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CHAIR'S MESSAGE

I need your help.

Or, more precisely, your Section needs your help. I'll get back to that.

We are off to a rousing start this year. Before I give you some particulars, I want to make sure you all realize just what an extraordinary Chair Gene Wolf was last year. It is not possible to describe to you the depth and breadth of my admiration for my good friend Gene, who led the Section to new heights last year. Under his leadership the Section, for the first time in our history, weighed in on Federal legislation and became the recognized leader in the fight against patented tax strategies. In these and so many other ways, Gene distinguished himself and brought great honor to the Section. I am, and I know all of you are, deeply grateful for his many years of service to the Section which culminated in an extraordinarily successful term as Chair. Thank you, Gene.

Our Annual Meeting last summer was the best—and best attended—Annual Meeting ever. Elizabeth Copeland did an excellent job of organizing a stimulating program and luncheon, highlighted by the participation of the Honorable Juan F. Vasquez, Judge of the United States Tax Court. His involvement, along with legends of Texas tax law such as Vester Hughes, Stanley Blend and Trey Cousins and other wonderful panelists, added great color and value to our Annual Meeting. Thanks so much, Elizabeth. You've set a very high bar for us to hurdle next summer.

My fellow Officers—Chair-Elect Dan Micciche, Secretary Tyree Collier and Treasurer Patrick O'Daniel—had the privilege of leading the first retreat of the Council right after this year's Annual Meeting. At that retreat, the Council was able to give some serious focus to strategic issues that face the Section, and the guidance we gained at that meeting helped us focus our energies in the Officers' retreat held the next day. We, along with Donna Passons, who handles the administrative aspects of our Section, were able to use that input to set forth an aggressive agenda for the year.

Speaking of Donna—this dear friend and partner of the Section has experienced the loss of both her father and her husband in the last few months. Many of us experience losses that the rest of us don't know about, but I would be remiss not to publicly express our deep condolences to Donna. She and her staff have continued to support our efforts through all of her trials, and we look forward to continuing our friendship with Donna as recovers from these dual losses.

We've again ratcheted up the objectives of the Section and the demands on its Council members and Committee Chairs and Vice Chairs. If you'd like to see exactly what I mean, just log on to www.texastaxsection.org and click on "Statement of Direction." This document shows in detail the plans of the Section and the challenges we have placed before our leadership.

And that leadership has already risen to the occasion.

Under the direction of Tina Green, we are delivering at least two Webcasts a month on various tax topics, and that now is the norm, not the exception. Mary McNulty, as the new Chair of our Committee on Governmental Submissions (COGS), building on the marvelous efforts of Patrick O'Daniel in prior years and working with her able Vice Chair, Dan Baucum, has already delivered comments on the recent tax patent legislation in the U. S. House of Representatives, a letter to Congress on the pending carried interest legislation (more comments to come) and a massive set of comments to the Comptroller on the newly proposed margin tax rules. All of these are posted on our Website, so log on and take a look. Moreover, active projects are in progress to provide more in-depth comments on the carried interest legislation, comments on the "zero-basis" corporate tax issue, and comments on the recently proposed regulations that would make certain aspects surrounding the use of patented tax strategies be treated as reportable transactions.

Which leads me to my call for help. We're making very, very big strides towards becoming a State bar tax section that is nationally recognized. The quality of our CLE is top-rate, and our increasing COGS activity gets us in the national tax press on a regular basis. The infrastructure has been built to provide this CLE and these COGS projects, but when the rubber meets the road the actual work of putting on the CLE and doing the comment projects falls to our membership—not just the leaders who already put in so much time, but each one of you. We're striving to give you a Section of which you can be proud, but only with your hands-on help can we actually do the tasks that give us the profile to which we all aspire.

So, come on! Bring your lunch bucket, strap on your work gloves, and let's keep on working together to make our Section the best in the country. When I send out an e-mail asking for your help, understand that you will get more than you give when working with your fellow Section members on these important projects. Call me (214.912.1219) or e-mail me (Kevin.thomason@tklaw.com) any time and I'll plug you in where you have an interest and are needed. My next newsletter will, I'm sure, be full of more reports on the successes that your work has produced. I'll also spotlight some of our other efforts that space prohibits me from addressing fully in this letter. Trust me—there's a lot more, from pro bono activities to law school outreaches to . . .

We'll talk. Until then, I continue to serve this marvelous Section with much gratitude for those that have gone before and for those with whom I serve. It's a great ride—come along and find out for yourself.

Your Chairbuddy,

KT

CALL FOR NOMINATIONS FOR OUTSTANDING TEXAS TAX LAWYER AWARD

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

Nominations should be submitted to Kevin Thomason, either by email (Kevin.Thomason@tklaw.com) or hardcopy (fax number 214-999-9261) no later than December 31, 2007. The award will be made at the 2008 Texas Federal Tax Institute in San Antonio the following June.

NOMINATION FOR OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Mailing Address: ____

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

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

PROPOSED CAFETERIA PLAN REGULATIONS EXPAND ON CURRENT GUIDANCE AND ADD NEW TWISTS

William M. Fischer[1]
San Antonio, Texas

On August 7, 2007 the Treasury Department issued comprehensive proposed regulations under Section 125 of the Internal Revenue Code, which governs cafeteria plans. (See 72 Fed. Reg. 43498). The proposed regulations synthesize much previously issued guidance on cafeteria plans but also impose new rules and expand on previously vague areas. This article summarizes some of the basic rules governing cafeteria plans as well as the most notable changes and expansions of the proposed regulations.

Overview of Cafeteria Plans and Regulatory History

Cafeteria plans (also known as 125 plans or flexible benefits plans) are popular tax-savings vehicles many employers adopt to allow employees to reduce their salary to pay for certain benefits (such as health plan premiums and medical expenses) on a pre-tax basis. Section 125 protects cafeteria plan participants from the constructive receipt doctrine. Normally, a person who may choose between a taxable benefit and a nontaxable benefit will be taxed on the value of the taxable benefit even if the person chooses to receive the nontaxable benefit. However, if the choice is made through a cafeteria plan, the constructive receipt doctrine will not apply and the person will not be taxed solely because a taxable benefit could have been chosen instead. (The person might be subject to tax for another reason, such as if the cafeteria plan is discriminatory or the salary reduction amount used to pay for the benefit was "currently available.) Nontaxable benefits provided through a cafeteria plan are also exempt from FICA and FUTA.

The Revenue Act of 1978 added Section 125 to the Code. Since then, the Treasury Department has promulgated numerous regulations interpreting Section 125, but only two have ever been finalized: Regulation 1.125-3, concerning the effect of the Family and Medical Leave Act on cafeteria plans, and 1.125-4, concerning mid-year election changes. There is also one temporary regulation, 1.125-2T, which gives brief guidance as to the permissible taxable and nontaxable benefits under a cafeteria plan. The two main regulations that describe the operation of cafeteria plans, Prior Proposed Reg. 1.125-1 and Prior Proposed Reg.1.125-2, have remained in proposed form since 1984, with several amendments since then.

Although the newly proposed regulations will not become effective until the first plan year beginning on or after January 1, 2009 (assuming they are finalized timely), the notice of proposed regulations withdraws the previously proposed regulations under Section 125. Thus, the newly proposed regulations are the only regulatory guidance that employers have to interpret much of the statutory framework governing cafeteria plans. Thankfully, they are also much more comprehensive and well organized than the previously proposed regulations, which were in Q&A format.

Prop. Reg. 1.125-1: General Cafeteria Plan Rules

The first proposed regulation prescribes the general rules for a plan to qualify as a cafeteria plan, including allowable and prohibited benefits, plan document requirements, and eligibility for participation. It is imperative that a plan meet all these requirements. Otherwise, the plan is not a cafeteria plan, the constructive receipt doctrine will apply, and the employer must include in the participants' gross income the value of the most valuable taxable benefit available under the plan, even if they chose to receive nontaxable benefits. 1.125-1(b)(1). These amounts will also be subject to employment taxes. This of course ruins the purpose of having a cafeteria plan, which is to allow for payment of certain benefits with pre-tax dollars.

Allowable Benefits under a Cafeteria Plan

A cafeteria plan must offer a choice between at least one permitted taxable benefit and at least one "qualified benefit." 1.125-1(b)(4)(i). This makes sense, because otherwise there would be no reason to worry over the application of the constructive receipt doctrine.

The proposed regulations provide greater guidance on permitted taxable benefits under a cafeteria plan, which include "cash" and certain other benefits. The proposed regulations define "cash" to mean compensation (i.e. a participant chooses to receive full salary instead of reducing it to purchase other cafeteria plan benefits), paid time off, and severance pay. With a few exceptions, permitted taxable benefits also include any benefit paid for with after-tax employee dollars or treated by an employer as being paid for with after tax dollars (meaning the employer reports the value of the benefit in the employee's income and employment taxes are paid). As discussed below, they may not allow for a deferral of compensation. 1.125-1(a)(2), (h)(1).

Generally, a "qualified benefit" is a benefit attributable to employer contributions (including salary reductions) that is excludible from a participant's income due to an express provision of the Internal Revenue Code and that does not defer compensation. Typical "qualified benefits" include employer-provided health coverage (excludible under Section 106), accidental death and dismemberment, short term disability, and long term disability coverage (section 106), up to $50,000 in employer-provided group term life insurance if not combined with any permanent benefit (excludible under Section 79), medical care expense reimbursements (excludible under Section 105), dependent care expense reimbursements (excludible under Section 129), and elective deferrals into a 401(k) plan.

The proposed regulations also affirmatively state that the following benefits are qualified benefits:

- COBRA premiums for health coverage from a former or current employer. (A participant could have COBRA coverage from a current employer if the participant suffers a qualifying event without a termination of employment, such as changing from full time to part time status) 1.125-1(a)(3)(C), 1.125-1(l)(2); and

- Contributions to a Health Savings Accounts (HSAs). 1.125-1(a)(3)(J).

Prohibited Benefits Under a Cafeteria Plan

The proposed regulations also add to the list of benefits that cannot be provided under a cafeteria plan, even though specific Code provisions may exclude them from income:

- Contributions to Archer MSAs;
- Group term life insurance on any person who is not an employee (whether taxable or not); and
- Elective deferrals to a 403(b) plan. 1.125-1(q)(1).

Other benefits that were already prohibited under a cafeteria plan include contributions to Health Reimbursement Arrangements, long-term care insurance and anything marketed as such; and long-term care services. *Id*. However, the proposed regulations point out a way to circumvent the bar on using a cafeteria plan to pay for long-term care services: contributions can be made to an HSA, and the HSA can make distributions to pay for long-term care services. 1.125-1(q)(3).

Prohibition of Deferral of Compensation

The proposed regulations expand on the already existing prohibition on deferral of compensation through a cafeteria plan and add several exceptions and safe harbors. The proposed regulations prohibit a cafeteria plan from offering health or insurance products with a savings or investment feature, such as whole life insurance, or group term life insurance combined with permanent benefits, on the grounds that they allow for a deferral of compensation. 1.125-1(k)(1), 1.125-1(o)(1). They also provide that the contributions to HSAs are allowed, even though they defer compensation. 1.125-1(o)(3)(iv) Finally, they allow cafeteria plans to offer the following benefits even though they relate to more than one plan year:

- Benefits under a multi-year long-term disability policy;
- Reasonable premium rebates/dividends paid within 12 months of close of plan year;
- A two-year "lock in" for vision or dental insurance (a requirement that coverage be for a two-year period) if the premiums are paid at least once a year and the cafeteria plan payments only relate to coverage in the year of application; and
- Insurance benefits such as credit toward the deductible for unreimbursed covered expenses from prior years, premium waiver during disability, guaranteed renewability without evidence of insurability, coverage for a specified accidental injury, progressive diagnosis payments, and payments of fixed amounts per day of hospitalization, if all the following requirements are met:
    - No part of a benefit is used to purchase a benefit in a later plan year;
    - Policies expire upon failure to pay premiums (except for disability waiver);
    - There is no investment fund or cash value that can be drawn on to pay premiums;
    - No part of any premium is held in a separate account for any participant or is otherwise segregated apart from the assets of the insurance company. 1.125-1(p).

Plan document requirements

The proposed regulations expand on the basic statutory requirement that a cafeteria plan must have a written plan document by requiring the plan document to adequately cover numerous specified topics

- Eligibility rules for participation;
- The procedure to make elections (including periods for which elections are effective and the general irrevocability of elections);
- How employer contributions may be made to the plan (salary reduction, employer flex credits, or both);
- The maximum amount of elective contributions;
- A specific description of each benefit available under the plan;
- The plan year;
- A description of any grace period;
- Additional required information if the plan offers a flexible spending arrangement (such as a medical expense or dependent care expense reimbursement account) or deferrals into a 401(k) plan;
- Ordering rules for the use of paid time off; and
- Provisions concerning "qualified distributions" from a health FSA to an HSA. 1.125-1(c)(1).

Existing cafeteria plan documents probably meet most of these requirements, with the exception of the last one which is a fairly new optional provision.

With respect to cafeteria plans that incorporate Health, Dependent Care, and/or Adoption Assistance FSAs, the proposed regulations provide that requirements under the various Code Sections (105, 129, and 137) requiring these arrangements to have a separate written plan document will be met if the FSAs are contained in a cafeteria plan document that meets the requirements of Section 125. 1.125-1(c)(2). Some practitioners previously used separate plan documents for FSAs, and the proposed regulations specifically allow this. *Id*. It may still be preferable for Health FSAs to be contained in a separately stated plan document for ERISA and HIPAA reasons. Furthermore, it may be preferable to maintain other FSAs in separate documents in light of the new rule in the proposed regulation that all amendments to a cafeteria plan document must be prospective. 1.125-1(c)(5).

Finally, the proposed regulations provide that if a plan is not operated in accordance with the written plan document or otherwise fails to operate in compliance with Section 125 and the proposed regulations, it fails to be a cafeteria plan, with all of the attendant tax consequences. 1.125-1(c)(7)(i). The examples given to illustrate this rule all involve clear violations of requirements of the proposed regulations, but the way in which the rule is written suggests that an operational violation of an optional (and perhaps inoffensive) provision contained in a written plan document can cause the entire plan to fail. There has been no indication of any de minimis rules or voluntary correction programs in connection with this new requirement.

Eligible Participants

The proposed regulations clarify that a director may not participate in a cafeteria plan unless the director is also an employee. In that case the director can participate in the plan solely in the person's capacity as an employee, which presumably means that any amount earned as director's fees cannot go into the plan. 1.125-1(g)(2)(i), (iii). However, a partner of a partnership and a 2% shareholder of an S corporation cannot participate in a cafeteria plan even if they are also employees. 1.125-1(g)(iii).

They also preserve the current rule that former employees may be covered by a cafeteria plan, although the plan may not be established or maintained "predominantly" for the benefit of former employees. 1.125-1(g)(1), (g)(3). However, this rule is not very useful, because few former employees will have a source of pre-tax dollars to go into the former employer's cafeteria plan.

Immediately Effective Rule Concerning Excess Group Term Life Insurance

Finally, one part of this proposed regulation became effective on August 6, 2007: a new method of determining the amount of imputed income due to excess group term life insurance. 1.125-1(k)(2)(i)(B), 1.125-1(s). An employer may provide up to $50,000 of group term life insurance coverage to an employee without any tax consequences, but to the extent that it provides more it must report income to the covered employee. Under the new rule, the cost of excess group term life insurance is calculated by subtracting any after-tax amount used to pay for the insurance from the Table I cost found in Regulation 1.79-3(d)(2). 1.125-1(k)(2). This replaces the previous calculation announced in Notice 89-110, and depending on the circumstances may result in smaller amounts of imputed income.

