effectively connected with a U.S. trade or business.[151] When the nonrecognition provision for U.S. real property interests overlaps with the nonrecognition rules for assets used in a trade or business, the U.S. real property interest rules take priority.[152]

A foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in a domestic corporation that is a U.S. real property interest would not recognize any gain under sections 367(a) or 897(e)(1) on the receipt of property in a section 332(a) liquidation.[153] The nonrecognition rule applies to the distribution of (1) a direct interest in U.S. real estate, (2) an interest in a partnership with assets of U.S. real property, or (3) the stock of a U.S. real property holding corporation. Even if the domestic corporation is a U.S. real property holding corporation, a section 332 liquidation results in no recognized gain for the foreign parent.[154] The domestic corporation would not recognize gain on the distribution of U.S. real property interests, unless the domestic corporation is a former U.S. real property holding corporation that is treated as a U.S. real property interest.[155]

The domestic corporation would recognize gain under section 367(e)(2) on the distribution of stock in a former U.S. real property holding corporation that is treated as a U.S. real property interest. If a domestic corporation that is or has been a U.S. real property holding corporation during the holding period distributes property to a foreign person in a corporate liquidation, it must deduct and withhold a tax equal to 10 percent of the amount realized by the foreign shareholder.[156] An entity or fiduciary must report and pay over to the I.R.S. any tax withheld pursuant to section 1445(e) by the 20th day after the transfer date with the filing of Form 8288/8288-A.[157]

The withholding tax provision will not apply, if the interests in the corporation are not U.S. real property interests as of the date of the distribution by reason of section 897(c)(1)(B).[158] Section 897(c)(1)(B) concerns the disposition of all of the U.S. real property interests by the domestic corporation in transactions on which gain or loss is recognized.[159]

At the time of the liquidation, the situation assumes that the domestic corporation has sold, or "purged," all appreciated assets in taxable sales and is no longer a U.S. real property holding corporation and is not treated as a U.S. real property interest. Section 367(e)(2) would not trigger any additional gain by the domestic corporation, since the domestic corporation already would have recognized gain under section 11 upon the filing of its final corporate income tax return.

Section 367(e)(2) does not limit the benefit of section 332 for the foreign corporate shareholder that receives distributions in liquidation. Section 332 liquidation results in no recognized gain on the receipt of the assets of a U.S. subsidiary in a section 332 liquidation for the foreign parent corporation.[160]

A foreign corporation pays no U.S. tax on its gains from the sale of the stock of a U.S. corporation.[161] Section 881 does not contain a provision that parallels section 871(a)(2) on the capital gains of individuals. If section 897(a) applied, the gains would be treated as a disposition of a U.S. real property interest as effectively connected with the conduct of a trade or business within the U.S.

By "purging" the domestic corporation of U.S. real property interests before the liquidation, the foreign corporation eliminates the effectively connected U.S. trade or business exception under section 897. The foreign corporation would no longer be subject to the rules of section 897. The foreign corporation would not recognize any gain on the distribution of the cash under section 367.

The domestic corporation was a "U. S. real property holding corporation" by definition under I.R.C. § 897. A foreign corporation pays no U.S. tax on its gains, when it sells or liquidates under section 332.12 its stock in a domestic corporation unless it is subject to sections 897 and 367. By "purging" the domestic corporation of U.S. real property interests before the liquidation, the foreign corporation eliminated the application of section 897 and 367. Thus, the foreign corporation would not recognize any gain on the distribution of the property. Any gain is exempt from income tax under Reg. 1.881-2(a) for the foreign shareholder.

V. CONCLUSION

Foreign enterprises, entering the U.S. market, have many decisions with respect to the cross-border entity structure, the extent of effectively connected U.S. trade or business, the use of debt financing and the treatment of real property for business or investment purposes. The existence of any tax treaties will influence most of the tax considerations. The decision with respect to the ownership of real property used by a U.S. corporation must consider many factors. Usually, appreciated real estate should not be held by a corporation because of double taxation. However, foreign shareholders may escape the double tax situation, if proper tax planning is performed for the entire cycle of property ownership from acquisition and ownership to a final purging of real estate interests before any sale.

The foreign investor may begin to acquire U.S. real property interests through a foreign corporation. The foreign corporation discovers that it must file a special tax return pursuant to the rules of section 882 and is subject to the section 884 dividend equivalent amount. A possible solution is the domestication of the foreign corporation to avoid being subject to the applications of section 882 and the branch profits tax. The domestication of the foreign corporation is nontaxable as an "F" reorganization and eliminates section 882 application, but is subject to sections 884 and 897. The reorganization could increase the transferor's dividend equivalent amount and trigger the branch profits tax liability under section 884. Section 897 could trigger the reorganization as a taxable event by a disposition of a U.S. real property interest.

However, a section 884 disposition does not include a transfer of stock pursuant to an "F" reorganization. For the nontaxable exception to apply for the "F" reorganization, the foreign corporation is required to attach a Form 8848 to its corporate income tax return for the year of domestication that extends the statute of limitations for the branch profits tax liability.

For purposes of section 897, stock received in an F reorganization qualifying for nonrecognition pursuant to section 354(a) will constitute the same interest in the corporation whose stock was exchanged for purposes of determining whether the interest received is a U.S. real property interest. Nonecognition would apply under section 897, but the foreign corporation would need to attach to their U.S. tax returns for the year of domestication a document setting forth information on the reorganization.

Subsequently, the foreign corporation may want to repatriate its real estate profits from the U.S., but how can it avoid taxable gain on the distribution. By "purging" the domestic corporation of U.S. real property interests before the liquidation, the foreign corporation eliminates the effectively connected U.S. trade or business exception under section 897 and would not recognize any gain on the distribution of the cash under section 367.

A foreign corporation pays no U.S. tax on its gains, when it sells or liquidates under section 332 its stock in a domestic corporation unless it is subject to sections 897 and 367. By "purging" the domestic corporation of U.S. real property interests, the foreign corporation eliminated the application of section 897 and 367 and would not recognize any gain on the distribution of the property.

ENDNOTES

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2 Treas. Reg. § 301.7701-3.

3 Treas. Reg. § 301.7701-2(b)(8).

4 I.R.C. §§ 871(i), 881(d).

5 I.R.C. § 881(c).

6 Except as noted, all statutory and section references herein are to the Internal Revenue Code of 1986 (26 U.S.C.), as amended, and all regulation references are to the U.S. Treasury Regulations.

7 I.R.C. §§ 881(a) and 1442.

8 I.R.C. § 882(a)(1).

9 I.R.C. § 875(1).

10 I.R.C. § 702(b).

11 I.R.C. § 1446.

12 I.R.C. § 884(a).

13 *Id.*

14 I.R.C. § 884(b).

15 *Id.*

16 I.R.C. § 1442.

17 I.R.C. § 884(e).

18 I.R.C. § 884(e)(2).

19 I.R.C. § 163(j).

20 I.R.C. § 163(j)(2)(A).

21 I.R.C. § 163(j)(2)(B).

22 I.R.C. § 163(j)(1)(A), (3)(A).

23 I.R.C. § 163(j)(5)(B).

24 Prop. Treas. Reg. § 1.163(j)-1(a)(1)(i).

25 Prop. Treas. Reg. § 1.163(j)-1(a)(1) and -8(a). Under section 1.163(j)-8, section 163(j) applies to U.S. branches of foreign corporations with effectively connected income.

26 Prop. Treas. Reg. § 1.163(j)-9 (reserved).

27 1984-2 C.B. 381.

28 1984-2 C.B. 383.

29 1989-2 C.B. 195.

30 INTL-870-89, 1991-2 C.B. 1040, 1044.

31 Omnibus Budget Reconciliation Act of 1993, 103d Con., 1st Sess., P.L. 103-66, 681 n. 55, 1993-3 C.B. 257.

32 Revenue Reconciliation Act of 1993, H.R. 2264, 103d Cong., 1st Sess. 185 (1993).

33 Aiken Industries, Inc. v. Commissioner, 56 T.C. 925, 934 (1971), *acq. on another issue*, 1972-2 C.B. 1.

34 *Id.*

35 T.D. 8611, 1995-37 I.R.B. 20.

36 T.D. 8611 at 289.

37 *Id.*

38 *Id.*

39 A financing arrangement means a series of transactions by which a financing entity advances money or property, or grants rights to use property and the financed entity receives money or property, or rights to use property, if the advance and receipt are effected through one or more intermediate entities and there are financing transactions linking all of the parties. Treas. Reg. § 1.881-3(a)(2)(i)(A).

40 Related means related as defined in sections 267(b) or 707(b)(1), or controlled as defined in section 482 and the underlying regulations. The constructive ownership rules of section 318 apply and the attribution rules of section 267(c). Treas. Reg. § 1.881-3(a)(2)(v).

41 The determination of "on substantially the same terms" is based upon all of the facts and circumstances. Treas. Reg. § 1.881-3(c)(1). There is a presumption that the intermediate entity would not have participated in the financing arrangement on substantially the same terms if there is a guarantee of the financed entity's liability to the intermediate entity. The presumption can be rebutted by clear and convincing evidence that the intermediate entity would have participated with the financed entity on substantially the same terms even if the financing entity had not entered into a financing transaction with the intermediate entity. Treas. Reg. § 1.881-3(c)(2).

42 A financing transaction means debt, stock, partnership interest, trust interest, lease, license, or any other transaction pursuant to which a person makes an advance of money or property, or grants rights to use property to a transferee who is obligated to repay or return money, property, or the equivalent in value. Treas. Reg. § 1.881-3(a)(2)(ii)(A). It includes an

advance of money for stock or a partnership interest if as of the issue date (1) the issuer of the stock or the interest is required to redeem the stock or partnership interest at a specified time or the holder has the right to require the issuer to redeem the stock or interest or to make any other payment with respect to the stock or interest, (2) the issuer has the right to redeem the stock or interest, but only if redemption pursuant to that right is more likely than not to occur, or (3) the owner of the stock or interest has the right to require a person related to the issuer to acquire the stock or similar interest. Treas. Reg. § 1.881-3(a)(2)(ii)(B)(1).

43 Treas. Reg. § 1.881-3(a)(4)(i)(standard for treatment as a conduit entity).

44 Treas. Reg. § 1.881-3(a)(3)(ii)(B).

45 Treas. Reg. § 1.881-3(b)(1).

46 *Id.*

47 *Id.*

48 FCC and FRC are members of the same controlled group of corporations as defined in I.R.C. §267(f).

49 I.R.C. §1442(a).

50 I.R.C. §267(a)(3).

51 *See* Treas. Reg. §1.482-2(a)(1)(i); -2(a)(2)(i) and - 2(a)(2)(iii)(B).

52 I.R.C. § 267(a)(3); Treas. Reg. § 1.267(a)-3.

53 103 T.C. 656 (1994), *rev'd and remanded*, 87 F.3d 99 (3d Cir. 1996).

54 Treas. Reg. §1.267(a)-3 (deduction of amounts owed to related foreign persons).

55 Related persons are defined under I.R.C. § 267(b).

56 I.R.C. §267(a)(2).

57 H. Rep. No. 98-432, 98th Cong., 2d Sess., *reprinted in* 1984 U.S.C.C.A.N. 697, 1206.

58 I.R.C. § 864(c)(4)(A).

59 I.R.C. § 864(c)(2), (3).

60 I.R.C. § 864(c)(4)(B).

61 I.R.C. § 864(c)(4)(B)(iii).

62 I.R.C. § 897(c)(1)(A); Treas. Reg. § 1.897-1(c)(1).

63 I.R.C. § 897(c)(6)(A); Treas. Reg. §§ 1.897-1(b)(2), (3), -1(d)(2).

64 Treas. Reg. § 1.897-1(d)(2).

65 I.R.C. § 897(c)(6)(B).

66 Treas. Reg. § 1.897-1(b)(4)(ii)(A).

67 Treas. Reg. § 1.897-1(b)(4)(ii)(A)-(D).

68 Rev. Rul. 73-522, 1973-2 C.B. 226.

69 *Id.*

70 I.R.C. § 882(d)(foreign corporation); see Rev. Rul. 77-174, 1977-1 C.B. 414 (A number of U.S tax treaties provide that nonresidents may elect to treat real property income as income attributable to a permanent establishment and taxed on a regular basis).

71 Treas. Reg. § 1.882-2(a).

72 Treas. Reg. § 1.1441-4(a)(2).

73 Form 1120-F is a U.S. Income Tax Return of a Foreign Corporation.

74 I.R.C. § 875(1).

75 Rev. Rul. 88-25, 1988-1 C.B. 116 ("F" reorganization occurred when foreign corporation filed under a state domestication law).

76 *Id.*

77 An "F" reorganization requires continuity of business enterprise and ownership. Rev. Rul. 89-103, 1989-2 C.B. 65; Rev. Rul. 88-25, 1988-1 C.B. 116.

78 Treas. Reg. § 1.367(b)-2(f)(4).

79 Treas. Reg. § 1.367(b)-2(f)(2).

80 Rev. Rul. 88-25, supra.

81 I.R.C. § 381(b).

82 I.R.C. § 382(g)(3)(A).

83 Treas. Reg. § 1.367(b)-3(b)(3)(inclusion of all earnings and profits amount).

84 Treas. Reg. § 1.367(b)-2(e)(2); Priv. Ltr. Rul. 95-120-01 (September 30, 1994). The "all earnings and profits amount" represents the U.S. shareholder's share of the foreign corporation's earnings and profits. Treas. Reg. § 1.367(b)-2(d).

85 *See* I.R.C. § 1248 (application only for U.S. shareholders).

86 Rev. Rul. 89-103, 1989-2 C.B. 65 (Sections 1246 and 1291 refer to a foreign investment company and a passive foreign investment company, respectively).

87 I.R.C. § 897(d).

88 Temp. Treas. Reg. § 1.897-6T(a)(1).

89 Temp. Treas. Reg. § 1.897-5T(d)(1)(iii).

90 I.R.C. § 897(c)(2).

91 Section 897(c)(2) pertains to "any corporation."

92 I.R.C. § 897(c)(4)(B); Treas. Reg. § 1.897-2(d)(4).

93 I.R.C. § 897(i)(1). Section 1445 concerns withholding of tax on dispositions of U.S. real property interests. Section 6039C concerns returns with respect to foreign persons holding direct investments in U.S. real property interests.

94 Temp. Treas. Reg. § 1.897-6T(a)(1).

95 *See* Notice 99-43, 1999-2 C.B. 344.

96 Notice 99-43, 1999-2 C.B. 344.

97 *Id.*

98 I.R.C. § 882 imposes U.S. corporate income tax on a foreign corporation engaged in a U.S. trade or business.

99 I.R.C. § 884(b)(2).

100 Temp. Treas. Reg. § 1.884-2T(d)(5)(ii).

101 *Id.*

102 Priv. Ltr. Rul. 96-040-30 (November 2, 1995)(a Section 368(a)(1)(E) recapitalization is not a disposition for purposes of the branch profits tax under section 884).

103 I.R.C. § 381(a) applies to a section 368(a)(1)(F) reorganization.

104 Temp. Treas. Reg. § 1.884-2T(c)(4).

105 I.R.C. § 897(c)(1)(A); Treas. Reg. § 1.897-1(c)(1).

106 I.R.C. § 897(c)(6)(A); Treas. Reg. § 1.897-1(b)(2), (3).

107 Treas. Reg. § 1.897-1(j).

108 Treas. Reg. § 1.897-3(a).

109 I.R.C. § 897(i)(1); Treas. Reg. § 1.897-3(b).

110 I.R.C. § 897(c)(1)(A)(ii).

111 I.R.C. § 897(c)(2)(A).

112 Treas. Reg. § 1.897-2(e)(1), Ex. 2.

113 Treas. Reg. § 1.897-1(c)(2)(iv).

114 Id.

115 I.R.C. § 897(c)(3); Treas. Reg. § 1.897-1(c)(2)(iii).

116 I.R.C. § 897(c)(2).

117 Treas. Reg. § 1.897-2(b)(2).

118 Treas. Reg. § 1.897-2(b)(2)(ii).

119 *Id.*

120 *Id.*

121 I.R.C. § 897(c)(4)(B).

122 I.R.C. § 897(c)(4)(B); Treas. Reg. § 1.897-2(d)(4).

123 Treas. Reg. § 1.897-2(e)(2).

124 *Id.*

125 I.R.C. § 897(c)(5)(A).

126 I.R.C. §897(c)(5); Treas. Reg. § 1.897-2(e)(3).

127 Treas. Reg. § 1.897-1(f)(1).

128 Treas. Reg. § 1.897-1(f)(2).

129 Treas. Reg. § 1.897-1(f)(2)(ii).

130 Treas. Reg. § 1.897-1(f)(3).

131 Treas. Reg. § 1.897-1(f)(4), Example (1).

132 Treas. Reg. § 1.897-1(f)(4), Example (2).

133 Treas. Reg. § 1.897-2(b)(1).

134 *Id.*

135 Treas. Reg. § 1.897-2(c)(1).

136 Treas. Reg. § 1.897-2(f)(1).

137 Treas. Reg. § 1.897-2(c)(2).

138 Treas. Reg. § 1.897-2(c)(1).

139 *Id.*

140 I.R.C. § 897(c)(2); Treas. Reg. § 1.897-2(f)(1).

141 Treas. Reg. § 1.897-2(h)(4)(i).

142 Treas. Reg. § 1.897-2(h)(5)(iv).

143 I.R.C. § 897(c)(1)(A)(ii)(II); Treas. Reg. § 1.897-2(f)(1).

144 I.R.C. § 1001(c).

145 See I.R.C. § 897(c)(1)(B); Treas. Reg. §§ 1.897-1(c)(2)(ii), -2(f).

146 I.R.C. § 897(c)(1)(B).

147 I.R.C. § 897(c)(1)(B); Treas. Reg. § 1.897-2(f)(2).

148 I.R.C. § 897(c)(1)(B)(ii)(II); Treas. Reg. § 1.897-2(f)(2)(ii).

149 Treas. Reg. § 1.367(e)-2(b)(1).

150 Notice 87-66, 1987-2 C.B. 376, 377.

151 Temp. Treas. Reg. § 1.897-5T(b)(3)(iv).

152 Treas. Reg. § 1.367(e)-2(b)(2)(ii).

153 Temp. Treas. Reg. § 1.897-5T(b)(3)(iv)(A).

154 Temp. Treas. Reg. § 1.897-5T(b)(3)(iv).

155 *Id.*

156 I.R.C. § 1445(e)(3); Treas. Reg. § 1.1445-5(b)(3), -5(e).

157 Treas. Reg. § 1.1445-5(b)(5)(i).

158 I.R.C. § 1445(e)(3); Treas. Reg. § 1.1445-5(e)(2)(i).

159 Treas. Reg. § 1.1445-5(e)(2)(i).

160 See Notice 86-17, 1986-2 C.B. 379.

161 I.R.C. §§ 881, 882.

TAX TREATMENT OF CONTINGENT ATTORNEY'S FEE

by Alan Chew, CPA, JD[1]

The Fifth Circuit's Position on the Tax Treatment of Contingent Attorney's Fee.

What are the differences in tax treatment between receiving a damages award from a lawsuit and separately paying the attorney's fee, and alternatively, first setting up a contingency fee arrangement with the attorney at the onset of the suit? While not knowing the answer may prove costly to the taxpayer, the proper answer will nonetheless depend on the venue of the suit. Fortunately, Texas is under the favorable jurisdiction of the Fifth Circuit, which excludes such contingent attorney's fees from gross income to the litigant-recipient of the damages award, thereby subjecting only the net award amount to income taxation. In analyzing the above question, this article will review: (1) the concept of gross income and the anticipatory assignment of income doctrine; (2) the circuits' split on the application of the anticipatory assignment of income; (3) the reasons for and against including the contingent attorney's fees in gross income; (4) the current position of the Fifth Circuit on the issue; (5) the oppositions to the Fifth Circuit's line of reasoning; (6) the differing tax treatments under the majority and minority circuits' holdings; and (7) finally, the implications on setting up an attorney-client's engagement letter.

Concept of Gross Income and the Anticipatory Assignment of Income Doctrine.

Section 61(a) of the Internal Revenue Code defines "gross income" to mean "all income from whatever source derived."[2] This definition is broadly interpreted by the Supreme Court, which has held that it is "the intention of Congress to tax all gains except those specifically exempted."[3] Income is, however, not taxable until it is realized, which occurs when the taxpayer receives the benefit of the income rather than when the taxpayer acquires the right to receive it.[4] A taxpayer can also realize income not only by being paid, but by obtaining fruition of the economic gain that has already accrued to the taxpayer.[5] Thus, income can be realized regardless of whether the amount ever passed through the taxpayer's hands.[6] Such principles coincide with the accrual accounting method of income recognition under the Generally Accepted Accounting Principles (GAAP).

At the heart of the controversy that created the current split in the circuits involves the mixed applications by the various circuit courts of the doctrine of anticipatory assignment of income. Under this doctrine, a taxpayer is deemed a recipient of taxable income even though the taxpayer has assigned or shifted the income-producing property to another party while still effectively retaining control of the property. The U.S. Supreme Court first developed this doctrine in the landmark cases of *Helvering v. Horst*[7] and *Lucas v. Earl*.[8]

In *Horst* the Court opined that:

> [The anticipatory assignment of income doctrine states that] income is "realized" by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them.[9]

There, the taxpayer owned negotiable bonds, but he detached from the bonds the negotiable interest coupons to give as gifts to his son while still owning the titles to the negotiable bonds. The Court held the arrangement as an anticipatory assignment of income because the donor-taxpayer had continued to retain control of the bonds even after gifting the interest coupons to his son. The Court explained that "[w]hen, by the gift of the coupons, he has separated his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings."[10]

Earlier in *Lucas*, the Court had similarly held that a taxpayer is attributed all the income, under the anticipatory assignment of income doctrine, even though he had creatively contracted with his wife to receive half of his future income.[11] In so holding, the Court made famous the metaphor that when "the fruits are attributed to a different tree from that on which they grew," anticipatory assignment of income would be held.[12] Hence, in determining whether there is an anticipatory assignment of income, a court will determine whether a taxpayer continues to have dominion and control over the source of the income after it has been assigned to another party.[13]

Circuits Split on Application of the Anticipatory Assignment of Income Doctrine.

The anticipatory assignment of income doctrine has since been subject to much analyses and critiques by the courts when dealing with the tax treatment of contingent attorney's fees. The varied arguments employed by the circuits have created a current split: the majority of the circuits, First, Second, Third, Fourth, Seventh, Ninth, Tenth, and Federal Circuit, have supported including such fees in gross income,[14] while the minority renegade circuits, Fifth, Sixth, and Eleventh Circuits, have excluded these fees from gross income.[15] The significance of this spit is that until the Supreme Court decides to intervene, a Tax Court in a particular jurisdiction must adhere to the tax law as promulgated by the Circuit Court of Appeals that maintains jurisdiction over appeals of that particular Tax Court's decision. This adherence principle is mandated under the decision in Golsen v. Commissioner, where the court held that "better judicial administration requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone."[16] Although the issue appears ripe for a Supreme Court review, the Court has nevertheless refrained from interfering by repeatedly denying certiorari in relevant cases; presumably, as some critics observed, the Court "has reasoned that these tax decisions could be based on the vagaries of how attorneys' liens are treated under applicable state law."[17]

Reasons For and Against Including the Contingent Attorney's Fees in Gross Income.

Generally, courts have been known to look to state law in determining property interests while employing federal law to determine the tax consequences of the receipt or disposition of such a property.[18] Applying this common principle, some courts, when dealing with a contingent attorney's fee issue, would naturally begin by analyzing the respective state laws to determine the relative strength of the litigant's interest in the cause of action as compared to the attorney's interest in the contingency fee. If the attorney's interest in the fee were found to be strong, these courts have held that the attorney had a property interest in the fee, which was then deemed exclusive of the client's interest. Under such a holding, the courts would conclude that the fee was never income to the client, but only to the attorney.[19] Other courts have, however, supported their arguments for including the contingency fee in gross income of the litigant-taxpayer by holding that even though state law might provide an interest in the fee to an attorney, the interest was merely a security interest, and not in the nature of a proprietary or property interest. Thus, these courts would conclude that the attorney did not acquire an interest in the cause of action, and the fee was plainly income to the taxpayer who remained in control and dominion of the source of income - or utilizing the fruit/tree metaphor, the "tree."[20]

The first case that dealt with the tax treatment of a contingency attorney's fee arrangement was the seminal Fifth Circuit's case of *Cotnam v. Commissioner*.[21] There the court held that the anticipatory assignment of income doctrine did not apply to the contingency fee paid to the taxpayer's attorney because under the attorney's lien statute of Alabama, an attorney has the same rights as his or her clients such that the attorney is in fact allowed an equitable lien in both the cause of action and the recovery judgment.[22] Consequently, the court held that the taxpayer had not realized income as to the portion of the award that went to his attorney as a percentage interest in the cause of action and judgment, and had not fully enjoyed the economic benefit of the whole judgment to implicate the anticipatory assignment of income doctrine.[23] The court further justified its holding by stating that the taxpayer was never obligated to pay the contingent attorney's fee since the fee was only payable upon prevailing in the suit, and the attorney's fee was fully paid through the assignment of a portion of a doubtful claim. Thus, in the language of the "fruit and tree" metaphor, the taxpayer's tree had borne no fruit and would have been fruitless had the taxpayer not transferred a part interest in the tree itself to his attorney, who rendered the necessary services to bring forth the fruit. Hence, the taxpayer had not retained ownership of the assigned tree to trigger the anticipatory assignment of income doctrine.[24] The *Cotnam's* holding was, however, not shared by the majority circuit.

The Current Position of the Fifth Circuit.

Following up on *Cotam*, the Fifth Circuit further complicated the issue with another controversial case in *Srivastava v. Commissioner* by employing a seemingly inconsistent analysis to derive an uncharacteristic holding.[25] The case was similar to *Cotnam*, except it had involved a Texas' attorney's lien statute that had afforded the taxpayer's attorneys a lesser degree of power to enforce their rights than that allowed for under the Alabama's attorney's lien statute in *Cotnam*.[26] Like *Cotnam*, the court ultimately rejected the application of the anticipatory assignment of income doctrine, holding that a portion of the settlement amount payable to the taxpayer's attorneys under a contingency fee arrangement did not constitute gross income.[27]

The *Srivastava* court's reasoning was, however, less than convincing. Initially, the court argued extensively in its opinion against the taxpayer stating that, if not for the contingency attorney's fee agreement, the taxpayer would have had to compensate his attorney out of his own pocket, and should not have received preferential treatment simply from the fortuity of hiring an attorney on a contingency fee basis.[28] Next, the court stated that if it had decided the case *tabula rasa*, or as an original matter on a clean slate without the *Cotnam* precedent, it might have applied the anticipatory assignment doctrine to hold against the taxpayer that the contingency fees were gross income to the taxpayer.[29] But strangely, after having articulated against the taxpayer in much of the opinion, the court nevertheless held for the taxpayer because it simply felt compelled to apply the *Cotnam's* ruling under the principle of *stare decisis*, which is the doctrine of precedent under which a court is to follow earlier judicial decisions when the same points arise again in a subsequent litigation.[30]

The *Srivastava* court had an opportunity but it refrained from distinguishing *Cotnam* based on the differences in the state attorney's lien laws of Alabama and Texas that would determine the attorney's proprietary interest in the separate suits. Instead, in seemingly contradictory languages to its earlier holding in *Cotnam*, the court wrote that "[w]hatever are the attorney's rights against the [taxpayer] under Texas law as opposed to Alabama law, the discrepancy does not meaningfully affect the economic reality facing the [taxpayer]" and "irrespective of whether it is proper to tax contingent attorney's fees under the anticipatory assignment doctrine, the answer does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state."[31] In other words, the Fifth Circuit apparently disregarded in its reasoning the *Cotnam's* approach of looking to state law in determining the parties' respective interests in the cause of action even though the court had adopted the *Cotnam's* ruling in its final holding.[32]

Oppositions to the Fifth Circuit's Line of Reasoning.