1.125-2: Election Rules

The proposed regulations make only a few changes and expansions in the election rules. First, cafeteria plans may implement an optional new rule to allow new employees to make a cafeteria plan election within 30 days after the date of hire. The election is treated as effective as of the date of hire, but any salary reductions used to pay for the election must be made from compensation that is not currently available on the date of the election. 1.125-2(d). In other words, the benefits can be provided retroactively but paid for with compensation that is earned later. They also note that elections need not be made in writing, and the safe harbor of 1.401(a)-21 concerning elections, revocations, and election changes applies in the cafeteria plan context. 1.125-2(a)(5). Finally, they incorporate previous guidance concerning changes in elections of HSA contributions, which can be made prospectively at any point in year. 1.125-2(c). This is a significant exception to the general rule of irrevocability of elections.

1.125-5: Flexible Spending Arrangements

Proposed Regulation 1.125-5 contains rules governing FSAs, with one notable change to current law and a few clarifications. The proposed regulation slightly relaxes the rule that prohibits reimbursement for services that have not yet been rendered by allowing cafeteria plans to offer reimbursement for advance payments for orthodontia services. 1.125-5(k)(3)(i).

The regulation also confirms the expected, but not completely clear, result that an HSA can be operated in connection with a blended post-dedutible, limited purpose health FSA. 1.125-5(m)(5). A participant in a full-purpose FSA may not make contribution to an HSA, and the IRS has previously issued guidance allowing contributions a limited purpose FSA (providing only vision, dental, or preventive care benefits) or a post-deductible FSA (providing the reimbursements for the full gamut of medical expenses, but only after the HDHP deductible is satisfied). The previous guidance did not affirmatively state that both features could be combined in one FSA. Employers who adopt FSAs with either of these features should be aware of the special substantiation rules in the proposed regulations: a participant must provide information from an independent third party that the HDHP deductible has been satisfied or that the benefits are for vision care, dental care, or preventive care. 1.125-5(m)(6).

The remaining provisions of the regulation generally follow current guidance. For instance, the proposed regulations allow unused FSA amounts to be rolled over into an HSA, which is another exception to the use it or lose it rule, but the requirements are so restrictive that it is unlikely many employers will allow them. 1.125-5(n).

1.125-6: Substantiation of Expenses

The proposed regulation's substantiation rules generally incorporate provisions of past guidance, including various IRS pronouncements concerning the use of debit cards in connection with health FSAs. The main development is that the proposed regulation offers the first guidance on using debit cards to pay for dependent care expenses. However, the provisions are not terribly useful because they prohibit the advance payment for dependent care expenses, and dependent care providers generally charge for their services in advance. 1.125-6(g). Also, the regulation also relaxes the use it or lose it rule by giving cafeteria plans the flexibility to allow terminated employees to spend down dependent care expense account for services incurred after termination. 1.125-6(a)(4)(v). This is unlikely to be a popular option either, since most participants incur dependent care expenses faster than the available amount in the FSA builds up.

There are also a few minor changes in the rules on substantiating Health FSA expenses paid for with debit cards, but the rules are so recent and the consequences of failing to properly substantiate expenses are so severe (a plan fails to be a cafeteria plan and all participants are taxed) that practitioners should review the rules in their entirety. When setting up a debit card program with a Health FSA, the following requirements must be met:

- Employee must agree in advance in writing to use card only for eligible expenses, and this fine print must appear on card;
- An employee's card must be deactivated upon termination; and
- The employer must limit use of card to:
    - Doctors, dentists, eye care professionals, hospitals, other medical providers (with proper my merchant category code);
    - Stores with drugstore/pharmacy merchant category codes; and

- Stores with IRS-approved "inventory information approval system." 1.125-6(d)(1)-(5).

If the debit card is used at one of the first two categories of providers, the expense will be automatically substantiated if:

- It is a multiple of a copayments (up to five times the copayment amount, as opposed to a three times limit in current guidance);
- It is a recurring medical expense (refilling of a prescription); or
- An employee at the store substantiates the expense in real time. 1.125-6(e).

If the debit card is used at a store with inventory information approval system, then more stringent substantiation requirements apply:

- The store must keep track of card use, match purchases with SKUs, and compare the SKUs with a list of approved expenditures; and
- If non-qualifying items purchased, require them to be purchased with cash or a different card. 1.125-6(f).

Although employers generally rely on debit card providers to set up a compliant debit card system, the regulations place the burden of compliance on the employers. If employer determines a debit card is used improperly, it must follow these steps, in order, or risk having the entire cafeteria plan disqualified:

- Deactivate card until the expense is properly substantiated;
- Demand repayment;
- Withhold the amount of the expense from the employee's pay, if legal;
- Use claims substitution (ie link the improper payment to a properly substantiated expense that has not yet been reimbursed); and finally
- Treat as it does other business debt. 1.125-6(d)(7).

1.125-7: Discrimination Rules

The major impact of the proposed regulations is in their description of the precise limits of discrimination in a cafeteria plan. Per statute, a cafeteria plan may not discriminate in favor of:

- "Highly compensated individuals" (HCIs) concerning eligibility;
- "Highly compensated participants" (HCPs) concerning contributions and benefits; or
- Key Employees concerning their use of the plan. Code Section 125(b)(1)-(2).

If a cafeteria plan violates one of these prohibitions, all benefits provided under the cafeteria plan to the HCIs, HCPs, or key employees will become taxable. Employers must then report these amounts as income to the affected employees and make the customary withholding and payment of income and employment taxes. However, the current rules concerning the first two types of discrimination are so vague that it is often unclear when discrimination occurs.

The proposed regulations adopt the current rules concerning discrimination in favor of key employees, and for the first time provide various tests, both objective and fact-based, to determine when plans discriminate in favor of HCIs and HCPs.

HCIs are defined to be:

- Officers;
- 5% shareholders; or
- "highly compensated," meaning their compensation exceeds the Section 414(q)(1)(B) limit ($100,000 for 2007, $105,000 for 2008), and, if the employer elects, is among the top 20% of employees ranked by compensation. 1.125-7(a)(3), (9).

The statute does not define the term "highly compensated," so the clarification in the final prong of the HCI definition is welcome.

Under the eligibility test of the proposed regulation, a cafeteria plan does not discriminate in favor of HCIs if the plan:

- Covers employees under a "reasonable classification," per Regulation 1.410(b)-4(b), and
- satisfies either:
    - the safe harbor percentage test per of Regulation 1.410(b)-4(c) or
    - the facts and circumstances test of Regulation 1.410(b)-4(c). 1.125-7(b)(1).

In other words, the proposed regulations import many of the minimum coverage rules that apply to qualified plans.

The proposed regulations define HCPs broadly to include any HCI who is eligible to participate in plan, which seems to contradict the statutory provision that an HCP must actually participate in a plan, not just be eligible to participate in a plan. Code Section 125(e)(1), Prop.Reg. 1.125-7(a)(4).

In any event, the proposed regulations provide that a plan does not discriminate in favor of HCPs as to contributions and benefits if:

- Similarly situated participants have a uniform opportunity to elect qualified benefits and employer contributions (meaning that a plan cannot offer better benefits/contributions to HCPs) and
- HCPs do not disproportionately elect qualified benefits or employer contributions. 1.125-7(c)(2).

Under a mathematical test provided in the proposed regulations, a plan is discriminatory if:

- Aggregate qualified benefits elected by HCPs divided by the aggregate compensation of the HCPs exceeds the aggregate qualified benefits elected by non-HCPs divided by the aggregate compensation of the non-HCPs; or

- Aggregate employer contributions used by HCPs divided by the aggregate compensation of the HCPs exceeds the aggregate employer contributions used by non-HCPs divided by the aggregate compensation of the non-HCPs. 1.125-7(g).

There are many exceptions and special rules in the discrimination provisions, including a safe harbor for the contribution and benefits test for premium only plans and plans providing only health benefits. 1.125-7(e)-(f). The proposed regulations also have a permissive disaggregation rule that may be used with respect to all three discrimination tests. 1.125-7(g).

Conclusion

Except for the new method of calculating imputed income from excess group term life insurance, which goes into effect immediately, the proposed regulations will not be finalized until at least January 1, 2009. Nevertheless, attorneys should begin now to evaluate the potential impact of the proposed regulations on their clients' cafeteria plans. Cautious clients may want to amend their plans now to comply with the proposed regulations, both because they are entitled to rely on the proposed regulations and the previously proposed regulations have been withdrawn, leaving a regulatory vacuum. In any event, employers must amend their cafeteria plans before the eventual effective date in light of the new prospective amendment rule. Clients who do not wish to rely on the proposed regulations now should nevertheless begin exploring the effect of the discrimination rules on their plans, which will probably be the major impact caused by the proposed regulations. Employers should institute necessary changes before the effective date if there is a potential discrimination issue. Even if there is no issue, employers should assign responsibility for monitoring discrimination on an ongoing basis either in house or with a third-party administrator.

ENDNOTES

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A PRACTITIONER'S GUIDE TO HANDLING IRS APPEALS

Larry Jones, Dallas, Texas
Farley Katz, San Antonio, Texas
Tom Rhodus, Dallas, Texas
Juan F. Vasquez, Jr., Houston, Texas[1]

Overview of the Appeals Process

The Office of Appeals ("Appeals") is a principal office of the Internal Revenue Service ("IRS") independent of any other office or division and provides a venue where disagreements concerning the application of tax law can be resolved on a fair and impartial basis. The Commissioner has granted Appeals the authority to consider and negotiate settlements of federal tax controversies. (Internal Revenue Service Delegation Order No. 66; Internal Revenue Service Policy Statement P-8-47.) Currently, line authority for Appeals field operations is through the National Chief of Appeals who reports directly to the Commissioner. Appeals settles approximately 85 to 90 percent of the cases it reviews. This outline deals primarily with going to Appeals after an IRS examination. Most of the procedures discussed, however, apply to all types of appeals.

Appeals provides taxpayers with a prompt and independent review of their cases after another IRS examination office has proposed changes that adversely affect them. The Appeals process provides the final administrative opportunity for the taxpayer and the IRS to fairly resolve tax disputes without litigation.

The goal of Appeals is to settle as many cases as possible within the broad guidelines of its Mission Statement (Internal Revenue Manual ("IRM" or "Manual") 8.1.1.1 (02-01-2003)):

> The Appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service. The Appeals program is designed to effectively carry out the Appeals mission.

Even though much of the work of Appeals comes from examinations, its jurisdiction has greatly expanded in recent years. In examination cases involving income, gift and estate taxes, the taxpayer receives a 30-day letter. This letter is accompanied by the Revenue Agent's Report ("RAR") and gives the taxpayer 30 days to request a conference with Appeals ("Appeals conference"). In most cases, the taxpayer is required to file a protest describing the taxpayer's position. If the taxpayer does not request an Appeals conference, then the IRS will send the taxpayer a notice of deficiency. If the taxpayer files a petition with the Tax Court, and has not had an Appeals conference, the IRS will send the case to Appeals to consider a possible settlement. *See* Rev. Proc. 87-24, 1987-1 C.B. 720. In other types of cases, the IRS will send the taxpayer a letter advising the taxpayer of his right to an Appeals conference and giving the taxpayer a time limit for such request.

Much of the information discussed herein is drawn from the Manual. Understanding the IRS's view of the Appeals process, as expressed in the Manual, is important for at least two reasons. First, the Manual sets forth the basic ground rules which apply when taking a case to Appeals. Second, there may be occasions where the Manual provisions support the taxpayer's position or are in conflict with an unfavorable position taken by the IRS. Either way, knowledge of the

Manual provisions should assist the taxpayer in achieving a resolution of the case short of a trial.

According to the Manual, the "mission" of Appeals is as follows:

8.1.1.1 (02-01-2003)

Appeals Mission

1. The Appeals mission is accomplished through a program of considering protested cases, holding conferences, and negotiating settlements in a manner which ensures:

   A. A prompt conference and a prompt decision in each case. - A prompt conference and decision enable the taxpayer to know with the least amount of delay, the final decision of the Service as to the amount of tax liability, or other issue in contention, and results in getting into the Treasury additional revenue involved at the earliest practicable date.

   B. A high-quality decision in each case. - A decision of high quality is required in each case and should represent judicious application of Service policy and sound legal principles.

   C. A satisfactory number of agreed settlements. - It is a fundamental purpose of the Appeals function to effect settlement of contested cases – on a basis fair to both the Government and the taxpayer – to the end that the greatest possible number of nondocketed cases are closed in that status and the greatest possible number of docketed cases are closed without trial.

2. The Appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service. The Appeals program is designed to effectively carry out the Appeals mission.

3. An integral part of accomplishing the Appeals mission is to schedule conferences on dates and at locations reasonably convenient to taxpayers and representatives. We also offer to schedule telephone conferences, and taxpayers may use correspondence as a method of having a conference, at their convenience.

The Manual describes the functional authority and jurisdiction of Appeals as follows:

8.1.1.3 (03-01-2006)

Appeals' Functional Authority and Jurisdiction

1. Appeals is the Internal Revenue Service's dispute resolution forum. The Commissioner has granted Appeals authority to consider and negotiate settlements of internal revenue controversies. (See Delegation Order No. 66, as revised, in IRM 1.2.47, Delegation of Authorities for the Appeals Process, and Policy Statement P-8-47 in IRM 1.2.1, Policies of the Internal Revenue Service.)

2. Appeals' responsibility includes but is not limited to:

   - the administrative determination of liability for income, estate, gift, employment and excise taxes, plus additions to tax, additional amounts and penalties;
   - collection due process;
   - collection appeals program;
   - offers-in-compromise;
   - penalty appeals;
   - abatement of interest;
   - consideration of requests for administrative costs under Internal Revenue Code ("Code" or "IRC") Section 7430;
   - jeopardy levies;
   - recommendations concerning settlement offers in refund suits;
   - IRC Section 534(b) letters [burden of proof in accumulated earnings cases];
   - refund claims including Joint Committee cases; and
   - overassessments in which a taxpayer appeals the decision of a compliance Area Director, or a Campus Director.

3. Appeals jurisdiction includes, but is not limited to, cases that are subject to notice of deficiency procedures or that involve a tax liability. In most cases, a preliminary (30 or 60 day) letter has been issued to the taxpayer by the compliance Area Director or Campus Director. In general, taxpayers request an Appeals conference and, when required, file a protest against the proposed deficiency, overassessment, or determination. See IRM 8.6.1, Conference and Settlement Practice for protest requirements.

4. A functional description of Appeals may be found in IRM Part 1.1.7, Organization and Staffing.

5. The Statement of Procedural Rules for the Appeals activity is in 26 CFR 601.106.

Appeals does not consider cases that only involve the failure or refusal to comply with the tax laws because of moral, religious, political, constitutional, conscientious, or similar arguments. See Treas. Reg. Section 601.106(b).

B. Appeals Involving Collection Issues

There are two separate procedures for obtaining review by Appeals of collection disputes. These are the statutory Collection Due Process ("CDP") Appeals and the administrative program referred to as Collection Appeals Program ("CAP"). These collection appeals make up an increasing portion of Appeals' workload and present numerous special issues. The Internal Revenue Manual devotes extensive discussion to these issues. See IRM 8.7.2.

1. Collection Due Process Appeals

Under the Code, taxpayers can have an Appeals conference after the filing of a notice of federal tax lien (IRC Section 6320) and prior to levy on the taxpayer's property (IRC Section 6330). In both instances, the IRS is required to issue the taxpayer notice of his right to appeal. To appeal, the taxpayer must file IRS Form 12153, *Request for a Collection Due Process or Equivalent Hearing*. The form must be submitted within 30 days from the date of the notice. The taxpayer will then be afforded a hearing before an officer of Appeals ("Settlement Officer"). At the hearing, the taxpayer may raise the following issues:

- Collection alternatives such as installment agreement or offer in compromise.
- Subordination or discharge of lien.
- Withdrawal of Notice of Federal Tax Lien.
- Appropriate spousal defenses.
- The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an

See IRS Pub. 1660, Collection Appeal Rights (Revised 3/07). A taxpayer, however, may not raise an issue that was raised and considered at a prior administrative or judicial hearing if the taxpayer participated meaningfully in that hearing or proceeding.