The Fifth Circuit's reasoning in *Srivastava* has struck a discord with scholars, and has since been subject to much criticism. One scholar argued that the strict adherence to a holding of a 41-year-old precedent in *Cotnam* was wrong, especially when the court had noted in its own analysis that it found the *Cotnam* line of reasoning unpersuasive, and in contravention to the wisdom of former Supreme Court Justice Hugo Black who stated that "when precedent and precedent alone is all the argument that can be made to support a court-fashioned rule, it is time for the rule's creator to destroy it."[33] Another scholar concurred noting that "the analysis of the majority [Justices of the *Srivastava's* court] followed more from unwillingness to distinguish *Cotnam* than from a logical and practical analysis of the inclusion of contingency fees in a litigant taxpayer's gross income."[34] Notably, only the Fourth and the Sixth circuits have since followed the *Srivastava's* line of reasoning in refusing to look to a state's lien law when deciding on the tax treatment of contingent attorney's fee.[35]

The response of the Internal Revenue Service (IRS) in a private letter ruling (PLR) also suggests that it would look to state law in determining whether a contingent attorney's fee should be included in the taxpayer's gross income.[36] There, after reviewing the various circuits' conflicting case law on the issue, the IRS opined that the particular state law in which the taxpayer was subject to did not grant the taxpayer's attorney a lien in the taxpayer's cause of action. The IRS argued further that even if the state law had allowed an attorney to "have a claim on a judgment that is superior to that of a defendant's right to set-off, that common factor does not mean that attorney could exercise dominion and control over the cause of action or judgment while it was on appeal."[37] Thus, looking to the provisions under state law, the IRS held the contingency fee paid to the taxpayer's attorney was includible in gross income by analogizing the taxpayer's situation to the case of *Benci-Woodward v. Commissioner*, where the court there similarly noted that the California state law did not confer ownership interest or any rights upon attorneys over their suits.[38]

The IRS would also review the provisions under a contingency fee agreement on a case-by-case basis. In holding against the taxpayer in the PLR, the IRS reviewed the contingency fee arrangement noting that the taxpayer's "attorney merely provided services to [the taxpayer] and agreed to be paid out of any settlement that [the taxpayer] received."[39] Therefore, the attorney did not gain an interest in the suit and the contingency fee was taxable as gross income to the taxpayer. But whether the IRS would continue to follow the PLR's approach in a Fifth Circuit's case after *Srivastava* remains uncertain, especially when a PLR is not a source of authority that could be cited to as a precedent.[40]

The latest major development in this controversy likewise favors the majority's stance. While the debate rages on like wild fire in the various circuits, the influential and highly regarded Second Circuit that has long been conspicuously missing in this debacle has finally offered its view in the case of *Raymond v. United States*.[41] There, the taxpayer argued that that contingent attorney's fee paid by the taxpayer should not be included in his gross income because, under the Vermont state law, the interest that his attorney has in the contingent-fee portion of the judgment is a property interest, which the taxpayer does not own.[42] The Second Circuit, utilizing the dominion and control argument, disagreed stating that "the concept of property is not exhausted by the right to possess; it is also about the right to control."[43] Citing *Horst*, the court opined that "exercising the right to 'control disposition' of a fund is sufficient for the realization of taxable income."[44] Thus, the court held the contingent attorney's fee was income to the taxpayer because he has "controlled" the source of the judgment income, and had diverted the judgment payment from himself to his attorney for the satisfaction of his wants.[45] Hence, the taxpayer was deemed to have sufficient dominion and control of the whole judgment award to warrant inclusion in his gross income the portion used to pay the contingent attorney's fee.

Differing Tax Treatments under the Majority and the Minority Circuits' Holdings.

The Internal Revenue Code specifically states that compensatory damages received on accounts of personal injuries or sickness are exempt from taxation while punitive damages are included in gross income and taxable.[46] Any related interest income on both the compensatory and the punitive damages amounts are also taxable as gross income.[47] Accordingly, the following discussion on the differing tax treatments of contingent attorney's fees by the various circuits would primarily relate to the receipts by the litigant-taxpayer of punitive judgment awards, and actual damages that have been deemed by the courts as not solely awarded for personal injuries or sickness.

The differing tax treatment methods were presented in *Srivastava*. The Fifth Circuit noted that if the contingent attorney's fee were included within gross income, the deductibility of which would depend on its classification as either an "ordinary and necessary expense paid or incurred * in carrying on any trade or business," or as an "ordinary and necessary expense paid or incurred * for the production or collection of income."[48] That is, if included within gross income, the test of how the attorney's fee is deducted will depend on *whether* the expense is characterized as a business or a personal expense.[49] Under the business expense classification, the fee is potentially 100-percent deductible while under the personal expense classification, the fee will be deducted as a miscellaneous itemized deduction subject to the 2-percent floor of adjusted gross income.[50] But because the Fifth Circuit (including Texas) excludes such contingency fee from gross income, only the net damages amount, after subtracting the contingent attorney's fee from the judgment award, will be taxable as gross income to the taxpayer.[51]

Finally, the Alternative Minimum Tax (AMT) scheme would reduce the miscellaneous itemized deduction amount that a taxpayer could take if the contingent attorney's fee were included in gross income. In circuits that require the contingent attorney's fee to be included in gross income, the AMT system will operate to preclude the taxpayer from deducting the contingent attorney's fee, because miscellaneous itemized deductions are not allowed to offset gross income in computing the AMT.[52] Of course, under the current Fifth Circuit's position that a contingent attorney's fee paid from a judgment award is precluded from gross income, the deductibility issue under the AMT scheme would not even be applicable.

Implications on Setting Up Attorney-Client's Engagement Letter.

Until the Supreme Court decides to grant a *certiorari*, this issue will no doubt remain unsettled. For this reason, some commentators believe it would be prudent to set up explicit languages in the attorney's engagement letter stating that such contingency fees, if any, will be "directly paid" from the damages award to the taxpayer's attorney so as to possibly avoid the anticipatory assignment of income doctrine.[53] This suggestion is based on the premise that the result of the taxpayer's lawsuit is speculative and dependent on the lawyer's services; therefore, there will be room to argue that the portion of the damages award assigned by the taxpayer to his or her attorney as a contingency fee has not already been earned, vested and relatively certain to be awarded as judgment to the taxpayer that would require the recognition of such a fee as taxable gross income.[54]

Furthermore, in holding against the taxpayer in the PLR mentioned above, the IRS had in fact reviewed the contingency fee agreement to conclude that the taxpayer there did not transfer any interest in the judgment or the cause of action to the taxpayer's attorney.[55] Hence, strong terms should be provided in the attorney's engagement letter to expressly state when interest in the case is assigned to the lawyer since the IRS would likely look to the languages contained under a contingency fee agreement to determine if interest in the judgment or in the cause of action has been transferred. Such terms would include how the award payments will be made, and which party will receive any Forms 1099 or W-2 in an ultimate settlement agreement. The rationale for these measures is that even if such provisions should fail to influence a particular court, they could still potentially serve as valuable tools in assisting in the negotiation and resolution of tax controversies with the IRS.[56]

Conclusion.

As noted, the presumption of the Supreme Court is to let individual state's attorney's lien laws decide the attorney's interest in a case to determine whether a contingency fee should properly be included in the gross income of the litigant-taxpayer. The Court would therefore be unlikely to grant a new *certiorari* request based simply on such a distinction when it had previously refused to review similar cases. But after the controversial Fifth Circuit's holding in *Srivastava*, which unexpectedly refused to distinguish *Cotnam* but ruled that the recognition of contingent attorney's fee would not be based on the provisions under state law, and arguably, not under the traditional application of the anticipatory assignment of income doctrine as well, the Court may be enticed with a new incentive to resolve the issue once and for all.

Until the Court agrees to resolve this controversy, a litigant-taxpayer under the Fifth Circuit, which includes Texas, would not have to include in gross income any contingency fee paid out of the any judgment award to the taxpayer's attorney under a contingency fee arrangement. Consequently, only the net damages award, after deducting the contingent attorney's fees, granted to a Texas taxpayer will be included in his or her gross income and be subject to income taxation. Such a tax treatment by the Fifth Circuit would also have no AMT effect because the AMT scheme will not be applicable under the net award method of income recognition.

[Note: since the completion of this article, and as suggested herein, the U.S. Supreme Court has finally decided to grant *certiorari* to resolve the split in the Circuits by consolidating the cases, *Banks v. Comm'r*, 345 F.3d 373 (6th Cir. 2003) and *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003). See *Comm'r v. Banks*, 124 S. Ct. 1712 (Mar. 29, 2004)].

ENDNOTES

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2 I.R.C. § 61(a) (2003).

3 *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955).

4 *See Horst*, 311 U.S. at 115.

5 *Id.*

6 *See Id.* at 116.

7 311 U.S. 112 (1940).

8 281 U.S. 111 (1930).

9 *Horst*, 311 U.S. at 116-117.

10 *Id.* at 119-20.

11 *Lucas*, 281 U.S. at 113-15.

12 *Id.* at 115.

13 *See Comm'r v. First Sec. Bank*, 405 U.S. 394, 403 (1972) (Holding that a taxpayer must have complete dominion over income for it to be taxable).

14 *See Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995); *Raymond v. United States*, 2004 U.S. App. LEXIS 417 (2d Cir. Jan. 13, 2004); *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963); *Young v. Comm'r*, 240 F.3d 369 (4th Cir. 2001); *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001); *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 532 U.S. 1056 (2002); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

15 *See Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959).

16 54 T.C. 742, 747 (1970), *aff'd on other grounds*, 445 F.2d 985 (10th Cir. 1971).

17 Robert W. Wood & Dominic L. Daher, *Attorney Fees: Rebellious Circuit Don't Need No Stinkin' Lien Law*, TAX PRACTICE, Jan. 2, 2004, at p22; *see supra note 13*.

18 *See United States v. Nat'l Bank of Commerce*, 472 U.S.713, 722 (1985); *Morgan v. Comm'r*, 309 U.S. 78, 80 (1940) ("State law creates legal interest and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.").

19 *See Cotnam*, 263 F.2d 119; *Estate of Clark*, 202 F.3d 854

20 *See Raymond*, 2004 U.S. App. LEXIS 417 at *7; *Young*, 240 F.3d at 379 n.7.

21 263 F.2d 119 (5th Cir. 1959).

22 *Id.* at 125-26.

23 *Id.*

24 *Id.* at 126.

25 220 F.3d 353 (5th Cir. 2000).

26 *Id.* at 363 & n.32.

27 *Id.* at 367.

28 *Id.* at 363.

29 *Id.* at 357, 363.

30 *Id.* at 363.

31 *Id.* at 364-65.

32 *See Banks v. Comm'r*, 345 F.3d 373, 384 (6th Cir. 2003) (Agreeing with the Fifth Circuit in refusing to draw distinctions between contingency fees based on the attorney's lien law of the state in which the fee originated).

33 Benjamin C. Rasmussen, Note, *Taxation of an Attorney's Contingency Fee of a Punitive Damages Recovery: The Srivastava Approach*, 15 BYU J. Pub. L. 301 (2001) (citing Francis v. S. Pac. Co., 333 U.S. 445, 471 (1948) (Black, J., dissenting).

34 Stephanie M. Smith, Note, *Fifth Circuit Holds That Portions of Settlements Payable to Taxpayer's Attorney Pursuant to a Contingent Fee Agreement Under Texas Law Do Not Constitute Gross Income to the Taxpayer - Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000), 54 SMU L. Rev. 461, 465 (2001).

35 *See Banks*, 345 F.3d 373 (6th Cir. 2003); Young, 240 F.3d at 378.

36 Priv. Ltr. Rul. 200107019 (Feb. 16, 2001).

37 *Id.* at *25.

38 *Id.*; see 219 F.3d 941 (9th Cir. 2000).

39 Priv. Ltr. Rul. 200107019 at *25.

40 *See* I.R.C. § 6110(k)(3) (2003) ("Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent.").

41 *Raymond*, 2004 U.S. App. LEXIS 417 at *24.

42 *Id.* at *20.

43 *Id.* at *21.

44 *Id.* (citing *Horst*, 311 U.S. at 116-117).

45 *Id.* at *24.

46 I.R.C. § 104(a)(2) (2003) ("[G]ross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as a lump sums or as periodic payments) on account of personal physical injuries or physical sickness").

47 I.R.C. § 61(a)(4) (Including interest within gross income); *see Wheeler v. Comm'r*, 58 T.C. 459 (1972) (Interest payments assessed as part of judgment in addition to damages are taxable as ordinary income).

48 *Srivastava*, 220 F.3d at 356 & n.6 (citing I.R.C. §§ 162(a), 212(1)).

49 *See id.* (citing *United States v. Gilmore*, 372 U.S. 39, 49 (1963)).

50 *See id.* at 357 n.7; see also Coady, 213 F.3d 1187; *Alexander v. Internal Revenue Service*, 72 F.3d 938, 944-46 (Holding that legal fees incurred should be included in gross income and deducted as a miscellaneous itemized deduction).

51 *See Srivastava*, 220 F.3d 353; Cotnam, 263 F.2d 119.

52 I.R.C. § 56(b)(1)(A)(i) (Deduction is not allowed for any miscellaneous itemized deduction); *see also Raymond*, 2004 U.S. App. LEXIS 417 at *24. (Stating that the Alternative Minimum Tax would preclude the taxpayer from taking advantage of the deduction of contingent attorney's fee paid); *Kenseth* , 259 F.3d at 884-85; *Campbell*, 274 F.3d at 1314-15.

53 *See supra* note 15, at 24-25.

54 *Id.* at 24.

55 *See supra* note 35.

56 *See supra* note 15, at 25.

U.S. INTERNATIONAL TAX DEVELOPMENTS - 2004

William P. Streng[1]

I. The Current U.S. International Tax Environment

During 2004 the U.S. Congress has been examining (unsuccessfully, thus far) a response to the World Trade Organization (WTO) decision determining the U.S. export tax subsidy regime to be illegal under international trade rules. Democratic Presidential candidate John Kerry is challenging his opponent concerning allowing U.S. corporations to expatriate to tax haven countries, changing their organizational status to foreign while continuing to have significant operations in the United States. Foreign corporations continue to make major business acquisitions in the United States premised (some assert) upon having a better after-tax competitive position in the U.S. (because of transfer pricing and earnings stripping advantages) than their frustrated U.S. corporate competitors. The Internal Revenue Service is challenging certain charitable foundations as supporting international terrorism. Meanwhile, the U.S. Department of the Treasury has embarked on an aggressive program for renovating the bilateral income tax treaty structure of the United States.

These are examples evidencing current evolving issues impacting U.S. income taxation, as relevant to business and investment transactions. Against this background the objective of this presentation is to identify some important recent developments in U.S. cross border income taxation.[2] These include the U.S. rules concerning the export incentive tax legislation, tax havens, taxation of inbound investment and business activities, taxation of outbound investment arrangements, and tax treaties.[3] Finally, an identification of some interesting foreign country tax developments is included so as to enable a comparison with U.S. tax rules and to identify possibilities for certain worldwide tax planning by U.S. based enterprises.

For those readers who consider themselves domestic tax advisors with little exposure to cross border transactions (and perhaps limited interest in this subject) several observations seem appropriate:

1) many parallels exist between the U.S. domestic tax rules and the U.S. cross-border tax rules (sometimes enabling answers for domestic questions to evolve from an examination of the U.S. cross border tax rules);
2) in many situations the continuing evolution of the cross border tax rules mandates fundamental considerations of appropriate U.S. tax policy important for examination by tax professionals, and
3) the globalized world is confronting many more cross border commercial transactions, causing many to realize that these cross border tax rules will become ever more pervasive.

II. Possible 2004 Federal Tax Legislation

A. The ETI Controversy in Perspective

The United States has some of the lower income tax rates among developed countries in the world, but has determined that special tax incentives to exporters are essential for getting export transactions consummated.[4] The U.S. can not seem to "get it right", however, in providing export tax incentives to U.S. based manufacturers. The World Trade Organization (WTO) has declared the DISC, then the FSC, and now the ETI (extraterritorial income exclusion) export tax incentive systems to be illegal under world trading rules.[5] Under present IRC § 114 an exclusion from gross income of a U.S. taxpayer is available for "extraterritorial income", defined as gross income of the taxpayer attributable to "foreign trading gross receipts" (as defined in IRC § 942) of the taxpayer.[6]

The patience of the European Union (EU) has been severely tried as EU representatives have been repeatedly assured by U.S. Administration and U.S. Congressional representatives that a legislative remedy would be implemented in the U.S., but no resolution has occurred as of late Summer, 2004. The EU (after giving significant advance warning to the U.S. Congress) began imposing the first stage of over $4 billion in sanctions against U.S. exports because the ETI legislation was not terminated by March 1, 2004. These sanctions come at a time when the trade deficit has further mushroomed even though the U.S. dollar value has been falling, when compared to the Euro.

B. Possible ETI Repeal Legislation & The Christmas Tree Bill Effect

The Bush Administration's Fiscal Year 2005 Budget submitted to the U.S. Congress on February 2, 2004 contributed little (if anything) towards the resolution of this issue. The U.S. Department of the Treasury's "General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals" provides little more than a notation that the ETI provisions must be repealed to comply with the WTO rulings regarding the FSC and ETI provisions:

> "The ETI provisions should be replaced with tax law changes that preserve and enhance the global competitiveness of U.S.-based businesses and American workers. The Administration intends to work with the Congress on prompt enactment of legislation that satisfies the twin goals of honoring our WTO obligations and making changes to our tax law to promote the competitiveness of American manufacturers and other job creating sectors of the U.S. economy."

This Explanation identifies in general terms (less than one page) a number of possible approaches: Extensions of both the R&E tax credit and increased spending for small businesses; corporate income tax rate reduction; alternative minimum tax reform; reexamination of depreciation rules; and rationalization of the U.S. international tax rules. The Explanation then concludes: "The Administration looks forward to working closely with the Congress on prompt enactment of legislation that brings our tax law into compliance with WTO rules with changes that will enhance the competitiveness of American businesses and the workers they employ." Obviously the task in this context belongs to the U.S. Congress.

Several versions for ETI repeal legislation have been debated in the U.S. Congress for an extended period: H.R. 2986, the "American Jobs Creation Act of 2003", and, S. 1637, the "Jumpstart Our Business Strength Act." The House measure offered a 3 percent point rate cut for U.S.-based manufacturing and international relief focused mostly on the deferral provisions under Subpart F (and was predicted to cost $60 billion over 10 years). The revenue neutral Senate bill would provide a deduction for manufacturers and would offer global tax relief based mainly on foreign tax credits.[7]

The tax writers in the U.S. House of Representatives subsequently asked the Bush Administration for help in achieving the repeal of the ETI legislation.[8] Before the March 1, 2004 deadline House Ways & Means Committee Chairman Thomas noted his concern "that we're running out of time."[9] Many Democrats adamantly oppose H.R. 2896, with House Ways & Means Committee Ranking Member Charles Rangel stating that the Thomas Bill (H.R. 2896) would enact $40 billion in tax breaks for offshore operations of U.S. based multinational companies and would result in the movement of thousands more jobs to offshore locations. The Thomas bill evolved into H.R. 4520. The Senate bill passed with many extraneous riders attached, as described below.

The E.U. representatives, particularly those from "Old Europe", have probably enjoying watching this scenario evolve, particularly during a presidential election year. March 1, 2004 has come and gone and the special tariffs are being imposed on U.S. exports–even as the news becomes worse about the increasing U.S. trade deficit. Even as the tariffs rachet up on a monthly basis the U.S. Congress seems almost gridlocked in seeking a resolution to this issue. During late summer House Speaker Hastert said that he continues to believe that the U.S. Congress needs to complete final action "before the end of the year" on legislation that would repeal the U.S. export tax regime.[10] In a speech before the National Press Club he indicated that "we have to finish the international tax bill that will keep more jobs here in America instead of the outsourcing that everybody talks about overseas."

By late summer 2004 the House and Senate bills had coalesced into two versions of H.R. 4520 (the Senate version originally numbered S. 1637).[11] The Senate version of the legislation (based on S. 1637) would repeal the U.S. export tax regime and replace it with about $174 billion in various kinds of corporate tax relief over ten years. As passed by the Senate on July 15 the bill would include a provision that would end the federal tobacco subsidy through a buy-out program and would allow the Food and Drug Administration to regulate the tobacco industry. In this bill extraneous to taxation are the various nontax provisions containing intergovernmental mandates (as defined in the Unfunded Mandates Reform Act).

When enactment will come remains problematical. Whether any ETI repeal legislation is passed in any late 2004 session of the U.S. Congress (particularly before November elections) seems possible, but unlikely. Perhaps (dependent upon election results) this will await the next Congress. Meanwhile the penalties resulting from the WTO decision continue to increase.

C. The Debate on Corporate Inversions and Outsourcing

An issue which has become highly politicized during 2004, including, particularly during the 2004 Presidential campaign, is the issue of "corporate inversions" and the outsourcing of U.S. based jobs. This is often coupled with suggestions by some that the Subpart F, controlled foreign corporation (CFC) regime be considerably strengthened. Corporate inversions are those arrangements where the U.S. corporation becomes a foreign corporation, thereafter being outside U.S. tax jurisdiction (assuming no CFC status). A publicly traded company would not likely be a CFC. Of course, the income of that foreign enterprise would thereafter be subject to U.S. income tax if realized by a U.S. subsidiary or U.S. branch of a foreign corporation. The profits distributions outbound from the United States as dividends would also be subject to tax withholding at source, subject to possible reduction or elimination under an applicable U.S. income tax treaty. However, much of the "profits" in the U.S. may have already been "stripped" out of the U.S. through borrowing arrangements, technology licensing, and similar structures to facilitate both deductions to the payor and limited tax to the (now foreign) corporate parent.

This is a quite large U.S. international tax policy issue. It ultimately involves the question of whether the U.S. provides a level tax playing field for both domestic and foreign business enterprises in the United States. The manner in which this debate tilts and how these important issues will be resolved will be very much determined by the 2004 presidential election.[12]

III. Outbound Investment from the United States

A. The Impact of Using Foreign Disregarded Entities

In IRS Announcement 2004-4, 2004-4 I.R.B. 357, the Service requested comments concerning a proposed new form, IRS Form 8858, "Information Return of U.S. Persons With Respect to Foreign Disregarded Entities." The form will be required to be filed by U.S. persons that own a foreign disregarded entity (FDE) directly or, in certain circumstances, indirectly or constructively (for example, U.S. persons that own a 10 percent or greater interest in an FDE indirectly through a controlled foreign corporation (CFC) or controlled foreign partnership (CFP)). This form had not been officially released as of late summer, 2004.

In this Announcement the Service indicated that Proposed Form 8858 was developed to enable the Service to administer more efficiently the provisions of the tax law with respect to U.S. persons that own FDEs. The promulgation of the elective entity classification regulations in 1997 has facilitated the use of FDEs by U.S. persons with cross-border investments or operations.[13] The Service has had significant difficulties administering the relevant provisions of the tax law because the information reporting requirements still date from a time when the substantive entity classification rules did not contemplate disregarded entities. The current lack of relevant information reporting with respect to FDEs apparently has hindered the Service's ability to identify potential compliance issues efficiently and effectively. The Service indicated it is committed to reducing the length of the corporate examination process and improving the currency of examinations. The information to be reported on Form 8858 will help the Service identify issues more efficiently, ensuring that the Service can better focus resources and reduce exam cycle time. This Announcement has a series of Questions and Answers concerning under what circumstances this form will be required to be filed.

B. Notice 98-5 and the "Listed Transactions" Rules

Notice 98-5[14] was earlier issued in the midst of the Compaq Tax Court litigation, but Compaq subsequently won its tax case, Compaq Computer Corp. v. Commissioner,[15] involving a foreign tax credit arbitrage arrangement involving about $1 billion and completed in slightly more than one hour. In Notice 98-5 the Service described several methods of foreign tax credit arbitrage that multinational companies have used to get the benefit of the foreign tax credit without actually incurring the economic burden of the foreign tax. The regulations threatened by this Notice 98-5 have not been issued. In Notice 2000-15[16] the Service did specify that, for purposes of identifying certain tax shelter arrangements, certain transactions identified in Notice 98-5 are "listed transactions", i.e., the transactions described in Part II of Notice 98-5 (transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits). This was reaffirmed in Notice 2001-51,[17] and subsequently reaffirmed in Notice 2003-76,[18] issued late in 2003.

The sequel to Notice 98-5 was served up by the Service in Notice 2004-19.[19] Nicholas DeNovio, senior counsel to the IRS Chief Counsel, had indicated earlier during 2004 that the Service would issue new guidance on "abusive transactions" under Notice 98-5. He indicated that this guidance "will be consistent with our overall goal of being very focused in targeting abusive transactions without impeding legitimate tax planning and without impeding cross-border structures."[20] In Notice 2004-19 the Service has withdrawn the economic profit test established in Notice 98-5 to enable identification of abusive foreign tax credit transactions. Regulations are to be forthcoming. Perhaps an important element of this debate is the risk in litigation of a result challenging the application (and even the fundamental premises) of an economic profit test in determining whether transactions are tax appropriate.

Further, in the Bush Administration's 2005 Budget Proposals a proposal is included to specify that the minimum holding period requirement for obtaining a foreign tax credit for foreign taxes paid with respect to dividends would be expanded to disallow any foreign tax credit with respect to any item of income or gain from property if the taxpayer that receives the income or gain has not held the property for more than 15 days (within a 30 day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. In addition, the legislative proposal would grant regulatory authority to the Treasury Department in order to address transactions "that involve the inappropriate separation of foreign taxes from the related foreign income in cases where taxes are imposed on any person in respect of income of an entity. Because the types of transactions involved are varied, the regulations could provide for either the disallowance of a credit for all or a proportion of the foreign taxes, or the allocation of the foreign taxes among the participants to the transaction in a manner that is more consistent with the underlying economics of the transaction."[21]

C. Profits Repatriations into a U.S. "Bank"

Under the Subpart F rules ten percent shareholders of a "controlled foreign corporation" (CFC) are subject to U.S. tax on the CFC's investments in certain U.S. property, being treated as deemed profits repatriations.[22] U.S. property for this purpose generally includes debt obligations issued to the CFC by related U.S. persons. However, deposits with persons "carrying on the banking business" in the U.S. are excluded from the definition of U.S. property subject to this general rule. Many attempts (some successful) have been made to create private banks to enable fitting within this and similar exceptions. For example, in The Limited, Inc. v. Commissioner,[23], the Court of Appeals held that a U.S. affiliate was "carrying on the banking business" even though its operations were limited to administering the U.S. group's private label credit-card program. Therefore, the court held that certificates of deposit issued by the U.S. affiliate and held by the U.S. parent corporation's CFC were covered by the exception and, consequently, did not constitute taxable repatriations of the profits of the CFC.

The Bush Administration's Fiscal Year 2005 Budget proposal submitted to the U.S. Congress on February 2, 2004 would limit the exception for foreign earnings invested in U.S. property as bank deposits to those deposits with institutions regulated as "banks." The U.S. Department of the Treasury's "General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals" notes that the result in The Limited case is inconsistent with the policy underlying the exception from U.S. property of deposits with a person carrying on the banking business. It states that the result in The Limited case inappropriately extends the exception for deposits with persons carrying on the banking business to cases in which the deposits should be characterized as a profits repatriation.[24] Whether this proposal will be enacted (if at all) as a separate "fix", or be considered as part of a more comprehensive examination of the fundamental Subpart F approach, is difficult to predict.

D. Compensation Sourcing Rules for Multi-country Services

The Service has proposed regulations for determining the source of compensation for labor or personal services performed partly within the United States and partly in other countries.[25] These rules would provide that, for individuals who are employees, their compensation is sourced on the basis of time spent working within and without the United States, except that fringe benefits are sourced on a geographic basis. The Service noted that compensation provided to an employee for a specific time period is generally considered to be earned by the employee ratably over that time period "so it is appropriate to source such compensation on a ratable basis." The fringe benefits that would be subject to geographic sourcing would include housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay, and moving expense reimbursement.

Employees would be permitted to source income on an alternative basis if they can demonstrate to the Service that the alternative more properly determines the source of the income. This might occur where, for example, hazardous duty pay is appropriate in a particular location. With the release of these regulations the Service withdrew prior proposed rules[26] that would have required that the source of compensation received by any individual for a specific time period be determined solely based on the portion of time worked in a particular location. The proposed August 5, 2004 regulations would retain a facts and circumstances approach for the source of income for labor or personal services performed by a corporation or an individual who is not an employee.

The U.S. resident taxpayer ordinarily would want, of course, to maximize the amount of income treated as foreign source to enable maximizing the foreign tax credit. Of course, in the foreign country the taxpayer may want to take the position that the income is all U.S. sourced, so as to eliminate any income tax liability from arising there. Rules included in a bilateral income tax treaty may resolve any disputes arising in this context.