A taxpayer is entitled to only one hearing with respect to the first lien notice issued and one hearing with respect to the first levy notice issued for each taxable period involved. It is critical that the taxpayer make all positions known and provide all pertinent documents at or before the CDP hearing, as such items constitute a part of the administrative record. The IRS's current position is that a taxpayer's judicial review is limited to the administrative record. However, the United States Tax Court, with the exception of cases in the Eighth Circuit, concludes that it is not limited to the administrative record. It is important to note that this state of the law is in flux, so it is important to make the administrative record as complete as possible.

Once the IRS makes its decision, it issues a Notice of Determination informing the taxpayer of its position. If the taxpayer is dissatisfied with the CDP conference, he may seek a judicial review in the United States Tax Court if the Tax Court has jurisdiction over the underlying tax liability, or if not, to a United States District Court or Court of Federal Claims. The United States Tax Court has exclusive jurisdiction for CDP cases with respect to IRS Notices of Determination issued after October 18, 2007, regardless of type of underlying tax involved. The taxpayer must file the notice of appeal within 30 days after the determination.

For CDP cases in which the taxpayer did not receive a notice of deficiency or otherwise have an opportunity to dispute the underlying tax liability, the United States Tax Court has de novo review. For other CDP cases, the United States Tax Court reviews the IRS decision under an abuse of discretion standard.

Where a taxpayer files a Request for a Collection Due Process Hearing after the deadline as set forth in the original notice, the taxpayer may request an "equivalent hearing." An equivalent hearing is essentially the same as a Collection Due Process Hearing, but the taxpayer will not have the opportunity for judicial review after determination. *See* IRS Pub. 1660, *supra*.

2. Collection Appeals Program Appeals

In addition to the Collection Due Process Appeals, the IRS has made administratively available appellate review for a variety of matters relating to collections, which program is referred to as the Collection Appeals Program. Under this program, a taxpayer essentially may obtain appellate review of virtually any significant action taken by the IRS during collection, including the issuance of a federal tax lien, a levy on wages or garnishment on salary, the seizure of property, the rejection of an offer in compromise or a proposed installment agreement, or where the IRS has denied a request to withdraw a notice of tax lien, or denied a discharge, subordination or notice of a lien. Depending on the nature of the issue and the level of IRS involvement, a taxpayer may obtain appellate review by making an oral request or in writing by filing IRS Form 9423, *Collection Appeal Request*. *See further* IRS Pub. 1660, Collection Appeal Rights (Revised 3/07).

C. Options to Resolve Issues

Appeals plays a vital role in the protection of taxpayer rights by having authority to settle disputes between taxpayers and operating divisions within the IRS. The IRS encourages the resolution of tax disputes through administrative appeals, rather than court litigation, in order to minimize expenses incurred by both the Government and the taxpayers. If the taxpayer disagrees with Appeals' determination, the taxpayer's basic remedies are: (1) Tax Court litigation or (2) paying the tax and filing suit for a refund in United States District Court or the Court of Federal Claims.[2]

Appeals has reorganized its staffing to include a headquarters and three operating units associated with the IRS operating divisions. Headquarters is responsible for addressing Appeals strategic needs, while the operating divisions provide service to different segments of taxpayers. The head of Appeals reports directly to the IRS Commissioner and is responsible for planning, managing, directing and executing nationwide activities for Appeals.

Appeals has revamped its processes and is creating new services for taxpayers. These services include:

1. Fast Track Settlement

This program is designed to reduce the time it takes to resolve Large and Mid-sized Businesses ("LMSB") cases in Appeals. After a taxpayer has received IRS Form 5701, *Notice of Proposed Adjustment*, but before the taxpayer has received the RAR, it may request Fast Track Settlement ("FTS"). The IRS may accept a case for FTS only if it is satisfied that the issue is sufficiently developed to permit resolution under FTS. Although FTS is designed for LMSB cases, other case types, such as Small Business/Self-employed ("SB/SE") cases, may be considered for FTS resolution. An independent Appeals Officer is assigned to mediate the case, with the goal of resolving the case within 120 days of acceptance into the program. The Appeals Officer may propose settlement for any or all issues, but neither IRS exam nor the taxpayer is required to accept the proposal. If resolution is not reached, the taxpayer may request standard review by Appeals upon receipt of the RAR. Certain issues are not eligible for FTS consideration, including issues in cases designated for or considered for designation for litigation. *See* Rev. Proc. 2003-40, 2003-1 C.B. 1004.

2. Fast Track Mediation

Fast Track Mediation ("FTM") is a streamlined process designed to expedite resolution of disputes, designed for SB/SE taxpayers. It is similar to FTS, but is more informal. It is designed to promote issue resolution 30 to 40 days after the initial meeting with the Appeals Officer. FTM is generally available for all non-docketed cases and collection matters over which SB/SE Division has jurisdiction, including income tax examinations, offer in compromise cases, trust fund recovery penalties and Collection Due Process cases. It is generally not available for issues as to which resolution will depend on an assessment of the hazards of litigation. Specific categories of cases are excluded from the FTM program, including cases designated for litigation or under consideration for designation, issues for which there is an absence of legal precedent, issues for which there are conflicts between the circuit courts of appeal, and issues involving change in methods of accounting. FTM should be initiated only after an issue has been fully developed. As with FTS, if a case is not resolved by FTM, the taxpayer will have all standard Appeals rights preserved. *See* Rev. Proc. 2003-41, 2003-1 C.B. 1044.

3. Arbitration

The arbitration program is a new alternative dispute resolution initiative designed to assist taxpayers who are unable to reach a settlement in the normal course of the appeals process. This program uses a neutral decision-maker who will reach a binding decision on the issues that prevented the taxpayer and Appeals from reaching a settlement. Arbitration is available only for factual issues such as valuation and reasonable compensation, but is not available for a number of categories of cases, including cases designated for litigation or docketed in any court, cases involving the substantiation of expenses and cases involving Industry Specialized Program or Appeals Coordinated Issues. Arbitrators may be IRS personnel or non-IRS personnel upon agreement of the parties. If a non-IRS arbitrator is selected, the IRS and the taxpayer will share the costs. Arbitration has been rarely used. *See* Ann. 2000-4, 2000-3 I.R.B. 317.

4. Mediation

Mediation is an alternative dispute resolution initiative designed to assist taxpayers and Appeals in reaching a settlement. An IRS or Appeals mediator is used to facilitate negotiations between Appeals and taxpayers when they are unable to reach a settlement in the normal course of the appeals process. The taxpayer may elect to have a non-IRS person serve as co-mediator. Mediation is available for a wide range of issues, including legal issues, factual issues, Industry Specialized Program Issues, Appeals Coordinated Issues, early referral issues, and unsuccessful attempts to enter into a closing agreement. It is not available for issues designated for litigation or docketed in any court, collection cases, and certain other categories. *See* Ann. 98-99, 1998-2 C.B. 652, and Rev. Proc. 2002-44, 2002-2 C.B. 10.

5. Early Referral

Early referral procedures allow taxpayers whose returns are being examined to request the transfer of a developed but disputed issue to Appeals, while the IRS Agent continues to examine other issues. The purpose of this initiative is to resolve cases more expeditiously. *See* Rev. Proc. 99-28, 1999-29 I.R.B. 109.

As outlined in Revenue Procedure 99-28, issues that are appropriate for early referral include those that can reasonably be expected to result in a quicker resolution of the entire case if resolved. In addition, both the taxpayer and the IRS must agree that the issues should be referred to Appeals early. Finally, the issues must be fully developed and be part of a case in which the remaining issues are not expected to be completed before Appeals could resolve the early referral issues.

Early referral of an issue is not appropriate where a 30-day letter has already been issued. Issues that are not fully developed are also inappropriate, as are issues that are designated for litigation.

D. Non-Docketed and Docketed Cases (IRM 8.4.1) (09-01-2006)

A non-docketed case is one where the IRS has not issued a statutory Notice of Deficiency and the taxpayer has not filed a Tax Court petition. In a non-docketed case, a 30-day letter is issued by the IRS Agent conducting the examination. In these cases, the taxpayer must file a protest as a means of obtaining an Appeals conference. If the taxpayer has petitioned the Tax Court before consideration by the Appeals Office, the case is a docketed case. In docketed cases, the Appeals Office will have exclusive settlement jurisdiction for a period of about four months.

The main difference between a non-docketed and a docketed case is how the taxpayer gets to Appeals. A protest is required in non-docketed cases, but after the protest is filed, the Appeals conference is basically the same in either a non-docketed or a docketed case.

If the taxpayer elects not to file a protest for an Appeals conference after receiving the 30-day letter, a 90-day letter will be issued, giving the taxpayer 90 days to file a petition with the Tax Court. After the taxpayer files his petition, the case will be forwarded to Appeals for the four-month period.

This four-month period begins when Appeals receives the case from IRS Counsel. In all cases, Appeals will attempt to arrange a settlement conference within 45 days of receiving the case. However, this four-month period depends on the workload of Appeals. If a settlement is reached in a docketed case, the Appeals Officer will prepare the necessary computations and send them to IRS Counsel. IRS Counsel then prepares the settlement documents for execution and filing with the Tax Court.

At the end of the four-month period (or earlier if Appeals feels the case is not susceptible of settlement), the case will be returned to IRS Counsel. IRS Counsel will then have exclusive authority to dispose of the case by trial.

E. Advantages and Disadvantages of Going to Appeals

1. Advantages:

a. The taxpayer and the IRS may be able to settle the case without litigation at substantially less cost.

b. The taxpayer does not have to make an immediate decision to file suit in the Tax Court or in the United States District Court or the Court of Federal Claims.

c. The taxpayer will have more opportunity to prepare the case before a suit commences.

d. The taxpayer will not have to pay the tax immediately.

e. The taxpayer can obtain information about the IRS's position that he could not otherwise obtain from the Revenue Agent.

f. The protest gives the taxpayer a chance to tell his story.

2. Disadvantages:

a. The Appeals Officer may raise new issues. See below at K6.

b. Delay in resolving the case may subject the taxpayer to more expenses.

c. The Appeals Officer might further investigate or analyze the case and strengthen the IRS's position.

If the taxpayer unreasonably fails to go through the Appeals procedure, he could be subject to a penalty imposed by the Tax Court of as much as $25,000 for failure to exhaust all administrative remedies. IRC § 6673(a). A taxpayer should exhaust all remedies to be eligible to request legal fees and administrative costs in the future. *See* IRC § 7430 (b)(1).

F. The Need for a Protest

The taxpayer must request an Appeals conference with respect to an examination in writing by submitting a protest. The protest is a written document which sets forth the taxpayer's position. The dollar limitation for requiring a formal protest has increased. If the total amount for any tax period (including tax and penalties) is more than $25,000, the taxpayer must submit a written protest to obtain Appeals consideration. If the total amount for any tax period is $25,000 or less, the taxpayer can request Appeals consideration by making a "Small Case Request." A taxpayer can make such a request for Appeals consideration by writing the IRS, indicating the disputed issues and the taxpayer's reason for not agreeing. IRM 8.6.1.1.4.

Special appeal procedures may be provided for cases such as appeals of liens, levies, seizures or installment agreements. The IRS provides an appeal request form for these types of cases. *See* IRS Pub. 1660, Collection Appeal Rights.

G. Preparing the Protest

The taxpayer's first step in going to Appeals is preparing a protest requesting an Appeals conference. The taxpayer must file the protest within the 30-day period required in the IRS' letter summarizing the Revenue Agent's findings or advising of other action that gives the taxpayer the right to request an Appeals conference. If a taxpayer elects not to file the protest within the 30-day period, the taxpayer will then receive a 90-day letter, after which it is usually still possible to have an Appeals conference after filing suit in the Tax Court.

The taxpayer may request an extension of time to file the protest. Recently, the IRS has been reluctant to grant extensions, even where clearly justified, e.g., taxpayer has just hired a representative. If an extension cannot be obtained, the representative should file as complete a protest as possible (sometimes referred to as a "skeletal protest") and amend it later. If a taxpayer does not retain a representative until after the time for filing the protest has expired, the taxpayer's representative should go ahead and file a protest. There is always the possibility that the IRS will accept and process the protest and give the taxpayer an Appeals conference.

Although there is no official form for protests, the protest must contain the following information (*See* IRS Publication 5, "Your Appeal Rights and How to Prepare a Protest If You Don't Agree" (Revised 1/99)):

1. Name and Address

This is the full name(s) and current address of the taxpayer(s), including social security number or taxpayer identification number on the tax return(s) which are being appealed.

2. Statement of Appeal

This is a statement setting forth why the taxpayer wishes to appeal the Revenue Agent's findings.

3. Letter Date and Symbols

This information will be found in the upper right-hand portion of the 30-day letter under the heading "In Reply Refer To:".

4. Tax Period(s) or Year(s) Involved

List the years or tax periods found on the RAR of income tax changes that are in dispute.

5. Itemized Schedule of Tax Changes

This should correspond to the RAR of income tax changes. The taxpayer should list the items disagreed with and the years in which the adjustments appear.

6. Statement of Facts

The statement of facts section is very important. In this section, the taxpayer should individually address each item in the itemized schedule that he disagrees with. The taxpayer should state the facts and the reasons why these items were included on the tax return. For penalties, the taxpayer should explain why he disagrees with the Revenue Agent. It is not sufficient to state, "At the time of the Appeals conference I will present my facts."

7. Statement of Law and Authority

The taxpayer should state the law and authority that supports his position and cite and discuss the Code sections, Revenue Rulings, Publications, or court cases that support his position. If the taxpayer chooses, he can incorporate the statement of law or authority into each item under the statement of facts instead of making separate sections.

8. Perjury Statement

The perjury statement is mandatory if the taxpayer signs the protest. The exact wording the taxpayer should use is:

> Under the penalties of perjury, I declare that I have examined the statement of facts presented in the protest and in any accompanying schedules and, to the best of my knowledge and belief, it is true, correct, and complete.

If a representative submits the protest, he may substitute a declaration stating that he prepared the protest and accompanying documents, and whether he knows personally that the statement of facts contained in the protest and accompanying documents is true and correct.

9. Signatures Required for a Written Protest

If the protest relates to a jointly-filed return, both the husband and wife must sign the protest. If the protest relates to a corporation, the corporation's name should be followed by the signature and title of the officer authorized to sign for the corporation. A representative holding a power of attorney may instead sign the protest.

10. Attach a Copy of the RAR

After the protest is prepared, the protest is filed with the IRS office that sent the letter advising the taxpayer that an Appeals conference may be requested. Once that office receives the protest it will forward it to Appeals.

H. Protest Strategy

1. Detailed versus Bare Bones?

There are different views as to how detailed a protest should be: it can be very skeletal or very detailed. Experience shows, however, that it is usually better to have a detailed protest setting forth all of the facts and the law that support the taxpayer's position. Also, if the protest is so minimal as to be inadequate, Appeals could reject it. *See* I2, below.

2. Tone

The protest should set forth why the taxpayer should prevail. It should be written in positive language and should not personally attack the IRS Agent. Attacking the Revenue Agent is not perceived as convincing by Appeals. In most cases, maintaining an even tone is usually a good idea. However, an outrageous statement or position in the 30-day letter may warrant a strong, pointed response.

3. Using the RAR and the Manual

In drafting a protest, quote the RAR and the Manual back to the Appeals Officer where helpful. Many times, there are statements in the RAR or the Manual which are directly at odds with the position taken by the auditor.

4. Read the Boilerplate

It is always advisable to read the boilerplate, whether that language is contained in the RAR or the cases or studies cited in the RAR. Many times, there are favorable statements buried within these materials which can be quoted back to the Appeals Officer in support of the taxpayer's position.