This issue is quite similar to the state and local tax issue regularly arising in the United States for professional athletes performing at various locations in the United States. When they provide their athletic services (at a significant income level) in some states and cities other than their residence those locations will often impose state (and city) income tax earned for that on-site athletic performance. Athletes are well aware that this tax obligation is merely a cost of doing business in those many "away games."

E. Determining a CFC Shareholder's Subpart F Income Portion

The Service has proposed rules to determine a U.S. shareholder's pro rata share of a CFC's Subpart F income.[27] This is the first revision of these rules in almost four decades. These rules identify how shareholders are to compute their CFC income shares to be included in their gross income for Subpart F purposes. These rules provide guidance on transactions involving multiple classes of stock where a board of directors or other governing body has discretion over the distribution of earnings. In this situation the earnings and profits are to be allocated to classes of shares with discretionary distribution rights based on the relative values of the stock on the hypothetical distribution date. The proposed regulations also specify that the Service will disregard certain types of restrictions in determining the appropriate allocation of Subpart F income to shareholders, including:

1) an arrangement that restricts the ability of the CFC to pay dividends on a class of shares of the CFC until a condition or conditions are satisfied;
2) a loan agreement entered into by a controlled foreign corporation that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied; or
3) an arrangement that conditions the ability of the CFC to pay dividends to its shareholder on the financial condition of the CFC.

The concern of the Service is that the applicability of the Subpart F rules is being frustrated by both increasingly complex international structures and arrangements that purport to subvert the true economic realities of relationships between the several parties to a transaction. Not unlike partnership "special allocations" it seems that the Service believes that corporate structure engineers can make income disappear from the income of U.S. shareholders.

IV. Inbound Investment

A. Tax Treaty Applicability to Nonresident Partners

In Rev. Rul. 2004-3,[28] the Service concluded that a nonresident partner in a service partnership with a U.S. fixed base is subject to U.S. tax on the partnership's U.S. income under the U.S.-Germany income tax treaty and all other similar income tax treaties. The Service identified a situation where a German service partnership with both a German resident partner and a U.S. resident partner has offices in the United States and in Germany. The U.S. office is a "fixed base" under Article 14 of the U.S.-Germany income tax treaty. The partners perform services solely in the offices of their respective countries of residence, although they agree to divide the partnership's profits equally. The Service noted that the German resident partner is treated as having a regularly available U.S. fixed base. The Service concluded that the partner is, therefore, subject to U.S. tax on that partnership income allocable to the U.S. regardless of where he actually performs his services. Article 14 of the treaty provides that "[i]ncome derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State, unless such services are performed in the other Contracting State and the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his activities." As supporting authority the Service noted Unger v. Commissioner,[29] where the court concluded that the office or permanent establishment of a partnership is, as a matter of law, the office of each of the partners–whether general or limited.

This ruling is consistent with the Unger case and earlier decisions, and the question then arises as to what motivated the Service to issue this ruling. This tax position does often come as a surprise to the foreign partner who has no activities in the United States. This is often solved by making a guaranteed payment to the in-country partner, thereby avoiding (or reducing) the proportionate allocation, or through some other special allocation, assuming no Code § 704(b) impediment in determining that this allocation does have "substantial economic effect."[30]

Note that, to avoid confusion in the tax treaty context between these rules in Article 14 and the definition in Article 5 of a "Permanent Establishment", Article 14 has been eliminated in the Model Tax Treaty promulgated by the Organization for Economic Cooperation and Development (OECD). The OECD Commentary on former OECD Tax Treaty Article 14 specifies: "Article 14 was deleted from the Model Tax Convention on 29 April 2000 on the basis of the [identified] report.... That decision reflected the fact that there were no intended differences between the concepts of permanent establishment .. and fixed base .. or between how profits were computed and tax was calculated. In addition, it was not always clear which activities fell within [either Article]. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits."

B. Which U.S. Income Tax Treaty Applies to Outbound Payments Of U.S. Sourced Income?

Unlike in the United States where the determination of tax status is based on where an entity is legally organized, in many foreign countries this determination is based on the "place of management" of the entity. This enables U.S. tax planners to legally organize a foreign corporation (often a corporate subsidiary) in one foreign country although having its business situs and tax residence in another (often lower tax) jurisdiction. When outbound payments (such as dividends and royalties) are made from the United States the question might become which U.S. income tax treaty will provide preferred tax relief from withholding at source, i.e., the treaty with the country where the entity is organized or the country where the entity has its primary place of management .

In Rev. Rul. 2004-76[31] Corporation A was incorporated under the laws of Country X but its "place of effective management" was situated in Country Y. Corporation had no fixed place of business in Country X. Under the laws of Country X, before the application of any tax treaty, Corporation is liable to tax as a resident. Under the laws of Country Y, before the application of any income tax treaty, Corporation A is also liable to tax as a resident, thereby presenting the possible dilemma of double economic taxation. Corporation A receives U.S. source income during the taxable year and seeks benefits under a U.S. income tax treaty, either with Country X or with Country Y. The relevant articles of the U.S.-Country X treaty and the U.S.-Country Y treaty each provide that "the term 'resident of a contracting state' means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature." However, the treaty between Country X and Country Y provides that "the term 'resident of a contracting state' means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management, or any other criterion of a similar nature."

After applying this article of the Country X-Country Y tax treaty, Corporation A is treated as a resident of Country Y and not a resident of Country X because its "place of effective management" is in Country Y. Therefore, under the U.S.-Country Y treaty, Corporation A is a resident of Country Y also regarding the treatment of its U.S. source income (assuming that it satisfies the requirements of the applicable "limitation on benefits" article). Corporation A is not a resident of Country X under the U.S.- Country X treaty and is not entitled to claim any benefits under this treaty as a resident of Country X.

This ruling is of particular importance to U.S. parties making certain outbound payments to foreign recipients of passive income who will be subject to obligations for withholding at source. The foreign recipient will want to assert that the owner of this income is a resident in that jurisdiction having the lowest applicable U.S. tax treaty rate on the particular item of income. That recipient will be required to provide an IRS Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding," identifying that the recipient is a resident of a particular country "within the meaning of the income tax treaty between the United States and that country." The withholding agent can ordinarily rely on that representation as to residency status. The withholding agent will not want to be in the position of making the determination that, because of facts similar to those described in Rev. Rul. 2004-76, the recipient is a resident of one of several countries. Therefore, indirectly this ruling is really an admonition to the foreign payee to correctly identify the country of residence on the withholding certificate. The U.S. payor should ordinarily be entitled to rely on that representation in the Form W-8BEN unless knowing that it is clearly erroneous.

C. Intercompany Financing Through Partnerships

When the interest expense deduction for interest paid to a foreign lender is restricted (under the Code §163(j) interest stripping limitations) can alternative structuring avoid this limitation? Consider the following structure identified in Notice 2004-31[32]: Foreign parent corporation owns two domestic corporations, One and Two. The parent forms a partnership with Two and the partnership then contributes assets to One in exchange for preferred stock issued by One. Under the partnership agreement the foreign parent corporation receives a substantial guaranteed payment for the capital contributed to One and a small share of both (i) the gross dividend income from One and (ii) the partnership's deduction for the guaranteed payments. Two receives a large share of the gross dividend income and the partnership deductions for guaranteed payments. The Service asserts that this transaction attempts to convert nondeductible interest payments into a business expense deduction (i.e., the guaranteed payments). Notice 2004-31, states that this arrangement (and those that are "substantially similar") are "listed transactions" for purposes of Reg. § 1.6011-4(b)(2) (the tax shelter rules).

The Notice states that the Service will use several grounds to challenge the "purported" tax benefits flowing from One's payment of a dividend into the partnership. The Service notes that it may disregard the partnership's formation because of the lack of a "nontax business purpose" for its formation. Further, the arrangement may be attacked under the partnership anti-abuse rules, including because it lacks "substantial economic effect."

D. Lottery Winnings are Not Annuity Payments

For the domestic winner of a lottery prize U.S. income tax will apply and the payor will be obligated to withhold U.S. income tax when making payments to the winner. Some lotteries allow the lottery winner to receive payments over some extended period, rather than in a lump sum, thereby benefitting from the time value of money (interest) component which will increase the nominal total of the payments. These extended payments are also subject to withholding when periodically paid since the receipt has been delayed and no "constructive receipt" concept applies to cause earlier realization.

When the Texas (or other state) lottery is won by a nonresident alien gross income inclusion will also be required, under Section 871(a)(1)(A), being an item or fixed or determinable annual or periodic income. Similarly, U.S. income tax withholding at source will be required of the payor (ordinarily a government agency). An applicable income tax treaty will not ordinarily enable any rate reduction for lottery winnings but the question arises whether some other categorization may enable a reduced tax rate (which, in turn, would enable a reduced withholding rate at source).

In Abeid v. Commissioner[33] a nonresident alien resident in Israel became entitled to 20 annual payments of $772,000 each through the purchase of a $1 ticket that won a California based lottery. The taxpayer asserted that the payments constituted "annuities" under the Israel-U.S. income Tax Treaty, Article 20(5), and consequently, the outbound payments were exempt from U.S. income tax under the provisions of that treaty. This treaty provides that annuities are taxable only in the jurisdiction in which the recipient resides. The court determined that the payments were not annuities (within the meaning of this treaty) since not paid "under an obligation to make payments in return for adequate and full consideration" as provided in the treaty and therefore were subject to 30 percent withholding tax imposed at source.

Although the result appears to be technically correct, the court could perhaps have been influenced by the tax treatment of the taxpayer in Israel. The court noted that the taxpayer apparently successfully claimed that, for Israeli income tax purposes, the payments were lottery winnings and, under applicable domestic Israel law (unlike U.S. tax rules), were exempt from income taxation. Therefore, the taxpayer was not successful in obtaining total income tax immunity on these winnings. Finding better tax treatment under an applicable income tax treaty for lottery winnings is unlikely, but this suggests a regular challenge to the tax advisor to explore the many available approaches to decrease the tax burden on cross border payments.

V. Transfer Pricing Between Related Parties

A. Proposed Code § 482 "Services" Regulations

Many believe that significant revenues escape from the U.S. income tax base because related parties engage in aggressive "transfer pricing" arrangements to shift income outside the United States, particularly those taxpayers who are foreign based and can protect their foreign income from taxation in their home countries through other means. IRC § 482 does provide that the Service has the authority to reallocate income and deductions among taxpayers where necessary "in order to prevent evasion of taxes or clearly to reflect the income" of related entities. Over the past few years the IRS has not been very successful at litigating "transfer pricing" cases. Consequently, the alternative approach to litigation is a more rigorous tax regulations structure, coupled with onerous penalties, and the "Advanced Pricing Agreement" (noted below).

On September 10, 2003 the IRS issued proposed IRC § 482 regulations to revise the transfer price treatment concerning services in regulations last issued in 1969. This followed earlier revision of regulations dealing with the transfer of tangible personal property and intangibles. The belief has developed that the transfer of services (including with respect to the delivery of intangibles) has become much more important economically and can enable significant revenue shifting between related entities. These proposed regulations provide that an arm's length charge for services rendered between members of a controlled group must be determined under one of the following six specified transfer pricing methods:[34]

1) The comparable uncontrolled services price method.[35]
2) The gross services margin method.[36]
3) The cost of services plus method.[37]
4) The comparable profits method.[38]
5) The simplified cost-based method.[39]
6) The profit-split method.[40]

Further, these regulations would provide that unspecified methods also may be used in appropriate circumstances.[41] These proposed regulations take a similar, quite detailed approach to complement the tangible property and intangible transfer pricing regulations previously revised.

B. The Advance Pricing Agreement (APA) Program

Under the Advance Pricing Agreement (or "APA") program taxpayers can obtain an agreement with the IRS concerning their pricing procedures so as to avoid future IRC § 482 transfer pricing disputes.[42] In Rev. Proc. 2004-40[43] the Service updated procedures concerning dealing with the APA program. This revenue procedure states that the APA process has increased the efficiency of tax administration by encouraging taxpayers to present to the Service all the facts relevant to a property transfer pricing analysis and to work toward a mutual agreement in the spirit of openness and cooperation. This revenue procedure encourages implementation of an APA on a bilateral or multilateral basis between the competent authorities through the mutual agreement procedure of applicable income tax treaties.

Apparently concerned that multinational taxpayers are taking excessive advantage of this quite successful program, U.S. Senate Finance Committee Chair Charles Grassley and ranking minority member Max Baucus earlier announced a review to determine if multinational corporations that obtain APAs are paying their fair share of taxes.[44] Apparently, these U.S. Senators seem to believe that exploitation of the APA option has turned into another form of tax shelter. They requested from IRS Commissioner Mark Everson an immense amount of information about APAs and APA pricing agreements between the IRS and corporate taxpayers. In addition to the request for details concerning how a transfer pricing method (TPM) was agreed upon in each APA in the last ten years, they requested information concerning:

1) Question 9: "How much federal revenue is lost annually as a result of abusive or improper transfer-pricing practices or income shifting?"
2) Question 10: "How does the amount of U.S. taxes paid by foreign-controlled corporations compare with taxes paid to foreign governments by U.S. companies operating overseas?"
3) Question 11: "How does the rate of return on assets of foreign controlled corporations compare with the rate of return on assets of domestic corporations? Please also provide the rate of return on capital employed."
4) Question 12: "How many foreign controlled corporations paid no Federal income tax for the last five years? How many domestic corporations paid no tax in these years?"
5) Question 14: "Please provide data and an analysis of the IRS's success rate in the U.S. Tax Court and other courts as to section 482. Include in this analysis information on how many cases have been litigated involving section 482; how many cases have been won by the IRS; and in the cases where the IRS lost, the reasons why. Also include information about the total dollar value of tax adjustments that have been litigated and how much has been sustained by the courts. Please provide the number of times that section 6662 penalties have been imposed and sustained with companies involved in the APA program."

This letter also includes a request for the names of all professionals employed in the APA program and in the U.S. competent authority functions in the last 10 years. They have also asked concerning former employees who have contacted the Service regarding a proposed APA. This Christmas Eve letter (December 22, 2003) requested a response by January 28, 2004. Although the report was delayed it has been delivered and awaits a Senate response. Perhaps the response is delayed because of year 2004 politics. Perhaps this will be a subject for Senate Finance Committee discussion in the next Congress. When (if?) released this report will provide some interesting reading – unless IRC § 6103 is used to support extensive redacting of this document.