5. Shepardize

Cases cited should be shepardized. Significant changes may have occurred between the issuance of the RAR and the deadline for filing a protest with Appeals.

6. Legal Authorities Cited in Protests

a. **Private Letter Rulings ("PLRs")**

Technically, PLRs do not have any precedential value (except for the taxpayer making the ruling request), and are rarely cited in briefs or other pleadings filed in court. The same is not necessarily true at the Appeals level. While PLRs are certainly not the equivalent of a reported decision of the Tax Court, they are usually worth citing in a written protest as useful examples of how the IRS has treated similar factual situations in the past. In fact, one of the reasons which led to the publication of PLRs was that the IRS used those rulings as a reference body of legal authority.

b. **Dealing with Adverse Precedent**

Do not ignore adverse precedent which the IRS knows of or will discover, even if it is from other jurisdictions. Attempt first to distinguish it on valid legal or factual grounds. If it cannot be distinguished, you may decide to candidly admit that. At Appeals, the impact of adverse precedent from the Tax Court or the Fifth Circuit may be lessened if favorable opinions on the same issue have been issued by other courts. For example, if there is favorable case law from the United States Court of Federal Claims or other circuits, a taxpayer presenting his case at Appeals may wish to make a presentation based on his chances of success in those other courts, as opposed to the chances of success in Tax Court or the Fifth Circuit. Even if the taxpayer has no opportunity of filing suit in those circuits, arguments at Appeals can always be couched in terms of "the position that would or would not ultimately be sustained by the courts."

c. **Other Sources of Authority**

Written materials issued by other branches of Government are often a good source for bolstering disputed legal or factual positions which are addressed in a protest. IRS press releases, pamphlets and publications may also provide useful material for protests, including material that conflicts with other IRS publications.

d. **Use of Lexis/Nexis and the Internet**

In many cases, the use of Lexis/Nexis and the Internet is almost a necessity. Depending upon the issue and the amounts involved, it is well worth the expense of running a particular phrase or key-word through the tax files of Lexis. On occasion, it may be worth running the same through the "omni" file, which picks up all state and federal reported opinions. Nexis, which has newspapers and many other publications in full text format, is also a potential source of helpful information. Finally, the Internet can be a tremendous source of information for use in support of a taxpayer's position.

7. **Supplementing the Protest With Declarations**

Declarations are sometimes useful, but the statements in them must be carefully reviewed. The statement could have some unanticipated use at some point later in the proceeding in assisting the Government in proving its case. The declaration, which need not be notarized, should include the declarant's name, followed by statements that the declarant is over 21, of sound mind, capable of making the declaration and has knowledge of the facts stated.

8. **Transferring Appeals**

The Manual provides that non-docketed cases may be transferred in certain circumstances. For example, non-docketed cases may be transferred to an Appeals office that is closest to the taxpayer's residence or place of business if the books and records are available there. IRM 8.1.1.6.2 (02-01-2003). Cases may also be transferred at the taxpayer's request to any Appeals office if the receiving office is closer to the taxpayer's residence or place of business, or transfer of the case would relieve the taxpayer of undue hardship. *Id*. Transfers of non-docketed cases under other circumstances require approval by an Area Director. *Id*.

Docketed cases under Appeals jurisdiction should be transferred to the Appeals office serving the locality designated by the United States Tax Court for a hearing. IRM 8.1.1.6.1 (02-01-2003), with certain exceptions. Transfers of docketed cases in other circumstances require approval by the Area Director. *Id*.

I. **IRS' Handling of the Protest**

1. **Initial Review by Revenue Agent**

Currently, a protest is generally filed with the Revenue agent. According to the Manual, "Examination should be given the opportunity to timely review and comment on any significant new information or evidence presented by the taxpayer." IRM Section 8.2.1.2 (9-16-98).

2. **Initial Review by Appeals**

Upon receipt, Appeals will give a preliminary review of the protest. In certain circumstances, Appeals may return the case to IRS Exam. This may occur, for example, where substantial additional information is required to resolve an important issue, where there are significant unresolved factual variances between the examination report and the protest, or where there is a clear misapplication of the law that renders an important issue indefensible. IRM 8.2.1.2 (10-27-2006). The IRS may return the protest to the taxpayer where it fails to set forth the taxpayer's position, lacks substantive detail or is otherwise seriously deficient. *Id*.

3. **Notice of Receipt**

Appeals will send a letter to the taxpayer shortly after filing of the protest, acknowledging receipt. Appeals generally will then call to schedule a conference. IRM Section 8.2.1.2.3 (10-27-06).

4. **Extension of Statute**

Appeals will require consents to extend the statute of limitations for assessment in certain circumstances. Appeals may refuse to accept an income tax case if less than 180 days remains on the statute. IRM Section 8.2.1.3.1 (10-27-06). When less than 60 days remains on the statute (120 days in the case of certain large cases), Appeals will request a consent (Form 872 or 872-A) extending the statute. IRM 8.2.1.3.3 (10-27-06). If the consent is not received from the taxpayer, Appeals will issue a 90-day letter.

5. Ex parte Contact

Under the 1998 tax legislation, in order to foster impartiality, Appeals Officers generally are forbidden to have ex parte communications with the Revenue agent who handled the examination or other matter appealed. If the Appeals Officer desires to contact the Revenue agent, he must offer the taxpayer the opportunity to be present for such discussion. *See* Rev. Proc. 2000-43, 2000-2 C.B. 404. The ex parte rules do not apply in certain cases, however, such as docketed cases or mediations and arbitrations, where the taxpayer must waive the ex parte rule. *See* further IRM 8.1.1.4.1 (02-01-2003).

J. Preparing for the Appeals Conference

The Appeals Officer wants to maximize the possibility of closing the case with one conference, so he ordinarily will prepare all issues of the taxpayer's case. The taxpayer's representative should be equally – if not more – prepared and should do the following before preparing the protest and attending the Appeals conference:

1. Interview the taxpayer – learn the "exact" facts and "all" the facts.

2. Check the important facts – do not rely entirely on what the taxpayer says.

3. Obtain business records and any other documentary evidence from the taxpayer or third parties.

4. Develop the arguments after investigating the facts and analyzing the law.

5. Evaluate both sides of the case.

6. Determine what other evidence is needed – e.g., additional witnesses.

7. Assemble exhibits for use at the conference.

8. Review the entire file – it is better to postpone the conference than make a weak presentation.

9. Develop a proposed settlement.

10. Develop a strategy—Should you make an offer? Solicit an offer? Start the discussion? Have Appeals Officer start?

11. Determine if the taxpayer should attend the conference.

12. Consider tape recording the conference. *See* IRC § 7251; IRM Section 8.6.1.2.5.1 (5-13-04).

13. Realize that Appeals Officers may not be attorneys: This is an important factor to keep in mind when dealing with a case which hinges on the admissibility of certain records or testimony. Items may be viewed as inadmissible by Appeals Officers, when in fact the opposite conclusion is true. In these cases, it may be important to explain exactly why a particular piece of evidence will be admissible or inadmissible.

14. Determine problem issues, and how to handle problem issues. The following sections of Circular 230 may apply:

    § 10.20 Information to be furnished.

    (**a**) **To the Internal Revenue Service.** No attorney, certified public accountant, enrolled agent, or enrolled actuary shall neglect or refuse promptly to submit records or information in any matter before the Internal Revenue Service, upon proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, or shall interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service or its officers or employees to obtain any such record or information, unless he believes in good faith and on reasonable grounds that such record or information is privileged or that the request for, or effort to obtain, such record or information is of doubtful legality. . . .

    § 10.21. Knowledge of client's omission. Each attorney, certified public accountant, enrolled agent, or enrolled actuary, who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client is required by the revenue laws of the United States to execute, shall advise the client promptly of the fact of such noncompliance, error, or omission.

    § 10.22 Diligence as to accuracy. Each attorney, certified public accountant, enrolled agent, or enrolled actuary, shall exercise due diligence:

    a. In preparing or assisting in the preparation of approving, and filing returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

    b. In determining the correctness of oral or written representations made by him to the Department of the Treasury; and

    c. In determining the correctness of oral or written representations made by him to clients with reference to any matter administered by the Internal Revenue Service.

    § 10.23 Prompt disposition of pending matters. No attorney, certified public accountant, enrolled agent, or enrolled actuary shall unreasonably delay the prompt disposition of any matter before the Internal Revenue Service.

K. The Role of the Appeals Officer

It is the role of the Appeals Officer to be reasonable and impartial. (IRM 8.1.1.4.) The Appeals Officer usually does not act as an investigator or examining officer, but can request additional information or evidence if he feels it is required. The Appeals Officer should negotiate a settlement with the taxpayer or the taxpayer's representative, and recommend the settlement to his supervisor who has actual settlement authority. If the parties enter into an agreement to close the case with finality, the case will not be reopened after a supervisor approves the settlement except in very limited circumstances. Appeals has the authority to resolve cases on an intermediate or compromise basis based on the facts, law, and hazards of litigation. The unique part of Appeals' authority is its ability to consider the probability of the outcome of the case if litigated.

The Appeals Officer's exercise of settlement authority is subject to certain limitations, such as (IRM 8.1.1.3.2 (3-1-06):

1. **Recurring Nature of Issue**

   Since the goal of Appeals is to resolve issues with finality, it may not be in the best interest of the parties to settle an issue that continues from year to year on an intermediate basis without a closing agreement. A distinction should be made between a fact-intensive issue and pure legal issue.

2. **Compliance**

   Appeals may decline to settle a case if the taxpayer's voluntary compliance would produce a greater result than settlement or other resolution.

3. **Controlled Issues**

   If an issue is controlled by the National Office, Appeals cannot settle the case. The National Office controls issues in cases falling under the Appeals Coordinated Issue Program, Industry Specialization Program and product pricing cases.

4. **National Office Determination**

   Appeals may not settle cases if it is contrary to technical advice favoring the taxpayer or if it will disturb a change in accounting method approved by the National Office.

5. **Nuisance Value Settlement**

   Appeals cannot enter into any settlement that is not based on the merits of the issue, but is made solely to eliminate the inconvenience or cost of further negotiations or litigation. Appeals cannot demand or grant concessions if the only purpose is to relieve either party of such inconvenience or cost.

6. **New Issues**

   Although Appeals can raise new issues and, in some instances, reopen closed issues, it typically does not do so.

   IRS Policy Statements

   P-8-49
   New Issues Not to Be Raised Unless Material

   An issue, on which the taxpayer and the office of the District Director are in agreement, should not be reopened by Appeals. Additionally, a new issue should not be raised, unless the ground for such action is a substantial one and the potential effect upon the tax liability is material.

   P-8-50
   Mutual concession Cases Closed by Appeals Will Not Be Reopened by Service Except Under Certain Circumstances

   A case closed by Appeals on the basis of concessions made by both Appeals and the taxpayer will not be reopened by action initiated by the IRS unless the disposition involved fraud, malfeasance, concealment or misrepresentation of material fact, or an important mistake in mathematical calculation, and then only with the approval of the regional Director of Appeals.

7. **New Issues Raised by Taxpayer**

   Where a taxpayer raises an issue not previously examined or raised in the Tax Court petition, Appeals is required to prepare a memorandum for Area Counsel who will advise whether the issue may be raised without formal amendment to the pleadings. IRM 8.4.1.1.6 (09-01-2006).

8. **Appeals Technical Guidance Program**

   The Internal Revenue Manual contains specific technical guidance to Appeals Officers on a number of specific issues including:

   a. Personal holding company deficiency dividends (IRM 8.7.1.1.1 (11-30-2001)).

   b. Interest (IRM 8.7.1.1.2 (10-27-2006)).

   c. Corporate underpayment and overpayment (IRM 8.7.1.1.2.1 (10-27-2006)).

   d. Estate and gift tax issues (IRM 8.7.1.1.4 (11-30-2001)).

   e. Jeopardy and termination assessments (IRM 8.7.1.5 2-8.7.1.1.7 (10-27-2006)).

   f. Transferee liability (IRM 8.7.1.1.8. 10-27-2006)).

   g. Employment tax issues (IRM 8.7.1.2 (10-27-2006)).

   h. Refund suits (IRM 8.7.1.3 (11-30-2001)).

9. **Technical Guidance Programs**

   The Appeals Technical Guidance Program (formerly known as the Appeals Industry Specialized Program and Appeals Coordinated Issue Program) was established to ensure nationwide uniformity and consistency in settling issues, enhance the identification and timely resolution of issues and provide a vehicle for coordination of technical issues. See IRM 8.7.3. Among other functions, this program issues Appeals Settlement Guidelines which provide guidelines for settlement in specific issues of nationwide importance. See IRM 8.7.3.3.1 (3-1-2006). For example, the IRS has issued an Appeals Settlement Guideline on family limited partnerships (10-18-2006), a Settlement Guideline on Amortization of Employment Contracts

(5-18-1994) and a variety of other issues, including numerous tax shelters. Appeals Officers will rely heavily on these guidelines, and representatives filing protests on issues covered by such guidelines must study the guidelines before going to Appeals.

L. Appeals Conferences

Appeals conferences are informal meetings between the Appeals Officer and the taxpayer that are designed to promote frank discussion and mutual understanding. These conferences do not involve ideological arguments. The Appeals Officer must handle cases objectively by reaching a sound decision based upon the merits of the issues in dispute. (IRM 8.6.1.2.)

One purpose of the Appeals conference is to allow full disclosure by both sides. Since the Appeals conference is at the taxpayer's request, the taxpayer will be allowed to present his case and the Appeals Officer will ask questions to clarify the facts and law.

Appeals schedules conferences at times and places that are reasonably convenient to taxpayers and their representatives. Generally, they are held at Appeals Offices. Appeals Officers, however, do travel to locations where there is no permanent Appeals Office. Ordinarily, the amount in dispute is not an important factor in approving another conference site. (IRM 8.6.1.2.1.)

The number of conferences are usually held to a minimum, but the taxpayer should request as many conferences as is deemed necessary to settle the case. Cases are promptly concluded by frankly discussing the facts and the law.

The Appeals mission is to resolve tax controversies, without litigation, on a basis which is "fair and impartial" to both the Government and the taxpayer. A fair and impartial resolution is one which reflects on an issue-by-issue basis the probable result in event of litigation, or one which reflects mutual concessions for the purpose of settlement based on relative strength of the opposing positions where there is substantial uncertainty of the result in event of litigation.

The Appeals Officer will take into consideration several factors in connection with his evaluation of the hazards of litigation. Some of these factors are as follows:

1. The substantiating evidence likely to be presented.

2. The credibility of the taxpayer.

3. The availability of witnesses.

4. The probability that the evidence the taxpayer can present will carry the taxpayer's burden of proof.

5. The uncertainty as to any issue of fact and conclusion of law (the law in the circuit to which the case would be appealed).

Factors which Appeals will not consider when weighing the hazards of litigation are:

1. The Docketed or Non-Docketed Status of the Case

The standards for settling a case are the same for both a non-docketed case and a docketed case. The same standards also apply to a claim for refund or overassessment case.

2. The Proximity to Trial of a Case

The proximity to trial may increase the pressure for the Appeals Officer to settle a case, but this factor will not cause a change in the settlement criteria. It is possible that on reconsideration of a case or during trial preparation, the Appeals Officer may discover additional facts that may affect the evaluation of the case, or there may be a change in the law.

3. Competency of Counsel

The qualifications of counsel for the taxpayer or counsel for the Government is a neutral factor.

4. The Tax Court Judge Assigned to the Case

The idiosyncrasies of a specific judge may also create additional pressure for the Appeals Officer to settle, but should not cause a change in the criteria.

5. The Cost of Litigation

The cost of litigation will not be used as a criterion to settle a case or as a lever to force a settlement at a greater amount than is warranted by the merits of the case.