C. The GlaxoSmithKline Holdings Transfer Pricing Litigation

The Service has litigated (too often unsuccessfully) many transfer pricing cases over the last several decades which has caused the evolution of alternative conflict resolution mechanisms, such as the Advance Pricing Agreement (described above). Audit and litigation controversy does continue in the transfer pricing context and a significant example of this is the current U.S. Tax Court litigation involving Glaxo U.S., the wholly owned U.S. subsidiary of U.K. based pharmaceutical manufacturer GalxoSmithKline plc. The stakes are high: the Notice of Deficiency specified an amount of U.S.$ 2.7 billion owing the Internal Revenue Service for the years 1989 through 1996. The issues involve the appropriate pricing of intangibles. This battle will be long and highly fact intensive. Significant fact issues concern who provided value to the development of drugs, particularly Zantac, and in what proportions, i.e., the U.K. parent corporation or the U.S. subsidiary. The ultimate result will probably not contribute much new knowledge about the rules concerning the transfer pricing of intangibles, but it will provide much interesting information about managing a large transfer pricing case before the U.S. Tax Court.

VI. Evolving Bilateral U.S. Income Tax Treaties

A. U.S. Income Tax Treaty Negotiation Activity

Particularly since the enactment of the dividends tax reduction in the Jobs and Growth Tax Relief Reconciliation Act of 2003 the U.S. Department of the Treasury has seemed energized to enter into revised bilateral income tax treaties with important U.S. trading partners. Treaties have been concluded with the United Kingdom, Mexico (protocol), Australia (a protocol), Japan, Sri Lanka and Barbados (protocol).

B. Dividends Tax Withholding Relief

The U.S. Code rule specifies that outbound dividend payments are subject to a 30 percent withholding tax at source, but this rate might be modified by a bilateral income tax treaty. The September 20, 1996 U.S. Model Income Tax Treaty provides (in Article 10) that when dividends are paid by a resident of a contracting state to a resident of the other contracting state, both the source country and the shareholder's country of residence may tax the dividends. However, the U.S. Model ameliorates this treatment by providing that the dividend tax rate in the source country will be five percent if the beneficial owner is a corporation owning at least ten percent of the voting stock of the company paying the dividends and, otherwise, fifteen percent. For the reduced withholding tax rates (under Article 10) to apply the dividends must be beneficially owned by a resident of the other contracting state, they must not be attributable to a permanent establishment or fixed base of the shareholder in the source country, and the shareholder must qualify for treaty benefits under one of the tests specified in the "Limitation on Benefits" provision (Article 22). The 2003 OECD "Model Tax Convention on Income and on Capital" similarly provides (in Article 10(2)) for a five percent tax on the gross amount of dividends if the beneficial owner is a company (other than a partnership) which holds at least 25 percent of the capital of the company paying the dividends and 15 percent of the gross amount of the dividends in all other cases.

In the 2003 U.S. tax legislation the statutory income tax rate on dividends received was reduced to 15 percent for individual taxpayers (although remaining at a maximum 35 percent rate for corporations, before considering the impact of an dividends received deduction). More beneficial treatment for dividends paid from the United States to foreign corporate recipients has been reflected in recent U.S. income tax treaties (some negotiated prior to the time of the 2003 tax legislation).

1) A revised U.K.-U.S. income tax treaty was signed on July 24, 2001 and entered into force on March 31, 2003.[45] This was the first U.S. income tax treaty to provide a zero-rate withholding tax for certain intercompany dividends. The recipient corporation must own at least 80 percent of the voting power of the dividend-paying corporation for the 12 month period ending on the date the dividend is declared.

2) A protocol to the Australia-U.S. income tax treaty entered into force on May 12, 2003. This protocol also provides for zero-rate withholding tax on certain intercompany dividends. The dividends are beneficially owned by a company that is a resident of the other contracting state and that has directly owned at least 80 percent of the voting power of the company paying the dividends for a 12 month period ending on the date the dividend is declared.

3) A protocol to the Mexico-U.S. income tax treaty was signed on November 26, 2002 and entered into force on July 3, 2003. This also contains zero dividend withholding tax provisions.[46] This protocol to the Mexico-U.S. income tax treaty eliminates source-country withholding tax on cross-border dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation, provided conditions are met. The new provisions regarding the withholding tax on dividends have become effective for dividends paid or credited on or after September 1, 2003.[47]

4) A revised treaty with Japan, initialed during June 2003, was signed on November 6, 2003.[48] This treaty constitutes a modernization of the 1971 Japan-U.S. income tax treaty, one of the oldest U.S. income tax treaties. This treaty accomplishes significant reduction in cross-border withholding taxes. Tax withholding on dividend payments to a controlling parent corporation is eliminated. The withholding tax will be eliminated on dividends paid by a U.S. subsidiary to the Japanese parent company that owns more than a 50 percent interest (and, similarly, in the reverse situation). If the parent company owns a 50 percent interest or less in a subsidiary the dividends would remain subject to withholding under the revised treaty. Note that the Japan-U.S. income tax treaty provides the most liberal rule of these treaties concerning qualification for the elimination of withholding on the dividend payment from the subsidiary to the parent corporation. Under that treaty only a more than 50 percent interest in the subsidiary is necessary to obtain the zero rate.

These treaties have various "limitation on benefits" provisions to preclude an interloper from a third country from trying to achieve the zero dividend withholding benefits by using an entity in one of these treaty countries as an intermediary for this purpose.

C. Other Recent U.S. Income Tax Treaty (Non-Dividend) Relief

Each bilateral income tax treaty entered into by the U.S. is unique and, therefore, the tax advisor needs to carefully examine the treaty, and its accompanying Technical Explanation, to ascertain whether any special benefits might be obtained.[49] For example, the U.K.-U.S. treaty is the first U.S. income tax treaty that allows U.S. citizens resident in another country to deduct, for U.S. tax purposes, contributions made to a foreign pension plan. The 2002 protocol expands the benefit of the zero rate to pension fund investors in U.S. regulated investment companies and real estate investment trusts.

Under the Australia-U.S. protocol the maximum level of withholding tax on royalty payments is reduced from 10 percent to five percent (although the international treaty norm is zero tax at source). The protocol eliminates the withholding tax on rental payments for the use of industrial, commercial, or scientific equipment (other than equipment let under a hire-purchase agreement) by treating them as business profits instead of royalties. Consequently, these payments are taxable by the source country only to the extent that they are attributable to a permanent establishment (PE) of the recipient that is situated in the source country.

Under the Japan-U.S. income tax treaty other significant reductions in cross-border withholding taxes are implemented. All source-country withholding taxes on royalty income are eliminated, an item particularly significant because of the large inflow of royalties into the United States from Japan. The treaty eliminates withholding on interest earned by financial institutions and reduces presently higher withholding rates to lower rates of the preferred U.S. model treaty. This is the first time that Japan has ever agreed to eliminate source based withholding tax. This treaty is particularly important because it is a treaty between the two largest economies in the world. Note that in 1999 the flow of aggregate dividend, interest and royalty between the United States and Japan was $40 billion.[50]

D. The U.S. - Barbados Protocol

Representatives of the Government of Barbados and the United States have announced a protocol (signed July 14, 2004) to significantly limit the applicability of the Barbados-U.S. Income Tax Treaty. The 1984 Barbados-U.S. income tax treaty significantly reduces dividend, interest, and royalty withholding tax rates, even though Barbados is essentially a tax haven and U.S. tax treaties do not normally give generous benefits to residents of tax havens. Under IRS Notice 2003-69[51] the Service earlier determined that the current Barbados-U.S. income tax treaty was unsatisfactory for purposes of IRC § 1(h)(11) (the 15 percent dividends received taxation provision) because the treaty could operate to provide benefits intended to mitigate or eliminate double taxation where no risk of double taxation exists.[52] The recent U.S. interest in revising the tax treaty with Barbados has probably been motivated by reasons of attention paid to Barbados as a primary destination for corporate inversion structures, a highly politicized issue during 2004.[53]

This protocol implements a significantly restricting "limitations on benefits" provision to be included in this treaty. This provides that a person that is a resident of one country and derives income from the other country shall be entitled, in that other country, to all treaty benefits only if the person qualifies under certain specified categories. Like other "limitation on benefit" provisions, the objective is to assure that The objective is to assure the other country does not allow corporations to be organized which, for tax purposes, are merely conduits out to the rest of the world.

Various important limitations are included on what are eligible enterprises for treaty benefits, but one has particular current relevance. A Barbados parent company will be unable to qualify under the Barbados-U.S. treaty if its shares are primarily traded on a U.S. stock exchange. The obvious objective of this provisions is to prevent corporate inversions through the use of a Barbados company. As confirmed by Treasury Secretary Snow in his signing statement: "The agreement contains modifications necessary to address concerns about inappropriate exploitation of treaty benefits, including the potential for the unintended use of the treaty by U.S. companies that purport to migrate their corporate structures."

VII. Tax Havens and the Tax Haven Crackdown

A. Various Anti-Tax Haven Efforts Continue

Efforts continue in the U.S. and elsewhere to limit the use of offshore tax havens for the evasion of tax. These are being pursued directly by the U.S. and indirectly by the U.S. through multilateral efforts, by third countries individually, and by other multilateral groups such as the E.U. Many private groups have been adamantly opposed to these efforts as anti-competitive and constituting an invasion of privacy.[54]

B. The Use and IRS Monitoring of Foreign Trusts/Bank Accounts

In January 2003 the Service initiated a compliance initiative to get taxpayers to identify their offshore bank accounts and to settle up their tax responsibilities with the Service. Taxpayers had a deadline of April 15, 2003 in which to comply. The goal of the program was to identify taxpayers engaged in abusive offshore activities by examining four areas: who introduced the taxpayer to the offshore scheme; how the assets are sent offshore; how assets are controlled; and how assets are repatriated.[55] The Service received 1,300 applications under this "Offshore Voluntary Compliance Initiative" (out of 2 million offshore bank accounts held by U.S. taxpayers?). The Service collected $200 million under this program.[56] The Service indicated that a wide variety of financial arrangements were used to avoid U.S. taxes, including foreign entities, foreign bank accounts, foreign trusts, and credit cards. What is the next step in this process?[57]

C. The OECD Tax Haven Crackdown

In the year 2000 the Organization for Economic Cooperation and Development (OECD) began to consider how to limit the use of tax havens and in 2002 began an effort to crack down on "harmful tax practices." Some will remember that then Representative Dick Armey described this as merely a conspiracy to establish tax rates among developed countries (i.e., to achieve "tax harmonization"), and to preclude zero tax rates in tax havens, but most believe that the real OECD motivation was to impede international tax evasion. The probable real objective was to cajole most smaller tax havens to enter into arrangements to preclude secrecy and to exchange information. At first the OECD issued a "blacklist" of uncooperative countries (in 2000, 2001and 2002) but more recently has been seeking to work cooperatively with these jurisdictions.

The dilemma that has now arisen is that, although many of the smaller tax havens have complied, four countries (Austria, Belgium, Luxembourg and Switzerland) have indicated that will not respond to a year 2006 deadline for the cross border exchange of banking information. If this exchange arrangement were implemented, this would enable tax authorities in other OECD countries (including the U.S.) to verify the assets of citizens who locate their funds outside their home states. If this issue cannot be resolved the other tax havens may back away from their prior commitments concerning transparency.[58] Further, Hong Kong, Singapore and other significant finance centers have regarded these OECD efforts as not applicable to them, although their financial (including secrecy) laws often provide similar benefits as to the "island" tax havens. Whether this whole structure will crumble (with an ultimate "race to the bottom") or whether the OECD can continue to build on its hard won progress is currently quite difficult to predict.[59]

D. The EU Effort on Offshore Bank Accounts

On a parallel basis the EU has also implemented a program (sometimes called the "Savings Directive") to tax the income of EU citizens who place their funds on deposit outside their home countries.[60] This directive cannot take effect, however, without the participation of U.K. territories such as the Cayman Islands, a U.K. dependent territory. The UK has threatened to force the Cayman Islands to comply with the directive if not doing so voluntarily. This would necessitate U.K. legislation, but the Cayman Islands has threatened a legal challenge. The Cayman Islands has subsequently indicated conditional acceptance of this mandate if the U.K. Government will provide financial concessions for the damage which would occur to the Cayman Islands' financial services industry.[61]

VIII. Expatriating Individuals

IRC § 877 provides for application of the regular U.S. income tax to U.S. tax expatriates on an expanded class of income for ten years after the expatriation. These rules are only applicable if U.S. status was terminated with a principal purpose of avoiding U.S. tax. An individual is presumed to have lost citizenship or terminated long-term residency with a principal purpose of tax avoidance if meeting an average annual net income tax liability test or a net worth test.

The U.S Treasury Department and the IRS have apparently finally concluded (as many did originally) that this subjective test of determining a taxpayer's motive for expatriation is too difficult to administer.[62] Under the Bush 2005 Budget Proposal the applicability of the alternative tax system to a tax expatriate would apparently not be able to be rebutted if (i) an individual's average annual net income tax liability for the five taxable years preceding expatriation exceeds $124,000 (as indexed for inflation), (ii) the individual's net worth on the date of expatriation exceeds $2 million (indexed for inflation), or (iii) the individual fails to certify under penalties of perjury that he complied with his U.S. tax liabilities for the five taxable years preceding expatriation. Certain exceptions would be available for dual citizens.

Individuals who are subject to the alternative tax regime in a calendar year during the ten year period following expatriation but who are physically present in the U.S. for more than 30 days in that calendar year generally would be subject to U.S. tax on their worldwide income as though they were U.S. citizens or residents in that taxable year. Certain gifts of stock of closely-held foreign corporation by a former citizen or former long-term resident would be subject to U.S. gift tax. Annual reporting would be required for individuals subject to the alternative tax regime even if they have no U.S. tax liability for that year.

This issue is revisited every few years after a recognition that the system is not working. Whether, if implemented, this proposed revision will be any more effective in getting tax payments from expatriates when living in a foreign country is problematical. But, the U.S. Congress seems not politically capable of accepting the only proposal that would probably work best in this context, i.e., mark to market all assets at the time of expatriation and impose a tax at that time on the basis of a deemed realization event occurring. This was the original proposal of the Senate Democrats when the expatriation tax regime was first considered.