M. Extending the Statute of Limitations

After the protest is filed, the administrative file of the IRS, containing the protest, tax returns of the taxpayer, the RAR, and other documents relating to the taxpayer's liability for the years involved, is sent to the Appeals Office. A major concern of the Appeals Office is the expiration of the statute of limitations on assessment; accordingly, the file will be examined to determine when the statutory period of limitations expires. IRS offices are instructed not to transmit a case to the Appeals Office unless at least 180 days remain before the expiration of the statutory period for assessment. If the Appeals Office determines that the time for appellate review is inadequate, the taxpayer will be requested to execute a Form 872, which will extend the statutory period to a specific date. Alternatively, the Appeals Officer may also request a Form 872-A, which is an open-ended consent that extends the period of assessment until 90 days after either completion of the Appeals Office consideration or notice by either party on a Form 872-T of its desire to terminate the consent. Generally, it is best to use Form 872, and it should be executed for the minimum period of time that can be negotiated with the IRS.

N. Types of Settlements

Appeals is the only administrative function of the IRS with authority to consider settlement of tax controversies. *See* IRS Policy Statement P-8-47. Appeals is specifically authorized to settle tax controversies on bases which reflect the relative merits of the positions in light of the hazards if the case were litigated. *Id*. The IRS may settle cases in various ways. It may settle cases by trading off issues with the taxpayer, each side conceding one or more issues. Appeals is also authorized to settle individual issues based on a percentage settlement reflecting the hazards of litigation. This is referred to as a "split-issue" settlement. See IRS Policy Statement P-8-48.

The IRS, however, will not settle cases based on the nuisance value to either party. IRS Policy Statement P-8-47.

Negotiations should aim toward resolution of all issues in a case. If this cannot be done, then the taxpayer's representative and the Appeals Officer should attempt to reach agreement on all issues which can be settled.

The IRS resolves issues such as reasonableness of salaries, capital gain versus ordinary income on recurring sales of property, hobby losses, etc., on the basis of the facts and circumstances applicable to each year. In such cases, settlement has no binding effect on later years in which a similar issue may arise, but may, as a practical matter, set a "precedent" for resolution.

Where settlement involves issues such as basis of property, category of income, or amount of income from installment collections, it may be desirable to incorporate the effect on later years into the settlement by use of a closing agreement or collateral agreement.

Where the disposition involves mutual concessions and the subsequent tax effect is material, a closing agreement should be executed. Where there are no mutual concessions or where the tax effect is not material, a closing agreement is not required, but it may be executed if in the judgment of Appeals it is desirable or if the taxpayer requests a closing agreement.

Where a closing agreement is not required, a collateral agreement may be obtained since it will express in writing the understanding of the parties as to the tax effect in later years.

O. Forms Used to Settle Cases with Appeals

After settling the case, the Appeals Officer prepares an action/transmittal memorandum and supporting statement discussing the issues and evidence, the amount of settlement, and the reasons supporting settlement.

Appeals Officers do not have final authority to settle tax cases. No settlement reached with an Appeals Officer is binding unless and until it is approved by a reviewing officer appointed within the Appeals Office. This means that Appeals will not conclude a case merely because an Appeals Officer has reached some oral understanding with the taxpayer. A settlement will conclude when it is reflected in a settlement agreement (Form 870-AD), signed and accepted on behalf of the Commissioner. After this agreement is signed, the case will not be reopened unless there is later a suspicion of fraud, concealment, misrepresentation, etc., and then only with approval of Appeals. Further, the taxpayer agrees not to seek a refund for any tax covered by the agreement. Form 870 is less binding on the taxpayer and the IRS, and is generally used at the examination level in settling cases with the Revenue Agent. The taxpayer can still file a claim for refund and the IRS may assert deficiencies.

1. Closing Agreements (Form 866)

These agreements are final and conclusive and are used in cases where the settlement involves mutual concessions of continuing issues that affect later years or related cases. In general, basic contract law principles apply to closing agreements. *See generally* IRS Closing Agreement Handbook in the IRM.

2. Form 870-AD

These forms are used in cases where concessions are made by both the Service and the taxpayer. Typically, they include a provision that the taxpayer will not make a claim for refund. Some taxpayers have ignored this language, subsequently filing refund claims. Particular facts might justify a taxpayer to seek a refund, such as a subsequent favorable court decision. Some courts have held that taxpayers are equitably estopped from bringing the refund suit. *See, e.g., Flynn v. United States*, 786 F.2d 586 (3d Cir. 1986). Other courts have reached the opposite conclusion, holding that a closing agreement (Form 866) is the exclusive method of finally settling a tax dispute (other than by a court). *See, e.g., Whitney v. United States*, 826 F.2d 896 (9th Cir. 1987).

If the case cannot be settled, the Appeals Officer prepares an action/transmittal memorandum and Appeals case memo, which discusses the settlement offer and the Appeals Officer's settlement range. At this time, Appeals will request the issuance of a statutory notice of deficiency, which IRS Counsel reviews before issuance.

P. Miscellaneous Observations Regarding Certain Cases/Issues

1. Employee Classification Cases

In some cases, Appeals is willing to reduce or eliminate proposed liabilities in exchange for an agreement by the taxpayer to switch independent contractors to employees prospectively. See Notice 98-21, 1998-15 I.R.B. 14, describing the classification settlement program for worker classification cases.

2. Code Section 6672 Cases (formerly the "100 percent penalty," now the "trust fund recovery penalty")

In the Fifth Circuit (which includes Mississippi, Louisiana and Texas), responsible person cases are very difficult to settle absent overwhelming evidence. *See, e.g., Salzillo v. United States*, 66 Fed. Cl. 123 (2005).

3. Offers in Compromise

The denial of an offer in compromise based on doubt as to collectibility may be appealed. Unfortunately, absent some computational error, Appeals usually will uphold the denial.

4. Substantiation

The "either you have it or you don't have it" analysis is not always correct and is not always applied. In many cases, substantiation may be proved by other methods, such as testimony. It is definitely worth addressing the issue in the written protest.

Q. Conclusion

A taxpayer ordinarily should never pass up the opportunity to take his or her case to Appeals. Even though all cases are not resolved at Appeals, the majority of them are, and in many situations the results are better and certainly more predictable than the outcome of a trial.

ENDNOTES

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2 A less used alternative is filing bankruptcy where the liabilities can be judicially determined.

SECTION OF TAXATION
State Bar of Texas

September 14, 2007

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Eric Solomon
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Gentlemen:

On behalf of the Section of Taxation of the State Bar of Texas, we applaud your efforts to find a legislative solution to the many policy concerns presented by the growing body of issued and pending patents on tax planning methods. The recent passage of H. R. 1908, the Patent Modernization Act of 2007, by the House of Representatives, was a much appreciated first step towards finding that solution because it included, as an amendment offered by Representatives Goodlatte and Boucher, an improved version of the legislation suggested by the State Bar of Texas and this Section in resolutions passed last January 26 and forwarded at that time to Congress. We further commend Chairman Conyers and Ranking Member Smith of the House Committee on the Judiciary, along with Chairman Berman and Ranking Member Coble of that Committee's Subcommittee on Courts, the Internet and Intellectual Property, for their leadership in the approval of that amendment and the passage of such legislation. We also appreciate the support expressed for such legislation by Chairman Rangel and Ranking Member McCrery of the House Committee on Ways and Means in their letter to their colleagues dated September 6, 2007, and are quite certain that such support was a major factor in the ultimate inclusion of that amendment in H. R. 1908.

We also note and appreciate the Administration's Statement of Administrative Policy with regard to H. R. 1908 wherein it recognized the concerns surrounding patent protection for tax planning methods and pledged to work with Congress to address those concerns.

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We are aware that Chairman Leahy and Ranking Member Specter, along with other Members of the Senate Committee on the Judiciary, have been analyzing this issue, and we encourage them to propose legislation similar to H. R. 1908, either as a stand-alone bill or as part of the larger patent reform legislation currently under consideration. Moreover, we are especially appreciative of the recent statements issued by the offices of Chairman Baucus and Ranking Member Grassley of the Senate Committee on Finance indicating their intention to introduce legislation designed to ban tax strategy patents. These Committees will no doubt propose a solution that effectively addresses the concerns expressed by the State Bar of Texas and this Section last January in a manner that is as restrictive as that embodied in H. R. 1908, if not more so.

We continue to believe that the granting of patents on tax strategies is the result of a strained reading and application of the applicable laws. More importantly, it is a development that places severe strains on the tax system, including the perception of fairness of the system and the ability of the IRS to administer the tax law. If unchecked, the granting of patents on tax strategies will lead to immense compliance costs and many nonproductive alterations in the manner in which tax advice is provided. We applaud the efforts of all those, both in government and out, who are striving to rectify this strain on our tax system.

The Council of the Section of Taxation unanimously approved the sentiments expressed in this letter at a meeting held on September 14, 2007.

Very truly yours,

Kevin Thomason
Chair, Section of Taxation
State Bar of Texas

SECTION OF TAXATION
State Bar of Texas

September 6, 2007

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Re: H.R. 2834 and the Taxation of Carried Interests

Dear Chairmen Rangel and Baucus and Ranking Members McCrery and Grassley:

The Section of Taxation of the State Bar of Texas respectfully submits these comments on H.R. 2834. These brief comments will be followed by a more extensive report that examines in greater detail the technical issues and policy concerns raised by H.R. 2834. Because H.R. 2834 would potentially impact entities of all sizes and in many lines of business, and could prove complex to implement and enforce, we urge you to carefully consider the effect of the approach taken by the bill on all taxpayers. It is not our intention to advocate for or against the current proposal. Instead, we seek only to identify issues that we believe should be considered as you go forward in this process.

As you know, H.R. 2834 creates a special type of partnership profits interest, called an "investment services partnership interest," which is generally an interest held by a partner who provides a substantial quantity of services to a partnership with respect to commodities or real estate. Under H.R. 2834, the allocable share of partnership income of a partner holding an investment services partnership interest will be taxed as ordinary income subject to self-employment taxes, as will a partner's gain on his sale of such a partnership interest. The partner will be subject to this tax treatment regardless of the character of the partnership's income at the partnership level and regardless of the amount of time that the partner has held his partnership interest.

As currently drafted, H.R. 2834 would have an impact far beyond the world of large, investment partnerships such as private equity funds and hedge funds. For example, the proposal would impact nearly all real estate partnerships, including the many small partnerships that are formed to own real estate. Thus, the general partner of a small partnership that buys or builds a rent house would be subject to H.R. 2834 in the same manner as the portfolio manager of a billion dollar partnership that invests in developed properties.

Moreover, H.R. 2834 would impact partners operating businesses far from the world of investment partnerships. Among those who could be ensnared by H.R. 2834 are a farmer in a farming partnership, or any small businessman who is a member of a partnership with real estate assets, such as a grocery store, and who has the responsibility for managing the real estate. In addition, H.R. 2834 would impact an expanding number of businesses due to the fact, among others, that limited liability companies which are treated as partnerships for Federal income tax purposes are increasingly being used by small and emerging businesses as the entity of choice instead of corporations.

As with almost any significant change in the tax law, H.R. 2834 will likely prove complex to implement and enforce. In this regard, H.R. 2834 recognizes that a partner may receive a partnership interest in exchange for both capital and services provided to the partnership and imposes ordinary income treatment only with respect to the portion of the partnership interest received for services. It will be a significant challenge to establish clear, simple rules for determining when a partnership interest is attributable to invested capital rather than services. For example, where a partnership has several classes of capital partners entitled to different rates and priorities of return, it may be difficult to determine exactly what part of a partner's interest is obtained in exchange for invested capital.

Likewise, consider the common occurrence of a general partner who receives a profits interest in a partnership in exchange for providing services and contributing intangible property (such as contractual relationships or business plans) to the partnership. H. R. 2834 would appear to require a valuation of the intangible property and an allocation of the portion of the partnership interest obtained in exchange therefore. In normal practice, when this fact pattern arises the general partner often will simply accept a larger profits interest, rather than undertaking a complex and uncertain valuation of the intangible property contributed to the

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partnership. However, H.R. 2834 would force partnerships to grapple with these difficult valuation issues in every such circumstance.

Congress should carefully weigh the potential complexity of H.R. 2834 against the goals of the bill, particularly to small partners and partnerships ill-equipped to understand and comply with an already complicated partnership tax system. Many have suggested that the current complexity of the tax code is a major contributor to the "tax gap".

Finally, in addition to the potential complexity of H.R. 2834 itself, consideration must be given to the interaction of H.R. 2834 with existing provisions of the tax law. For example, section 707(a)(2)(A) of the Internal Revenue Code of 1986, as amended, calls for the promulgation of regulations that would characterize payments to a partner for services as payments made to a non-partner rather than as an allocation of partnership income. While no such regulations have yet been issued, there would appear to be significant overlap between the approach taken by H.R. 2834 and the existing language of section 707(a)(2)(A). Regulations promulgated by the Treasury Department and the Internal Revenue Service under section 707(a)(2)(A) may be an appropriate alternative way to address your policy concerns.

Thank you for the opportunity to provide comments on this important matter. Once again, in the near future we intend to submit a report that examines the issues raised by H.R. 2834 in greater detail.

Very truly yours,

Kevin Thomason
Chair, Section of Taxation
State Bar of Texas

cc: Hon. Eric Solomon, Assistant Secretary of the Treasury for Tax Policy
Mr. Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury
Mr. William P. Bowers, Special Counsel to the Assistant Secretary of the Treasury for Tax Policy

SECTION OF TAXATION
State Bar of Texas

October 12, 2007

Bryant K. Lomax
Texas Comptroller of Public Accounts
Manager, Tax Policy Division,
P.O. Box 13528, Austin, Texas 78711.

Dear Mr. Lomax:

On September 14, 2007, the Texas Comptroller's office published a draft set of Rules that implement the provisions of the new margin tax as enacted by the Third Called Session of the 79th Legislature and as amended by the Regular Session of the 80th Legislature. On behalf of the Section of Taxation of the State Bar, I am pleased to submit the enclosed set of Comments on the draft Rules.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Texas Comptroller's Office on putting together a well-drafted and comprehensive set of Rules despite the magnitude of the Legislature's changes to the Texas franchise tax and the significant time pressures relating to the implementation of these new provisions. We also appreciate the opportunity to submit these Comments.

Respectfully submitted,

Kevin Thomason
Chair, Section of Taxation
State Bar of Texas

cc: Susan Combs, Texas Comptroller of Public Accounts
Jerry Oxford, Texas Comptroller, Tax Policy Division

COMMENTS CONCERNING THE TEXAS COMPTROLLER'S DRAFT RULES AS PUBLISHED IN THE TEXAS REGISTER ON SEPTEMBER 14, 2007

The following comments are the individual views of the members of the Section of Taxation (the "Section") who prepared them and do not represent the position of the State Bar of Texas or the Section.

These comments were prepared by individual members of the Section's Committee on State and Local Taxation (the "Committee"). Principal responsibility was exercised by the Chair of the Committee, David E. Colmenero, and by two of the Committee's Vice Chairs, Matthew Larsen and Alyson Outenreath. The Comments were reviewed, and substantive contributions were made by, Geoffrey Polma, Cynthia Ohlenforst, Charlotte Noel, Dan Micciche, Christi Mondrik and Ira Lipstet. They were also reviewed by Steven Salch, a member of the Section's Committee on Government Submissions, and by the Chair of the Section, Kevin Thomason.

Although many of the members of the Section who participated in preparing these Comments have clients who would be affected by the state tax principles addressed by these Comments or have advised clients on the application of such principles, no such members (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: October 12, 2007

TAX SECTION OF THE TEXAS BAR OF TEXAS
STATE AND LOCAL TAX COMMITTEE
COMMENTS TO THE TEXAS COMPTROLLER'S DRAFT MARGIN TAX RULES

I. EXECUTIVE SUMMARY

These comments are submitted in response to the draft set of rules published by the Texas Comptroller in the Texas Register on September 14, 2007. Below is a brief summary of the comments included herein.

A. Proposed Rule 3.581, Margin: Taxable and Nontaxable Entities

1. Sole Proprietorships: We recommend amending the language in Proposed Rule 3.581(b)(3) to clarify that an entity that is treated as a sole proprietorship for federal income tax purposes may qualify as an excluded entity for margin tax purposes if it does not enjoy limited liability protection under the statutes of this or another state.

2. Treatment of Revocable Grantor Trust after Grantor's Death: We recommend amending the definition of a nontaxable estate to clarify that it includes a revocable grantor trust that elects to be treated as an estate for federal income tax purposes after the death of the grantor.

B. Proposed Rule 3.582, Margin: Passive Entities

1. Application of 90% and 10% Income Provisions: We recommend making several changes to the 90% and 10% income tests to (i) clarify that these provisions apply with respect to the gross income for the period on which margin is based; (ii) remove the word "net" as applied to gains from the sale of real property, commodities, and securities that may be included in applying the 90% test; and (iii) clarify that any of the specifically enumerated items of income that may satisfy the 90% test may not be treated as active income for purposes of the 10% test, regardless of whether that income would be viewed as having been generated from an active trade or business.

2. Definition of Securities: We recommend that the term "securities" for purposes of passive entities be defined by reference to The Securities Act under state law. We also recommend that the definition not be limited to non-controlling security interests.

3. Section 338(h)(10) Elections: We recommend that Proposed Rule 3.582 be amended to state that, for passive entity purposes, gain from the sale of stock continues to reflect gain from the sale of stock even where, for federal income tax purposes, the sale is treated as gain from the sale of the subsidiary's assets pursuant to an election under Section 338(h)(10) of the Internal Revenue Code of 1986, as amended.

4. Limited Liability Partnerships: We recommend amending Proposed Rule 3.582 to make clear that a limited liability partnership is a type of general partnership and can therefore qualify as a passive entity.

5. Nonoperating Working Interests: We recommend amending Proposed Rule 3.582 to specify that income from nonoperating working interests qualify as passive income, unless the operator of the property is a member of the owner's affiliated group.

C. Proposed Rule 3.583, Margin: Exemptions

1. Exiting Exempt Entities: We recommend amending Proposed Rule 3.583 to make clear that entities that were previously exempt from franchise tax do not need to reapply for exempt status. We also recommend amending Proposed Rule 3.583 to correct what appears to be a typographical error.

2. Requirements For Organizational Documents of Noncorporate Exempt Entities: We recommend that Proposed Rule 3.583 be revised to (i) clarify what must be included in the organizational documents of an entity that is not a corporation in order to qualify for an exemption granted to a "nonprofit corporation" under the Tax Code, Chapter 171, Subchapter B and (ii) provide a safe harbor regarding the organizational document requirements for a noncorporate entity seeking to qualify for certain exemptions granted to "nonprofit corporations" under the Tax Code, Chapter 171, Subchapter B.

D. Proposed Rule 3.584, Margin: Reports and Payments

1. Bankruptcy: To prevent circumvention of priorities established by the Bankruptcy Act, we recommend requiring a debtor in possession or appointed trustee or receiver of a taxable entity in reorganization to pay franchise taxes pursuant to the plan of reorganization or arrangement instead requiring, as do the Proposed Rules', that franchise taxes be paid prior to plan confirmation and consummation.

2. Coordination of Report Periods with Total Revenue Computation: We recommend amendments to clarify how total revenue is computed in situations in which a taxable entity's franchise tax report period differs from its last federal income tax accounting period.

3. Newly-Created Members of Combined Groups: We recommend an amendment to clarify that a newly-created member of a combined group is not required to file a separate initial report and that the combined group (if not otherwise required to file an initial report) will not be required to file an initial report due to the inclusion of the newly-created entity in the combined group.

4. Due Date for Electing Deduction is After Extensions: In order to allow taxable entities to make an informed decision based on all relevant information, we recommend that taxable entities have until the due date of the franchise tax return, including all valid extensions, to elect to deduct cost of goods sold.

5. Combined Group Tax Rate: We recommend language to clarify that, in determining whether a combined group is primarily engaged in retail or wholesale trade, the retail and wholesale trade activities of all members should be aggregated.

6. Forfeiture of Corporate Privileges for Failure to Sign a Public Information Report: We recommend that forfeiture of corporate or business privileges for failure to sign public information reports be discretionary with the Comptroller and that taxable entities be provided reasonable notice and opportunity to remedy inadvertent failures.

E. Proposed Rule 3.585, Margin: Annual Report Extensions

1. Extensions for Combined Groups: We recommend an amendment to allow a combined group, in certain circumstances, to file an extension even though in the previous calendar year the combined group did not file a franchise tax report, provided, however, that in the previous calendar year a member of the combined group filed a franchise tax report.

F. Proposed Rule 3.586, Margin: Nexus

1. Specific Activities That Create Nexus: We recommend that the list of enumerated specific activities that create Texas nexus be amended to conform with current Rule 3.546.

G. Proposed Rule 3.587, Margin: Total Revenue

1. Federal Consolidated Group Members and Disregarded Entities: We recommend an amendment that would allow a disregarded entity included in a consolidated group to include its information with its parent rather than to separately compute its total revenue.

2. Distributive Income from Passive Entities: We recommend an amendment to clarify that a taxable entity may exclude from total revenue its distributive share of a passive entity's revenue that was generated by a lower tier taxable entity, regardless of whether the passive entity directly or indirectly owned the lower tier taxable entity.

3. Exclusions from Total Revenue: With respect to disallowed deductions relating to excluded revenue, we address ambiguities that may arise due to different timing of deductions and revenue.

4. Lower Tier Entities: To prevent possible double taxation, we recommend an amendment that provides that a lower tier entity may exclude from total revenue that revenue which is included in an upper tier entity's calculation of taxable margin.

5. Foreign Payments: We recommend certain additional language relating to foreign royalties and foreign dividends subtractions to make the provision consistent with the apportionment dividend exclusion and legislative intent.

6. Medicare Payments: We recommend additional language to clarify the scope of the exclusion for payments under Medicaid, Medicare, and other programs. We also recommend an amendment to state that the determination of whether a taxable entity is a health care provider is made on a combined group basis.

7. Flow-through Funds: We recommend clarifying that a taxable entity may exclude from total revenue certain flow-through funds that are mandated by contract to be distributed to natural persons.

8. Revenue From Affiliated Group Members: We recommend an amendment to Rule 3.587(c)(4) to clarify an ambiguity in the Rule regarding payments received from affiliated group members.

H. Proposed Rule 3.588, Margin: Cost of Goods Sold

1. Production: We recommend amending the Rule's definition of production to conform to the statutory definition.

2. Direct and Necessary Costs: We recommend that the Comptroller provide regulatory guidance (including examples) as to the meaning of "direct" (and similar terms) for cost of goods sold purposes and clarify that the term will not be interpreted by reference to the renderings of similar terms that have been made with regard to the sales tax manufacturing exemption.

3. LIFO Taxpayers: We recommend an amendment to clarify that taxable entities that use LIFO for federal income tax purposes may capitalize their costs in the same manner and to the same extent that their costs were capitalized on their federal income tax returns.

4. COGS Deduction Elections for Capitalization or Expense: We recommend that the Comptroller provide additional guidance to address certain ambiguities relating to the election to capitalize or expense cost of goods sold items and the treatment of inventories.

5. Issues Related to Ownership of Goods: We recommend amendments to clarify that an entity may be considered the owner of goods for purposes of the cost of goods sold deduction in certain situations in which the entity may not have ownership for all legal purposes.

6. Transactions Between Members of an Affiliated Group: Instead of disallowing in their entirety deductions for non-arm's length payments, we recommend allowing members of an affiliated group to deduct, to the extent of an arm's length price, payments made to other members of the affiliated group who are not included in the combined group.

7. Officer's Compensation: We recommend that the Comptroller provide a definition of "officer" for purposes of the exclusion of officers' compensation from cost of goods sold.

I. Proposed Rule 3.589, Margin: Compensation

1. Definition of Wages and Compensation: We recommend an amendment to include in the definition of "wages and compensation" payments made to officers, directors, owners, partners and employees (other than independent contractors) on Form 1099-MISC. This recommended change is necessary even if it was the legislature's intent not to include payments made to independent contractors as part of the compensation deduction. Certain payments made to individuals listed in Section 171.1013(b)(1) (that is, officers, directors, owners, partners, and employees), to which the compensation deduction is specifically allowed, are required by the IRS to be reported on Form 1099-MISC, box 7 (nonemployee compensation) rather than on Form W-2.

2. Net Distribution Share of Income: We recommend an amendment to clarify that a compensation deduction

for an owner's distributive share of income is permitted for all pass-through owners, regardless of whether actual distributions are made.

3. Management Companies: We recommend that the term "active trade or business" be defined for purposes of determining whether an entity is acting as a "management company" within the meaning of Section 171.0001(11) and Proposed Rule 3.589(b)(3).

4. Benefits Deductible For Federal Income Tax Purposes: We recommend that Proposed Rule 3.589(e)(2) and (3) be amended to allow a deduction with respect to the amounts listed therein if such amounts are allowed to be deducted for federal tax purposes.

J. Proposed Rule 3.590, Margin: Combined Reporting

1. Pass-Through and Disregarded Entities: We recommend either deleting section (b)(2)(D) of Proposed Rule 3.590 or clarifying it to state that pass-through and disregarded entities and S corporations are included in a combined group only if they otherwise satisfy the criteria for combined reporting.

2. Examples Relating to Definition of Controlling Interest: We recommend addressing a variation of the scenario in Example (ii) of subsection (b)(4)(B) under which Corporation A owns 10% of Limited Liability Company C and 45% of Corporation B, which owns 90% of Limited Liability Company C.

3. Presumption of Unity: We recommend deleting language in Proposed Rule 3.590 stating that all affiliated entities are presumed to be engaged in a unitary business. We likewise recommend removing language in Proposed Rule 3.590 stating that a presumption exists for finding a unitary relationship when a taxable entity acquires another entity.

4. Reporting Entity: We recommend clarifying ambiguous language in subsection (b)(5) relating to the "reporting entity" for a combined group.

K. Proposed Rule 3.591, Margin: Apportionment

1. Sourcing of Services Provided By Subcontractors: We recommend that Proposed Rule 3.592(d)(26) be modified to clarify that the determination of where a service is performed is not limited to activities performed directly by a taxable entity.

L. Proposed Rule 3.592, Margin: Additional Tax

1. Due Date for Final Return When Loss of Nexus Activities: We recommend an amendment to provide the mechanics for filing a final report and making payment of additional tax due when a taxable entity ceases engaging in Texas nexus creating activities (versus terminating, dissolving, merging, or withdrawing).

2. Cross Reference to Passive Entities: We recommend an amendment to clarify the intent of the cross reference in Proposed Rule 3.592(d) to Proposed Rule 3.582 (Margin: Passive Entities).

3. Cross Reference to Combined Groups: We recommend an amendment to clarify the intent of the cross reference in Proposed Rule 3.592(e) to Proposed Rule 3.590 (Margin: Combined Groups).

M. Proposed Rule 3.594, Margin: Temporary Credit

1. Election Requirements: We recommend that Rule 3.594 be amended to clarify that all elections applicable to the temporary credit may be made on a taxable entity's first return originally due after January 1, 2008, taking into account all valid extensions.

2. Combined Group Application: We recommend amendments to allow certain changes in the composition of a combined group without the loss of any of the business loss carryforward where such changes in the combined group are "revenue neutral" (that is, any business loss carryforwards would be utilized and absorbed by the existing combined group, without regard to the addition or removal of any entity).

3. Eliminate Loss Offset Requirement When No Tax Was Due in Prior Years Under Earned Surplus: Proposed Rule 3.594(b)(1) requires that business losses must have been used to offset any positive amount of earned surplus, even in years when no tax was due. We recommend that this language be stricken in its entirety. There is no statutory authority or legislative intent to impose the requirement that business losses must have been used to offset any positive amount of earned surplus in years when no tax was due.

4. Eliminate Tying Allowable Business Losses to Those Created on or after 2003: Proposed Rule 3.594(b)(2) provides that the term "business loss carryforward" means "unused and unexpired amounts of business losses created on the 2003 and subsequent franchise tax report years." We recommend that this language be stricken in its entirety. There is no statutory authority or legislative intent to impose the requirement that, to be a business loss, such loss must have been created from the taxable entity's 2003 or subsequent tax report year.

5. Taxable Entity Leaving Combined Group and Becoming a Single-Entity Filer: Proposed Rule 3.594(c)(3) provides, in part, that "the business loss carryforward does not follow the member to a separately filed report or another combined group." We recommend that this language be amended to allow business loss carryforwards to follow a member to a separately filed report, at least in certain non-tax motivated circumstances.

6. Temporary Credit and Using E-Z Method Computation: Proposed Rule 3.594(e)(3) provides: "A taxable entity that uses the E-Z Computation to report and pay its franchise tax may not elect to take the business loss carryforward in that year. The unused credit may not be carried over to subsequent years." We recommend that this language be amended to clarify that the amount of the unused credit that cannot be carried over to a subsequent year is that portion of the unused credit that would have been available for the year that the taxable entity is reporting and paying tax under the E-Z Computation method.

II. COMMENTS

A. Proposed Rule 3.581, Margin: Taxable and Nontaxable Entities

1. Sole Proprietorships

a. Language at Issue

Proposed Rule 3.581(b)(23) states that the defined term "sole proprietorship" does not include single member limited liability companies or other entities treated as sole proprietorships for federal tax purposes.

b. Recommendation

We recommend clarifying Proposed Rule 3.581(b)(23) to recognize that entities which are sole proprietorships for federal tax purposes and do not limit the liability of the owner are treated for margin tax purposes as nontaxable sole proprietorships. We recommend that the last sentence of the definition be amended to read as follows: "It does not include single member limited liability companies or other entities treated as sole proprietorships for federal tax purposes, unless by statute the form of entity does not afford limited liability protection to the owner."

c. Explanation

Proposed Rule 3.581(b)(23) suggests that any "entities" treated as sole proprietorships for federal tax purposes will not qualify as nontaxable sole proprietorships, without exception. In contrast, Proposed Rule 3.581(e) provides that "[a]n entity treated as sole proprietorship for federal tax purposes is not a sole proprietorship for the purposes of this proposed rule if it is formed in a manner that limits the liability of its owners or members," which implicitly recognizes that a limited liability company which does not limit the liability of its owner is treated as a sole proprietorship not subject to margin tax. Our proposed revisions would make these provisions consistent and reflect legislative intent that individuals conducting business without any statutory limitation on their personal liability for the debts of the business should not be subject to margin tax.

The above amendment should also clarify that the reference in the Rule to liability protection that will exclude an entity from qualifying as an excluded entity relates only to the liability protection that exists under a statute of this or another state and not more generally to the liability protection that may come from other sources such as, for example, liability insurance.