IX. International Tax Administration Issues

A. The IRS International "No Rulings" List

Consistent with its practice in other areas, during early 2004 the Service has issued its list of those area in the U.S. international tax context where it will not issue a ruling. See Rev. Proc. 2004-3.[63] This listing identifies those items under the jurisdiction of the Associate Chief Counsel (International) where sufficient controversy exists that no advance ruling will be available. This no-rule list is essentially the same as in earlier years. Tax advisors should note that this list often provides advance notice of those transactions which (when completed without an advance ruling) will receive the attention of the Service during an audit (if identified).

B. Comparisons of the Effectiveness of National Tax Administrations

House Ways and Means Oversight Subcommittee Chairman Amo Houghton disclosed at a February 12, 2004 hearing that the IRS Business Systems Modernization (BSM) program has suffered cost overruns of $290 million since it began in 1999. The IRS Commissioner told the subcommittee that "there was a joint failure" involving poor management of BSM by IRS and inadequate performance by the primary contractor, Computer Systems Corp. A member of the IRS Oversight Board informed the Subcommittee that the IRS management team lacks the necessary skills and experience to manage modernization and the prime contract.[64]

Although this is a much more pervasive problem than taxation of cross border arrangements an interesting foreign comparison seems appropriate in this context: In Spain, beginning on March 1, 2004 taxpayers were able to use their cell phones to file their income tax returns. Starting on March 1, 2004 the Spanish tax agency began sending eligible taxpayers preliminary income tax returns stating what it has calculated as the amount due. The taxpayer who is in agreement with that data may simply reply with a Short Message Service (SMS) text message to confirm agreement. That confirmation will be considered to be a valid tax declaration. Apparently the tax office will have received from third parties information to facilitate this return preparation, including for earnings from employment, savings income (dividends and other investment income which is subject to withholding), rental income from a maximum of two properties, income from Treasury bills, capital gains subject to withholding and subsidies received for the purchase of a home. Tax returns for nonresidents may be filed online. Almost all documents the tax office needs may be handled electronically.[65]

C. IRS Reporting and Immigration Enforcement

IRC § 6039E enacted in the Tax Reform Act of 1986 provides (in § 6039E(a)) that an individual who applies for permanent immigration status in the U.S. (i.e., applies for a "greencard") must provide certain U.S. tax reporting information, including the taxpayer's tax ID number and information with respect to income tax returns for the prior three years. That information, provided to the Immigration and Naturalization Service (now the Bureau of Citizenship and Immigration Services), is required (under IRC § 6039E(d)) and is required to then be reported to the Service, presumably to enable the Service to verify the reported information about tax return filings.

Many advisors assisting individuals in illegal immigration status have encouraged them to file appropriate federal income tax returns, believing this would assist in ultimately obtaining a "greencard". Most advisors have believed assurances that this "exchange of information" provision was a one way street, i.e., that if the nondocumented individual does file an income tax return this information will not be provided to the INS to enable apprehension and deportation for violation of U.S. immigration laws. Note, however, the comment of Nina Olson, the IRS National Taxpayer Advocate, concerning the arrests of two illegal immigrants in Kentucky located with information taken from their federal tax returns as being a major breach of tax return confidentiality.[66]

Some further background in this context is essential concerning the IRS Taxpayer Advocate's 2003 report.[67] This report contains an extensive discussion concerning this subject in Topic Number 5 concerning the Individual Taxpayer Identification Number (ITIN) program.[68] As noted in its response to the Taxpayer Advocate's report, the IRS is concerned about IRC § 6103 prohibiting its sharing of this information with other agencies, and apparently wants some liberalization of IRC § 6103.[69] Organizations representing immigrant workers are quite concerned about how this proposed legislation will evolve.[70]

Some suggest that this information was not released by the Internal Revenue Service but by the Inspector General of the Treasury Department and that the (now departed) Assistant Secretary of the U.S. Treasury for Tax Policy has indicated that such release of U.S. income tax return information is not a policy of the IRS. In any event, the perception that this is IRS policy is of immense concern for those advisors wanting to assist individuals towards legal status (necessitating federal income tax return filing) but who believe that a tax return filing will be the triggering event for their exportation.

X. Selected Foreign Country Developments & Their U.S. Tax Relevance

A. Importance of Foreign Country Tax Developments

The objective of this segment is to consider a few recent foreign country tax changes because they are particularly relevant for considering where and how foreign investment from the U.S. might be structured. Obviously, this analysis cannot be comprehensive but several developments summarized here show how foreign countries structure their tax systems to compete, often successfully, in the worldwide quest for increasing invested capital and employment opportunities in their countries.

B. Irish Tax Incentives

The Government of Ireland on February 4, 2004 released its 2004 Finance Bill (the timing being close to the release of the Bush fiscal year 2005 budget) which proposed business friendly tax credits to stimulate investment and jobs in corporate headquarters operations. This bill would extend to July 2006 some capital allowances and tax incentives that were set to expire this year and include amendments to provisions on double taxation relief for dividends paid to parent companies. The objective is to further enhance the potential of Ireland as an attractive location for international holding structures. Further, credits for research and development expenditures would be provided.[71]

Note that the potential for Ireland as a developed country "tax haven" for U.S. companies will be maintained and enhanced by these developments. Ireland understands about the necessity for job creation. Dublin will probably retain its status as one of the hot places to live in Europe – including for young U.S. investment bankers. Will U.S. based research and development activities also move offshore to Ireland (since its location offshore would facilitate the avoidance of some of the § 482 complexities on the U.S. cross-border transfer of intangibles)?

C. India's Tax Applicability to U.S. Outsourcing

A highly politicized issue during the 2004 U.S. presidential election campaign concerns the issue of "outsourcing" of jobs from the United States to foreign countries where wages (and, therefore, corporate labor costs) are considerably lower than in the United States. India is well known for a destination for this outsourcing. Economic development officials in those foreign countries are well prepared to take advantage of these opportunities, believing (in that context) in being advantaged by "globalization." For example, the Finance Minister in India has announced that foreign nonresident companies establishing business process outsourcing ("BPO") units in India to undertake incidental and auxiliary activities will not have to pay taxes on the "insignificant profit" generated by such activity. The announcement indicates that, if the activities outsourced by a foreign company are ancillary and auxiliary in nature, and adequate remuneration was paid to the Indian firms, the company's income from those activities will be exempt from tax in India. For example, a foreign company will not have to pay taxes on the income generated through the incidental and auxiliary services being rendered by a call center based in India, provided the call center is paid an arm's length or fair market price for its services. The income of the call center will be taxable, however. Information from the Central Board of Direct Taxes concerning distinguishing between core activities and auxiliary services of companies outsourcing jobs to India is to be forthcoming.[72]

Consider the magnitude of U.S. jobs being "offshored" to India based call centers and that this Government of India tax immunity will provide further incentives to move those jobs offshore. This includes U.S. computer companies manufacturing components of their computers offshore and then using an offshore call center to sell the computers both inside and outside the United States. This includes foreign insurance companies (including subsidiaries of U.S. insurers) selling insurance outside of India and using an India call center to deal with inquiries of customers. This includes medical facilities using radiologists based in India to interpret the results reflected on X-rays transmitted electronically to India. And, it includes the preparation of U.S. income tax returns at India-based facilities.[73] Consider the many possibilities for the income of the U.S. multinational to be shifted outside the United States but to also fall outside the core (taxable) business of the call center in India, thereby immunized from a serious tax burden.

D. Thailand Plans to Cut Corporate Tax

The Finance Minister of Thailand indicated on February 6, 2004 that its corporate income tax rates will be cut from 30 percent to 27 percent.[74] Whether this tax rate reduction will be sufficient to attract more investment (including from the U.S.) is problematical. This does demonstrate, however, the "race to the bottom" (or the "top"?) occurring between many East Asian countries to maintain their competitiveness in the international manufacturing sector. For the U.S. enterprise it could enable a further tax deferral opportunity (i.e., 8 percent, the 35 percent U.S. tax rate vs. 27 percent, rather than the current 5 percent, i.e., 35 percent U.S. tax rate vs. 30 percent). Coupled with aggressive transfer pricing to facilitate shifting income from Thailand to an Asian tax haven, the rate of return on invested capital could be even further enhanced.

How is this relevant to U.S. international tax planners? This will represent another opportunity to currently incur reduced current foreign country income tax liability in an offshore entity (i) where the corporate tax rate is less than the U.S. rate (thereby enabling tax deferral), (ii) where wages are low, and (iii) where transfer pricing enables deflection of certain income to an even lower (no) tax jurisdiction.

E. Ambiguous Vietnamese Corporate Tax Legislation

Vietnam has a special corporate tax regime providing for rates of 10 percent or 15 percent applicable to income derived in specially designated industrial zones. Outside these zones corporate income is subjected to a rate of 20 percent (although the standard corporate income tax rate is 28 percent). Apparently concern exists over whether certain tax privileges available in these special zones might be withdrawn.[75]

How is this relevant to U.S. international tax planners? Obviously, a significant base of contacts exists among a portion of the U.S. population to enable Vietnam to be used as an effective offshore manufacturing base. U.S. manufacturers also recognize that their competitors (both Chinese and Japan) are using Vietnam for "offshoring" their own manufacturing activities because of the extremely low wage base in Vietnam. Apparently even the Chinese are anticipating the time when their goods will be less price competitive because of (i) wage increases in the PRC and (ii) the potential rise in the value of the Chinese currency vs. the U.S. dollar. Therefore, they will seek to maintain trading position by realizing lower wage costs in a third country like Vietnam.

F. The Net Worldwide Tax Impact for Multinationals

Code § 11 provides for the imposition of corporate income tax at the rate of 35 percent (after lesser brackets climbing to the $100,000 tax liability, which benefit is then gradually clawed back). Considering the opportunities noted above, why should any large U.S. multinational (which has not used already inversion to locate is corporate status offshore) pay a 35 percent U.S. income tax. This inquiry is particularly relevant when noting that the Subpart F rules (i.e., current U.S. income taxation for deemed repatriated profits) can be made irrelevant through the foreign use of only one corporation (for U.S. income tax purposes) but many entities structured into limited liability companies and treated as disregarded entities (under the check the box rules) for federal tax purposes. See Reg. § 301.7701-3(a) permitting the election to have disregarded status for eligible entities (i.e., those not specifically listed as corporations), including the foreign entity having a single owner and limited liability eligibility under local law.

The contest seems to be fully underway concerning how far the effective tax rate can be reduced for U.S. multinationals. Consider the following information:[76]

U.S. Company	Pre-tax income 2003 ($m)	Tax Rate 2003 (%)	Tax Rate 2002 (%)	Tax Savings ($m)
Citigroup	26,333	31.1	34.1	778.0
Merck	9,052	27.2	29.6	134.4
Intel	7,442	24.2	25.9	123.2
Merrill Lynch	5,649	26.0	28.0	113.3
Kimberly Clark	2,157	23.8	29.0	111.8
McDonald	2,346	35.7	40.3	107.7
J.P Morgan Chase	10,028	33.0	34.0	98.7
General Motors	2,981	24.5	27.5	90.1
Disney	2,254	35.0	38.9	88.9
Proctor & Gamble	5,164	30.7	31.5	40.6

This analysis helps understand why the corporate tax contribution to the U.S. Treasury Department continues to decline as a portion of the total tax collections and as a total amount even in the face of rising profits. Of course, some Tax Vice Presidents of these corporations are incentivized to move the effective tax rate of their employer corporation downward when their personal success (including bonuses) might be measured on the basis of comparative effective tax rates).

Current technical issues concerning transfer pricing rules are discussed above but, at this juncture, note the confirming data recently released from the U.S. Department of Commerce effectively indicating that the Service seems not to be able to prevent U.S. companies from artificially shifting profits to tax haven countries like The Netherlands, Ireland, Bermuda and Luxembourg. Except for Bermuda, these are not strange, isolated locations surrounded by water.[77] These statistics indicate that in the year 2001 subsidiaries of U.S. multinationals domiciled in these four countries reported 30 percent of all the foreign profits of U.S. corporations, despite accounting for only 5 percent of the productive capacity and 3 percent of the employment of these foreign subsidiaries. This 2001 data indicated that the effective tax rate for subsidiaries of U.S. corporations was as follows:

Country	Effective Tax Rate
Netherlands	8.8%
Ireland	7.3
Bermuda	3.0
Luxembourg	0.9
Singapore	10.4
Belgium	16.1
Switzerland	19.4
Cayman Islands	5.2
Denmark	10.7
Hong Kong	10.7

XI. Concluding Observations–Possible Future Developments

This discussion evidences that the broad ranging area of international taxation is exceptionally dynamic. U.S. international tax policy has become a quite interesting element of the debate in the 2004 Presidential election.[78] Even for the domestic tax advisor representing a domestic taxpayer the exposure to serious tax risks (e.g., withholding at source liabilities) must be examined if a transaction has any cross border aspects. Further, many of the international developments described above have important parallels in the domestic tax planning context (often being the precursor for subsequent domestic tax developments). Consequently, many of the cross-border U.S. tax rules described above can provide guidance for thinking about other common domestic-based transactions.

ENDNOTES

1 Vinson & Elkins Professor of Law, University of Houston Law Center, Houston, TX 77002-6060, and Consultant, Bracewell & Patterson, Houston, TX 77002-2781.

2 This paper does not purport to be an exhaustive survey of all important recent U.S. international tax development. This discussion is partially based on a presentation made by the author to the Section of Taxation, Houston Bar Association, during March, 2004. This material is current through late summer, 2004.

3 A useful recent summary of the underlying theory supporting various U.S. international taxation rules is included in the Staff Report of the Joint Committee on Taxation, "The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad" (JCX-68-03), July 14, 2003.

4 For a 2004 study examining tax rates on a comparative basis among developed countries see the International Monetary Fund's IMF Country Report No. 04/228, July 2004, "United States: Selected Issues," pages 43-50. At page 47 this report notes that "[t]ax rates on corporate and capital income display relatively little variance across countries." Note at the end of this paper that in various "tax haven" jurisdictions the rates are considerably lower.

5 For a summary of the evolution of this dispute see Joint Committee on Taxation Staff Report, JCX-67-03, July 3, 2003, "The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations", Part III, Selected Issues, Segment A, The FSC-ETI Dispute.

6 For an identification of the primary recipients of the ETI provision see Oyola, "FSC-ET Beneficiaries: An Updated Profile," Tax Notes International, October 6, 2003, p. 101.

7 Both bills would provide that, for a limited time, the earnings of foreign subsidiaries could be repatriated with a U.S. tax of only 5.25 percent (rather than the usual 35 percent, subject to any foreign tax credit offset). Many large corporations seem to be anticipating that this relief may be included in any final bill, accumulating significant profits in their offshore subsidiaries, rather than repatriating all of some of these profits. See Almond & Sullivan, "While U.S. Congress Dawdles, Trapped Foreign Profits Surge," Tax Notes International, Vol. 35, p. 11, July 5, 2004. This study identified 237 companies that reported a total of $510 billion of unrepatriated earnings in 2003, and similarly for 2002 found 237 firms with $406 billion of unrepatriated profits. Certainly some of these profits when repatriated will carry along available foreign tax credits, but many (through transfer pricing and other income shifting mechanisms) will have been realized in jurisdictions having low or zero tax regimes.

8 See "House Tax Writers Ask Bush Administration to Help Repeal ETI Act," 2004 TNT 29-1.

9 BNA Daily Tax Report, February 12, 2004, p. G-11.

10 BNA Daily Tax Report, August 5, 2004, p. G-7.

11 See the Joint Committee on Taxation analysis, "Comparison of the Estimated Budget Effects of H.R. 4520, the "American Jobs Creation Act of 2004," as passed by the House of Representatives, and H.R. 4520, the "Jumpstart Our Business Strength ('Jobs') Act," as amended by the Senate, JCX-53-04, July 23, 2004, comparing the budget effects of the House and Senate version of the legislation that would repeal the illegal U.S. export tax breaks and replace them with corporate tax relief.. This document provides an analysis of the budget effects of these two bills.

12 See Thompson and Clary, "Economic Substance, Inversions, And the Bush-Kerry International Tax Reform Debate," Tax Notes International, Vol. 35, p. 181, July 12, 2004.

13 The Preamble to the final check-the-box regulations stated: "As stated in the preamble to the proposed regulations, in light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties." T.D. 8697, Dec. 18, 1996.

14 1998-1 C.B. 334.

15 277 F.3d 778 (5th Cir. 2001).

16 2000-1 C.B. 826.

17 2001-2 C.B. 190.

18 2003-49 I.R.B. 1181.

19 2004-11 I.R.B. 606.

20 See BNA Daily Tax Report, February 13, 2004, p. G-1. See, also, Shepard, "Treasury Explains Foreign Tax Credit Proposals," Tax Notes, February 2, 2004, p. 577.

21 See in The U.S. Department of the Treasury's "General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals" a segment entitled "Close Loopholes and Improve Tax Compliance, Combat Abusive Tax Avoidance Transactions."

22 See Code § 956.

23 286 F.3d 324 (6th Cir. 2002).

24 See also "Tax Evader Pleads Guilty in Fraud Case", New York Times, February 14, 2004, p. B4, indicating that Jerome Schneider, a leading promoter of the use of offshore bank account to escape taxes, has pled guilty to one felony tax charge and can reduce his prison sentence by cooperating in the prosecution of clients. This article notes that the plea was reported on a Website: Stockwatch.com. This website notes that Mr. Schneider was an offshore bank promoter, noting that "[c]lients may be unhappy to hear he has pledged full cooperation with authorities, in return for an expected sentence of 18 to 24 months."

25 REG-136481-04, 69 Fed. Reg. 47,816, August 5, 2004.

26 REG-208254-90, 65 Fed. Reg. 3401 (Jan. 21, 2000).

27 REG-129771-04, 69 Fed. Reg. 47,822, August 6, 2004.

28 2004-7 I.R.B. 486.

29 936 F.2d 1316 (D.C. Cir. 1991),

30 For an extensive discussion of this issue see May, "Wrongs and Remedies: The U.S. Tax Treatment of Multinational Partnerships Of Individuals," Vol. 35, p. 447, August 2, 2004.

31 2004-31 I.R.B. 111.

32 2004-17 I.R.B. 1.

33 122 T.C. 404 (2004), on appeal.

34 See Granwell, Syringa and Brown, "Side-by-Side Comparison of Current and Proposed U.S. Transfer Pricing Services Regulations," Tax Notes International, November 24, 2003, p. 751.

35 Prop. Reg. § 1.482-9(b).

36 Prop. Reg. § 1.482-9(c).

37 Prop. Reg. § 1.482-9(d).

38 Prop. Reg. § 1.482-9(e).

39 Prop. Reg. § 1.482-9(f).

40 Prop. Reg. § 1.482-9(g).

41 Prop. Reg. § 1.482-9(a)(7).

42 For a recent summary of developments in the APA program see Gary, "Revolving Door Keeps Spinning, APA Program Keeps Ticking," Tax Notes International, February 2, 2004, p. 427.

43 2004-29 I.R.B. 50.

44 See "Finance Leaders Launch Inquest on Multinationals Paying 'Fair Share' of Taxes," 2003 TNT 246-28 (December 23, 2003), including their letter to the IRS Commissioner requesting information.

45 See (i) U.S. Congress, Joint Committee on Taxation's explanation of the proposed United Kingdom-United States income tax treaty, signed July 24, 2001, which also includes the JCT's description of a related U.K.-U.S. protocol signed July 22, 2002 (JCS-4-03) and (ii) the U.S. Department of the Treasury's "Technical Explanation" of this treaty and a related protocol dated March 5, 2003, 2003 WTD 45-27.

46 This revision provides Mexico with tax treaty treatment equivalent to the best treatment negotiated by the United States with any other tax treaty partner (i.e., a "most favored nation" clause). In the Senate Foreign Relations Committee Report (Exec. Rpt. 108-4, 2003 TNT 55-17, March 21, 2003) the Committee noted its displeasure with such a provision, indicating: "The Committee notes its continuing concern regarding the effect of such provisions [the self-executing MFN provision] and expects that the Treasury Department will not include such provision in future treaties."

47 Note that this treaty has a "most favored nation" provision providing (under some circumstances) for similar treatment as implemented in subsequent U.S. income tax treaties.

48 See BNA Daily Report for Executives, No. 216, p. L-5, November 7, 2003.

49 The Technical Explanation to a particular treaty is a unilateral document ordinarily issued by the U.S. Department of the Treasury contemporaneously with the finalization of the treaty.

50 See BNA Daily Tax Report, February 4, 2004, p. G-4.

51 2003-42 I.R.B. 851.

52 See IRC § 1(h)(11)(C)(i)(II). This IRS Notice also lists various countries where IRC §1(h)(11) status is available.

53 See Bell, "U.S., Barbados Step Up Treaty Negotiations," Tax Notes International, November 3, 2003, p. 415.

54 See the Cato Institute Report No. 491, October 2, 2003, by Richard W. Rahn and Veronique de Rugy, "Threats to Financial Privacy and Tax Competition," electronic citation: 2003 TNT 197-28. The first paragraph of this report notes: "Global economic growth and personal freedom are under attack by governments and international organizations seeking to squelch financial privacy and tax competition. Privacy rights and international tax competition are beneficial constraints on the monopoly power of governments. But high-tax nations and organizations such as the European Union are pressing for international agreements to remove those limits on government power at the expense of prosperity and freedom."

55 See Bennett, "IRS Offshore Compliance Initiative Collects $170 Million, Tax Notes," February 9, 2004, p. 713.

56 See "Senate Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript," 2004 TNT 145-30, the unofficial transcript of a July 21 Finance Committee hearing on the country's estimated $ 311 billion tax gap. Testimony indicated that, in response to the Offshore Voluntary Compliance Initiative, 861 taxpayers (of 2 million?) paid $200 million to the U.S. Treasury.

57 Some believe this program may not have been particularly effective. See Sullivan, "Economic Analysis: U.S. Citizens Hide Hundreds of Billions in Cayman Accounts," 2004 TNT 102-4, May 24, 2004.

58 Some smaller jurisdictions are seeking to opt out of their prior commitment, as permitted to do so if all OECD member countries do not themselves comply with the standards by December 31, 2005. See Scott, "Two Tax Havens Suspend Commitment Letters to OECD," Tax Notes International, October 20, 2003, p. 203, noting that Antigua and Barbuda and St. Vincent and the Grenadines have suspended their commitments.

59 See Financial Times, January 26, 2004, p. 9, "Crackdown On Havens Faces A Critical Test." See, further, Worldwide Tax Daily, "OECD Unveils 2004 Tax Haven Report." 2004 WTD 56-2. March 22,2004. This report is available on the Internet at: http://www.oecd.org./dataoecd/60/33/30901115.pdf

60 See European Union, "Savings Tax Proposal: Frequently Asked Questions," Memo/01/266, Brussels, July 18, 2001, http://europa. eu.int/comm/taxation_customs/publications/official_doc/ IP/ip011026/memo01266_en.pdf.

61 See Financial Times, February 3, 2004, p. 4, "Caymans to Comply With Evasion Crackdown."

62 See The U.S. Department of the Treasury's "General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals" for the explanation of this proposal.

63 2004-1 I.R.B. 114.

64 BNA Daily Report for Executives, February 13, 2004, p. G-14.

65 See BNA Daily Tax Report, February 13, 2004, p. G-4.

66 See "IRS Taxpayer Advocate Blasts Tax Return Use in Arrests of Aliens on Immigration Charges", Electronic cite: http://pubs.bna.com/ip/BNA/itm.nsf/is/A0A8B8D5B1 (February 10, 2003).

67 See IRS, National Taxpayer Advocate, "2003 Annual Report to Congress," Publication 2104, December 31, 2003; Electronic citation: 2004 TNT 12-122.

68 Note this discussion: "Confidentiality of Tax Return Information "Nowhere is the importance of the confidentiality protections of tax return information under IRC section 6103 more apparent than with the taxpayer population using ITINs. Many of these taxpayers are residing and/or working in the United States in violation of immigration laws. The IRS' ITIN databank is understandably of interest to other federal agencies charged with enforcing the immigration laws and protecting national security.

"Low Income Taxpayer Clinics and community service providers uniformly report that undocumented workers have a strong incentive to file tax returns because filing may be considered evidence of good moral character for immigration purposes. Yet these taxpayers also express concern that by filing a tax return with an ITIN, the taxpayer will enable the IRS to share that information with immigration authorities. This concern acts as a deterrent to filing by this population. Confidentiality of ITIN information, then, is critical to encouraging undocumented taxpayers to file tax returns."

69 "The IRS is prohibited under Internal Revenue Code section 6103 from sharing information provided to it on a Form W-7 or any other tax information with other agencies, with few exceptions. Thus a legislative change to Section 6103 would be required before the Service could share such information."

70 See Center for Economic Progress, "Advocates of Immigrant Workers Oppose Curbs on Use of ITINs," October 30, 2003. Electronic citation: 2003 TNT 210-42.

71 See BNA Daily Tax Report, February 10, 2004, p. G-7.

72 See BNA Daily Tax Report, February 10, 2004, p. G-2.

73 See New York Times, February 15, 2004, Business Section, p. 12.

74 See BNA Daily Tax Report, February 12, 2004, p. G-2.

75 See BNA Daily Tax Report, February 9, 2004, p. G-2.

76 Financial Times, "Multinationals Find Tax Relief Abroad – Shifting Resources Around Countries Through Their International Operations has Saved Big U.S. Groups Billions of Dollars in a Year of Rising Profits," February 2, 2004, p. 15.

77 See Sullivan, "U.S. Multinationals Move More Profits to Tax Havens," Tax Notes, February 9, 2004, p. 690.

78 See Sullivan, "U.S. International Tax Policy Debate Goes Prime Time," Tax Notes International, Vol. 34, p. 465, May 3, 2004.

BURDEN REDUCTION AND SUGGESTIONS TO IMPROVE THE INTERNAL REVENUE SERVICE

The Internal Revenue Service would like to reduce burden on Small Business Taxpayers. Taxpayer burden is defined as the time or money expended by taxpayers to fulfill their tax responsibilities. It is currently only measured as it relates to the amount of time that is expended to complete the required tax forms and to maintain the necessary records/information. The cost of having an employee or third party complete these tasks is also a measure of taxpayer burden. To accomplish this goal, Taxpayer Education and Communication is seeking the assistance of tax professionals.

The IRS is interested in your burden reduction issues. Download and complete the form and return it to Regeina Hall in Dallas at Regeina.D.Hall@irs.gov. Also any suggestions you have to improve the Internal Revenue Service can be sent to Regeina.D.Hall@irs.gov.

Learn more about burden reduction at:
http://www.irs.gov/businesses/small/industries/articles/o,,id=109256,00.html

Download the form at:
http://www.irs.gov/pub/irs-pdf/f13285a.pdf

OMB Control # 1545-1349

Reducing Tax Burden on America's Taxpayers

(Referral Form for Use by the Public)

The IRS Office of Taxpayer Burden Reduction (OTpBR) needs the taxpaying public's help to identify meaningful taxpayer burden reduction opportunities that impact a large number of taxpayers. This form should be used to refer ideas for reducing taxpayer burden to the OTpBR for consideration and implementation.

Please answer the following questions to the best of your knowledge. Attach additional sheets if needed.

Tracking Number
(Official Use Only)

Originator's name *(Optional)* Date

Address *(Optional)*

Phone number *(Optional)* E-mail address *(Optional)*

1. Are you? ☐ Business Owner ☐ Tax Professional ☐ Other (please specify) ________

2. What is the problem/issue causing taxpayer burden? *(Be as specific as possible)*

3. What kind of taxpayers or businesses does it affect? *(Please check the appropriate block and describe the nature of the business, i.e. restaurant, trucking.)*

☐ Sole Proprietorship ☐ Partnership ☐ Regular Corporation ☐ S. Corporation

☐ Limited Liability Company ☐ Other *(please specify)* ________

4. What is your proposed solution or remedy? *(Please check the appropriate box and provide a detailed description of the remedy below.)*

☐ Simplify forms/publications ☐ Change regulations or rulings ☐ Change the tax law

☐ Streamline policies or procedures ☐ Other *(please specify)* ________

Submit the completed form to:

Office of Taxpayer Burden Reduction
Internal Revenue Service - S:T
5000 Ellin Road - Room C2-101
Lanham, Maryland 20706

Thank you for taking the time to refer this issue to the Office of Taxpayer Burden Reduction.

Please send any questions concerning this form to:

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