2. Treatment of Revocable Grantor Trust Following Decedent's Death

a. Language at Issue

Proposed Rule 3.581(b)(5) defines an "estate of a natural person" as "an entity as defined by Internal Revenue Code, § 7701(a)(30)(D), excluding an estate taxable as a business entity pursuant to Internal Revenue Code, Treasury Regulation, § 301.7701-4(b)."

b. Recommendation

We recommend that Proposed Rule 3.581(b)(5) be amended to include an additional sentence that reads: "An estate of a natural person shall include a trust that makes an election under Internal Revenue Code § 645 to be treated and taxed as part of an estate for federal income tax purposes."

c. Explanation

Section 171.0002(c)(1) of the Texas Tax Code and Proposed Rule 3.581(d)(5) provide that a grantor trust is not a taxable entity, provided that all of the grantors and beneficiaries of the grantor trust are natural persons or charitable organizations as described in Internal Revenue Code § 501(c)(3). Section 171.0002(c)(2) and Proposed Rule 3.581(d)(6) provide that an estate of a natural person is not a taxable entity. A commonly used estate planning technique involves an individual's transfer of assets into a revocable grantor trust for the benefit of that individual during the individual's life, with the trust being administered after the individual's death for the purpose of distributing assets to the individual's beneficiaries. During the period in which the trust is administered post-death, the trust will be neither a grantor trust nor an estate under the Internal Revenue Code, although Internal Revenue Code § 645 allows the trust to elect to be taxed as part of the individual's estate. It is clear that the intent of section 171.0002(c)(1) is to avoid the imposition of franchise tax on grantor trusts created by individuals for estate planning purposes. However, without clarification, these trusts might be classified as taxable entities post-death because they are arguably neither grantor trusts nor estates. Our recommended language makes it clear that these trusts will continue to be treated as nontaxable entities during the post-death administration period. Failure to implement this clarifying language may have an unintended chilling effect on the creation of these trusts.

B. Proposed Rule 3.582, Margin: Passive Entities

1. Application of 90% and 10% Income Provisions

a. Language at Issue

Proposed Rule 3.582(c) sets forth the criteria that must be met for an entity to qualify as a passive entity. Subsection (c)(2) states that at least 90% of the entity's federal gross income must consist of certain types of income that are generally regarded as passive in nature.

Proposed Rule 3.582(2)(C) includes in the list of income items that may be included in income for purposes of satisfying the 90% income test "net capital gains from the sale of real property, net gains from the sale of commodities traded on a commodities exchange, and net gains from the sale of securities."

Proposed Rule 3.582(e) states, "To be considered a passive entity, an entity may not receive more than 10% of its federal gross income from conducting an active trade or business. Income described by subsection (c)(2) [i.e., income that will satisfy the 90% passive income test] of this section, may not be treated as income from conducting an active trade or business."

Proposed Rule 3.582(g) states that if an entity meets all the qualifications of a passive entity for the reporting period, the entity will not owe tax.

b. Recommendation

1. We recommend that the 90% passive income test and the 10% active income test provisions be clarified to state that these tests apply with respect to the gross income for the period on which margin is based.

2. We recommend changing the language in Proposed Rule 3.582(c)(2)(C) to read as follows: "capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities." Similar conforming changes should be made to the definition provisions at Proposed Rule 3.582(b)(6) and (7).

3. We recommend that the last sentence in Proposed Rule 3.582(e) be amended to read as follows: "Income described by subsection (c)(2) of this section may not be treated as income from conducting an active trade or business, regardless of whether that income is in fact earned from an active trade or business."

c. Explanation

1. Section 171.0003(a) of the Texas Tax Code sets forth the tests for qualifying as a passive entity. It states that "during the period on which margin is based," the entity's federal gross income must consist of certain types of passive income. Tex. Tax Code § 171.0003(a)(2). It goes on to state that the entity must also not receive more than 10% of its federal gross income from conducting an active trade or business, but does not specifically state that the 10% test applies with respect to the federal gross income for the period on which margin is based. *See* § 171.0003(a)(3). Proposed Rule 3.582 should be amended to clarify that both the 90% and 10% tests apply with respect to the federal gross income for the period on which margin is based.

2. Our recommended revision to Proposed Rule 3.582 (c)(2)(C) is simply for the purpose of tracking the language in the statute. The word "net" does not appear before the words "capital gains" with respect to gains from the sale of real property, commodities and securities that may be included in applying the 90% test.

3. The last sentence in Proposed Rule 3.582(e) applies the language in section 171.0003(a-1) of the Texas Tax Code which states that, in making the computation under section 171.0003(a)(3) (the 10% active income test), income described by subsection (a)(2) (the 90% income test) may not be treated as income from conducting an active trade or business. We believe that the intention of this provision was to make clear that any of the specifically enumerated items of income that may satisfy the 90% test cannot be treated as active income for purposes of the 10% test, regardless of whether that income would be viewed as having been generated from an active trade or business. The above proposed amendment would make this clear.

2. Definition of Securities

a. Language at Issue

Proposed Rule 3.582(b)(9) defines a "security" to include "(A) an instrument defined by Internal Revenue Code, § 475(c)(2), where the holder of the instrument has a non-controlling interest in the issuer/investee; (B) an instrument described by Internal Revenue Code, § 475(e)(2)(B), (C), (D); (C) an interest in a partnership where the investor has a non-controlling interest in the investee; (D) an interest in a limited liability company where the investor has a non-controlling interest in the investee; or (E) a beneficial interest in a trust where the investor has a non-controlling interest in the investee."

b. Recommendation

We recommend that the term "securities" be given the same meaning given to the term in article 581-4 of The Securities Act, Vernon's Texas Civil Statutes.

c. Explanation

The term "securities" for purposes of establishing the existence of a passive entity is not defined in the Texas Tax Code. The Texas Legislature did provide a definition of the term "security" for purposes of other provisions of the margin tax by referencing Internal Revenue Code § 475. *See* Tex. Tax Code § 171.0001(13-a). The fact that the Legislature defined this term by referencing Internal Revenue Code § 475 for purposes of some provisions of the margin tax, but not for purposes of the passive entity provisions, suggests that the Legislature intended for a different definition to apply in the passive entity context. The Comptroller's definition of this term by reference to Internal Revenue Code § 475 seems inconsistent with the Legislature's intent. We believe that a better approach would be to define this term by referencing the definition that the Legislature has given that term under article 581-4 of The Securities Act.

In addition, regardless of which definition the Comptroller decides to utilize, we do not believe that limiting the term to include only non-controlling interests is consistent with Legislative intent. There is nothing in the margin tax provisions that would suggest that only non-controlling ownership interests in securities may be included in establishing the 90% test.

3. Section 338(h)(10) Elections

a. Language at Issue:

Proposed Rule 3.582 (c)(2) states that at least 90% of an entity's federal gross income must consist of several specifically enumerated items of income. Included in that list are net gains from the sale of securities.

b. Recommendation

We recommend adding a subsection (c)(3) to Proposed Rule 3.582 to read as follows: "Gain from the sale of stock that is treated as gain from the sale of corporate assets pursuant to an election made under Internal Revenue Code § 338(h)(10) for federal income tax purposes shall be treated as gain from the sale of a security for purposes of determining if the entity qualifies as a passive entity."

c. Explanation

There is currently some ambiguity as to how to treat gain from the sale of stock that is treated as the sale of corporate assets for federal income tax purposes pursuant to an election made under Internal Revenue Code § 338(h)(10). Gain from the sale of stock continues to reflect gain from the sale of stock even where, for federal income tax purposes, the sale is treated as gain from the sale of the subsidiary's assets. Stated differently, an election made under § 338(h)(10) does not change the nature of the investment under state law. For this reason, we believe that gain from such sale should be treated as gain from the sale of stock in applying the passive entity provisions. The above recommended provision reflects this view.

4. Limited Liability Partnerships

a. Language at issue

Proposed Rule 3.582(c)(1) states that "to qualify as a passive entity, the entity must be one of the following: (A) general partnership; (B) limited partnership; or (C) trust, other than a business trust." Proposed Rule 3.582(b)(4) defines a "general partnership" as "[a] partnership as described in Revised Partnership Act, Article 6132b-1.01 et. seq., or Business Organizations Code, Title 4, Chapter 152, or an equivalent statute in another jurisdiction."

b. Recommendation

We recommend that Proposed Rule 3.582 be revised to add language specifying that a limited liability partnership, as a type of general partnership, can qualify as a passive entity. For example, Proposed Rule 3.582(b)(4) could be amended to define a "general partnership" as "[a] partnership as described in Revised Partnership Act, Article 6132b-1.01 et. seq., or Business Organizations Code, Title 4, Chapter 152, or an equivalent statue in another jurisdiction, without regard to whether the general partnership has registered as a limited liability partnership under the Business Organizations Code, Title 4, Chapter 152, Subchapter J or an equivalent statute in another jurisdiction.

c. Explanation

Section 171.002(b)(2) of the Texas Tax Code provides that the exclusion from the definition of "taxable entity" for a general partnership owned exclusively by natural persons does not include a general partnership that has limited liability, including by registration as a limited liability partnership. This provision suggests a recognition for margin tax purposes that a limited liability partnership is a type of general partnership. By contrast, section 171.201 provides certain reporting requirements for "a general partnership or limited liability partnership," which suggests that these are different types of entities for margin tax purposes. To remove ambiguity, we recommend that Proposed Rule 3.582 explicitly state that a limited liability partnership is a type of general partnership and therefore can qualify as a passive entity.

5. Nonoperating Working Interests

a. Language at Issue

Proposed Rule 3.582(c)(2)(D) defines qualifying sources of income for the 90% passive income test to include "royalties from mineral properties, bonuses from mineral properties, delay rental income from mineral properties and income from other nonoperating mineral interests."

b. Recommendation

We recommend that Proposed Rule 3.582(c)(2)(D) be revised to specify that income from nonoperating working interests qualify as passive income, unless the operator of the property is a member of the owner's affiliated group, by revising Proposed Rule 3.582(c)(2)(D) to read as follows: "royalties from mineral properties, bonuses from mineral properties, delay rental income from mineral properties and income from other nonoperating mineral interests including nonoperating working interests not described in subsection (d)(2) of this section."

c. Explanation

Working interests are a very common type of oil and gas mineral interest, and the question will repeatedly arise under what circumstance gross income from these types of mineral interests will qualify as passive income. The proposed addition provides direct guidance on this issue. Because section 171.0004(e) of the Texas Tax Code specifically defines "conducting active trade or business" specifically to exclude "the ownership of a . . . non-operating working interest in mineral rights," while section 171.0003(b)(2) excludes from qualifying passive income any "income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement," there are strong statutory indications that the suggested language is consistent with legislative intent.

C. Proposed Rule 3.583, Margin: Exemptions

1. Existing Exempt Entities

a. Language at Issue

Proposed Rule 3.583(b) begins with the statement that "[a]n entity must apply for an exemption from franchise tax." There are no provisions anywhere in Rule 3.583 addressing the treatment of entities that were previously qualified as exempt entities.

Proposed Rule 3.583(b)(2) sets out a list of items that must be submitted to the Comptroller in connection with an application for exemption. It begins as follows: "Except as otherwise provided in subsections (e), (i), and (j) of this section, each entity must submit to the comptroller . . ."

b. Recommendation

We recommend that the first sentence in Proposed Rule 3.583(a) be amended to read as follows: "Any entity that has not previously established its exempt status with the comptroller must apply for an exemption from franchise tax."

We recommend that the first sentence in Proposed Rule 3.583(b)(2) be amended to read as follows: "Except as otherwise provided in subsections (f), (i), and (j) of this section, each entity must submit to the comptroller . . ."

c. Explanation

The first proposed amendment above will clarify that entities that were previously exempt from franchise tax under the prior franchise tax rules do not need to reapply for exempt status.

The second proposed amendment corrects what appears to be a typographical error as subsection (e) deals with revocations, withdrawals and loss of exemptions. A reference to subsection (f) seems more appropriate as subsection (f) sets forth a special rule applicable to certain nonprofit organizations that have been exempted from federal income tax.

2. Requirements for Organizational Documents of Noncorporate Exempt Entities

a. Language at issue

Proposed Rule 3.583(b) is derived from section 171.088 of the Texas Tax Code and states "[a]n entity that is not a corporation, but whose activities would qualify it for a specific exemption under Tax Code, Chapter 171, Subchapter B, if it were a corporation, may qualify for the exemption from the tax in the same manner and under the same conditions as a corporation."

b. Recommendation

We recommend that Proposed Rule 3.583 be revised to clarify what must be included in the organizational documents of an entity that is not a corporation in order to qualify for an exemption granted to a "nonprofit corporation" under chapter 171, subchapter B of the Texas Tax Code.

We also recommend that Proposed Rule 3.583 be revised to provide a safe harbor regarding the organizational document requirements for a noncorporate entity seeking to qualify for certain exemptions granted to "nonprofit corporations" under chapter 171, subchapter B of the Texas Tax Code. For example, a new subsection could be added to the Proposed Rule reading as follows:

> An entity that is not a corporation and that is claiming exemption under Tax Code sections 171.057 -.062, 171.064 - .069, 171.082 - .083 or 171.087 is presumed to meet any applicable organizational document restrictions if the entity's formation document or governing documents either adopt by reference the provisions of Chapter 22 of the Business Organizations Code, adopt by reference the provisions of the nonprofit corporation act of another state, or contain substantially equivalent restrictions on the entity's operations.

c. Explanation

Several exemptions in chapter 171, subchapter B of the Texas Tax Code, are provided to "nonprofit corporations" that meet other operational requirements. An entity formed as a nonprofit corporation is subject by operation of law to a variety of operational and other restrictions under chapter 22 of the Business Organizations Code or equivalent laws in other states. Our proposed clarification provides a safe harbor that allows noncorporate entities to restrict their activities in order to meet any implicit requirement that they be functionally equivalent to nonprofit corporations. This presumption is unnecessary for noncorporate entities that qualify for exemption under section 171.063 based on a federal tax exemption, because the section 171.063 exemption is predicated solely and exclusively on the federal tax exemption determination without regard to other factors.

D. Proposed Rule 3.584, Margin: Reports and Payments

1. Bankruptcy - Paying Franchise Tax Pursuant to Plan of Reorganization

a. Language at Issue

The last sentence of Proposed Rule 3.584(c)(1) provides: "A debtor in possession or the appointed trustee or receiver of a taxable entity in reorganization or arrangement proceedings under the Bankruptcy Act is responsible for filing franchise tax reports and paying the franchise tax prior to confirming and consummating the plan of reorganization or arrangement."

b. Recommendation

We recommend that the last sentence of Proposed Rule 3.584(c)(1) be amended to read: "A debtor in possession or the appointed trustee or receiver of a taxable entity in reorganization or arrangement proceedings under the Bankruptcy Act is responsible for filing franchise tax reports and paying the franchise tax pursuant to the plan of reorganization or arrangement."

c. Explanation

Section 1141 of the Bankruptcy Code provides that upon confirmation of a plan of reorganization, pre-bankruptcy debts are discharged and creditors are entitled to receive only what the plan provides. The Texas franchise tax has previously been treated as an excise tax for purposes of the Bankruptcy Code. *See In Re: National Steel Corp. et al.*, Bankruptcy No. 2 B 08699 (Bankr. N.D. Ill. 2005). The Comptroller is entitled to payment of franchise tax on an unsecured priority basis, and such unsecured claims shall be discharged according to the priority order established by the Bankruptcy Code. Proposed Rule 3.584(c) appears to circumvent the intent of the Bankruptcy Code by requiring that a debtor in possession or appointed trustee or receiver of a taxable entity in reorganization or arrangement proceedings pay any due franchise tax to the Comptroller before the proper order of priority of payment has been established under the Bankruptcy Code. Accordingly, we recommend that Proposed Rule 3.584(c) be modified to properly reflect the provisions of the Bankruptcy Code.

2. Coordination of Report Periods with Total Revenue Computation

a. Language at Issue

Proposed Rule 3.584(c)(1)(B) provides that the taxable margin computed on the initial report is "based on the business done during the period beginning on the beginning date and ending on the last accounting period ending date for federal income tax purposes that is at least 60 days before the original due date of the initial report, or, if there is no such ending date, then ending on the day that is the last day of the calendar month nearest to the end of the taxable entity's first year of business."

Proposed Rule 3.584(c)(1)(C) provides that the taxable margin computed on the annual report is "...based on the business done during the period beginning with the day after the last date upon which tax was computed under Tax Code, Chapter 171 on a previous report, and ending with the last accounting period ending date for federal income tax purposes ending in the calendar year before the calendar year in which the report is originally due, or, if there is no such ending date, then ending on December 31 of the calendar year before the calendar year in which the report is originally due."

b. Recommendation

We recommend that Proposed Rule 3.584(c)(1)(B) be amended to include an additional sentence that reads: "If the period used to compute business done for purposes of the initial report differs from the taxable entity's last accounting period for federal income tax purposes, then the taxable entity's total revenue for purposes of the initial report shall be computed as if the taxable entity had reported its federal taxable income on an Internal Revenue Service form covering the period used to compute business done for purposes of the initial report."

We recommend that Proposed Rule 3.584(c)(1)(B) be amended to provide exact "due dates" and "accounting periods" for the two examples contained therein.

We recommend that Proposed Rule 3.584(c)(1)(C) be amended to include an additional sentence that reads: "If the period used to compute business done for purposes of the annual report differs from the taxable entity's last accounting period for federal income tax purposes, then the taxable entity's total revenue for purposes of the annual report shall be computed as if the taxable entity had reported its federal taxable income on an Internal Revenue Service form covering the period used to compute business done for purposes of the annual report."

c. Explanation

The periods for computing margin for purposes of the initial and annual reports under Proposed Rules 3.584(c)(1)(B) and (C) may differ from a taxable entity's federal income tax reporting periods. Because section 171.1011 of the Texas Tax Code requires total revenue to be computed based on specific line items from a taxable entity's federal income tax forms, we recommend that these proposed rules make clear that a federal income tax form actually filed with the Internal Revenue Service will not be used to calculate total revenue if the accounting period on which the form is based differs from the entity's margin tax accounting period. In such instances, the Internal Revenue Service "form" used to calculate total revenue should be one which covers the margin tax accounting period.

Proposed Rule 3.584(c)(1)(B) provides two specific examples of newly-chartered entities, the first example being an entity chartered on June 1, 2008, and the second example being an entity chartered on November 1, 2008. The examples could provide further clarification as to how and when initial reports should be filed if Proposed Rule 3.584(c)(1)(B) specifically stated the due date and accounting period for each of the two example entities.

3. Newly-Created Members of Combined Groups

a. Language at Issue

Proposed Rule 3.584(c)(1)(H) reads: "Combined reporting. Taxable entities that are part of an affiliated group engaged in a unitary business must file a combined group report in lieu of individual reports . . . ."

b. Recommendation

We recommend that Proposed Rule 3.584(c)(1)(H) be amended to read: "Combined reporting. Taxable entities that are part of an affiliated group engaged in a unitary business must file a combined group report in lieu of individual reports, except that a public information report or ownership information report must be filed for each member of the combined group. A newly-created member of a combined group is not required to file a separate initial report, and a combined group that would not otherwise be required to file an initial report shall not be required to file an initial report solely because a newly-created entity has become a member of the group."

c. Explanation

Our proposed language would make clear that if the reporting taxable entity is not filing an initial report, then no member of the combined group, even if newly-created, will be required to file an initial report.

4. Due Date for Electing Deduction is After Extensions

a. Language at Issue

Proposed Rule 3.584(d)(1) reads: "Calculation. If a taxable entity qualifies to deduct cost of goods sold the entity must make an annual election by the due date of its return. This election may not be amended."

b. Recommendation

We recommend that Proposed Rule 3.584(d)(1) be amended to read: "Calculation. If a taxable entity qualifies to deduct cost of goods sold the entity must make an annual election by the due date of its return taking into account all valid extensions. This election may not be amended."

c. Explanation

So that taxpayers will have access to the final financial or federal tax data relevant to making an appropriate deduction decision, the due date by which a deduction election should be made should be the same as the extended due date for the taxpayer's franchise tax report.

5. Combined Group Tax Rate

a. Language at Issue

Proposed Rule 3.584(d)(2) provides that a tax rate of 0.5% applies to a taxable entity primarily engaged in retail or wholesale trade under division F or G of the 1987 Standard Industrial Classification Manual published by the Federal Office of Management and Budget.

b. Recommendation

We recommend that a new Proposed Rule 3.584(d)(2)(D) be added to read as follows: "In the case of a taxable entity that is a combined group, the revenue from each retail and wholesale trade activity of each of the members of the combined group shall be aggregated for purposes of determining whether the taxable entity is primarily engaged in retail or wholesale trade. Each activity of each group member shall be separately analyzed to determine whether such activity shall be treated as a retail or wholesale trade."

c. Explanation

Proposed Rule 3.590(i) provides that the determination of whether a combined group is eligible for a lower rate is to be made for the combined group as a whole. Our recommended language would make it clear that this combined group determination calculates the aggregate revenue from all wholesale and retail trade activities performed by combined group members without regard to which combined group member performs such activities, rather than calculating the aggregate wholesale/retail revenue by classifying each group member's revenue as all retail/wholesale or all non-retail/wholesale based on the predominant activities of that group member and then aggregating the revenue of those group members determined to be retail/wholesale entities.

6. Forfeiture of Corporate Privileges for Failure to Sign a Public Information Report

a. Language at Issue

Proposed Rule 3.584(i)(3) states that: "Failure to file or sign a public information report or ownership information report shall result in the forfeiture of corporate or business privileges as provided by Tax Code, § 171.251 and § 171.2515."

b. Recommendation

We recommend that Proposed Rule 3.584(i)(3) be amended to read as follows: "Failure to file or sign a public information report or ownership information report ~~shall~~ may, at the Comptroller's discretion after reasonable notice to the taxable entity, after which such entity fails to take remedial action within a stated period, result in the forfeiture of corporate or business privileges as provided by Tax Code, § 171.251 and § 171.2515."

c. Explanation

Proposed Rule 3.584(i)(3) suggests that a taxable entity shall automatically forfeit its corporate or business privileges if a public information report is not signed or filed. Allowance should be made for accidental omissions. The Comptroller should notify the taxable entity of the failure to file or sign its required public information return and afford the taxable entity the opportunity to remedy the omission.

E. Proposed Rule 3.585, Margin: Annual Report Extensions

1. Extensions for Combined Groups

a. Language at Issue

Proposed Rule 3.585(d) reads: "No previous report. An extension shall not be granted under subsections (c)(3)(B) or (f)(3)(B) of this section, if no report was due in the previous calendar year or the report due in the previous calendar year is not filed on or before May 14 of the year for which the extension is requested."

b. Recommendation

We recommend that Proposed Rule 3.585(d) be amended to read as follows:

> No previous report. An extension shall not be granted under subsections (c)(3)(B) or (f)(3)(B) of this section, if no report was

due in the previous calendar year or the report due in the previous calendar year is not filed on or before May 14 of the year for which the extension is requested. With respect to a taxable entity that is a combined group, if a member of the combined group has filed a franchise tax report in the previous calendar year, an extension shall be granted under subsections (c)(3)(B) or (f)(3)(B) of this section if the taxable entity remits with its extension request 100% of the tax reported as due for the previous calendar year on all reports of combined group members due in the previous calendar year and filed on or before May 14 of the year for which the extension is requested.

c. Explanation

A combined group may have no franchise tax report filed for the previous calendar year, but one or more of the members of the combined group may have filed such a report. In that event, the combined group should be able to take advantage of the extension granted under subsections (c)(3)(B) or (f)(3)(B), provided that the combined group remit 100% of the tax due for the prior year for each member of the combined group that did make a previous franchise tax report for the prior calendar year. This provides a combined group with the same two options for extension payments (i.e., 90% of tax ultimately due or 100% of tax paid in the prior period) that are available to other taxable entities.

F. Proposed Rule 3.586, Margin: Nexus

1. Specific Activities That Create Nexus

a. Language at Issue

Proposed Rule 3.586(c) enumerates specific activities which subject a taxable entity to Texas franchise tax. Several of these specific activities are not currently enumerated under existing Rule 3.546.

b. Recommendation

We recommend that Proposed Rule 3.586(c) be amended to be consistent with current Rule 3.546.

c. Explanation

Proposed Rule 3.586(c) changes the list of activities which currently subjects a taxable entity to Texas franchise tax. Proposed Rule 3.586(c) provides several additional activities that generate nexus. Additionally, Proposed Rule 3.586(c) uses similar but different language to describe certain existing nexus-creating activities. We do not believe that the intention of Proposed Rule 3.586(c) was to expand the definition of nexus or to create confusion regarding previously settled areas of the law relating to nexus-creating activities. Therefore, we recommend that Proposed Rule 3.586(c) be amended to be consistent with current Rule 3.546.

G. Proposed Rule 3.587, Margin: Total Revenue

1. Federal Consolidated Group Members and Disregarded Entities

a. Language at Issue

Proposed Rule 3.587(c)(3) reads: "Federal consolidated group. A taxable entity that is part of a federal consolidated group or is a disregarded entity shall compute its total revenue as if it had filed a separate return for federal income tax purposes. Further information on total revenue for combined entities can be found in [Rule] 3.590 of this title (relating to Margin: Combined Reporting)."

Proposed Rule 3.590(d)(6) states that "[w]hen reporting revenue, cost of goods sold, compensation and gross receipts for a disregarded entity, that information may be included with the parent; in that event, both entities are presumed to have nexus."

b. Recommendation

We recommend that Proposed Rule 3.587(c)(3) be amended to read: "Federal consolidated group. A taxable entity that is part of a federal consolidated group or is a disregarded entity shall compute its total revenue as if it had filed a separate return for federal income tax purposes; provided, however, that a disregarded entity may combine its revenue, cost of goods sold, compensation and gross revenue with its parent as provided by [Rule] 3.590(d)(6). Further information on total revenue for combined entities can be found in [Rule] 3.590 of this title (relating to Margin: Combined Reporting)."

c. Explanation

The proposed amendment makes Proposed Rule 3.587(c)(3) consistent with Proposed Rule 3.590(d)(6).

2. Distributive Income from Passive Entities

a. Language at Issue

Proposed Rule 3.587(c)(4) states: "Passive entity. A taxable entity will include its share of net distributive income from a passive entity, but only to the extent the net income of the passive entity was not generated by any other taxable entity."

b. Recommendation

We recommend that Proposed Rule 3.587(c)(4) be rewritten to read: "Passive entity. A taxable entity that owns an interest in a passive entity shall exclude from the taxable entity's total revenue the taxable entity's share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity, whether or not the taxable entity generating such net income is owned directly by the passive entity."

c. Explanation

Our recommended language removes potential confusion by tracking the language of section

171.1011(e) of the Texas Tax Code. Our recommendation also clarifies that the income generated by a taxable entity with a passive entity owner will not be subject to multiple layers of tax in the hands of an indirect owner. For example, taxable LLC is owned by passive Partnership 1, which is in turn owned by passive Partnership 2, which is in turn owned by taxable Corporation. It is unclear whether Corporation's distributive income from Partnership 2, which was originally earned by LLC, will be considered to be "generated by the margin of" taxable LLC for purposes of Rule 3.587(c)(4) because Partnership 2 does not own LLC directly. Our language makes clear that the net income of Partnership 2 was generated by LLC, thus avoiding the taxation of the same revenue again at the corporation level.

3. Exclusions from Total Revenue

a. <u>Language at Issue</u>

Proposed Rule 3.587(c)(5) states: "Exclusions from total revenue. For any revenue that is excluded from total revenue, the related costs may not be included in the determination of cost of goods sold (see [Rule] 3.588 of this title (relating to Margin: Costs of Goods Sold)) or the determination of compensation (see [Rule] 3.589 of this title (relating to Margin: Compensation))."

b. <u>Recommendation/Explanation</u>

We recommend that Proposed Rule 3.587(c)(5) be expanded to address timing differences in expense and revenue recognition. The Rule should clarify whether costs of goods or compensation otherwise eligible for deduction will be required to be deferred until the corresponding item of revenue is either reported for margin tax purposes or excluded. It would also be helpful if the Rule would clarify whether deductions for compensation or costs deductible in an earlier tax period than the period in which the corresponding revenue is recognized will be reversed if the corresponding item of revenue is not later included in a taxpayer's total revenue. We also recommend that the Rule clarify whether allocations will be required to be made between tax periods as well as within the tax period in which an excluded revenue item is reported when allocating costs and compensation between excluded and included revenue for purposes of Rule 3.588(c)(3) (costs of goods sold) and Rule 3.589(d)(2) (compensation).

4. Lower Tier Entities

a. <u>Language at Issue</u>

Proposed Rule 3.587(c)(8) states the following: "Lower tier entities. A lower tier entity in a tiered partnership arrangement may not exclude from total revenue any revenue reported to an upper tier entity, regardless of whether the upper tier entity includes the revenue from the lower tier entity in the upper tier entity's calculation of taxable margin."

b. <u>Recommendation</u>

We recommend that Proposed Rule 3.587(c)(8) be amended to read: "Lower tier entities. A lower tier entity in a tiered partnership arrangement may not exclude from total revenue any revenue reported to an upper tier entity, unless the upper tier entity includes the revenue from the lower tier entity in the upper tier entity's calculation of taxable margin."

We recommend that the Comptroller add guidance to Proposed Rule 3.587 establishing procedures, pursuant to section 171.1015(b) of the Texas Tax Code, for a lower tier entity in a tiered partnership arrangement to report to the Comptroller the amounts of the lower tier entity's total revenue that should be included in the total revenue of each of the lower tier entity's upper tier owners. Section § 171.1015(e) calls for the Comptroller to adopt such rules.

c. <u>Explanation</u>

Section 171.1015(b) provides that an upper tier entity in a tiered partnership arrangement may, in addition to reporting its own revenue, report its share of the revenue of a lower-tier entity. The intent of section 171.1015 is to allow the lower tier entity's owners to report the lower tier entity's revenue in lieu of, not in addition to, the lower tier entity. Section 171.1015(b) calls for a lower tier entity in a tiered partnership arrangement to report to the Comptroller the amounts of the lower tier entity's total revenue that should be included in the total revenue of each of the lower tier entity's upper tier owners - it does not call for the lower tier entity to pay tax on such revenue. In fact, section 171.1015(c) makes clear that the lower tier entity is liable for the tax on its own revenue only if the upper tier entity is not subject to the margin tax. Proposed Rule 3.587(c)(8) would result in double taxation of revenue generated by a lower tier entity in a tiered partnership arrangement. Our proposed language would eliminate this double taxation.

5. Foreign Payments

a. <u>Language at Issue</u>

Proposed Rule 3.587(d)(1)(B)(ii), referring to a subtraction from total revenue, provides for the subtraction of foreign royalties and foreign dividends, including amounts determined under Internal Revenue Code § 78 or §§ 951-964.

b. <u>Recommendation</u>

We recommend that Proposed Rule 3.587(d)(1)(B)(ii) read: "foreign royalties and foreign dividends, including amounts determined under Internal Revenue Code, § 78 or §§ 951-964, <u>as well as royalties and dividends from a subsidiary, associate, or affiliated corporation that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the United States</u>." We recommend that similar language be added to Proposed Rules 3.587(d)(2)(B)(ii), 3.587(d)(3)(B)(ii), 3.587(d)(4)(B)(ii), and 3.587(d)(5)(B)(ii).

c. <u>Explanation</u>

It is our understanding that the intent of the foreign royalties and dividends exclusions in section 171.1011 of the Texas Tax Code was to provide the same exclusion as was available under the earned surplus component of the former franchise tax. This treatment is consistent with the apportionment dividend exclusion contemplated by Proposed Rule 3.591(e)(8)(B)(i).

6. Medicare Payments

a. Language at Issue

Proposed Rule 3.587(e)(10)(A)(i), in defining payments that a health care provider shall exclude, provides for the exclusion of total payments "under the Medicaid program, Medicare program, Indigent Health Care and Treatment Act (Health and Safety Code, Chapter 61), and Children's Health Insurance Program (CHIP)."

Proposed Rule 3.587(b)(4) defines health care provider as "[a]ny taxable entity that participates in the Medicaid program, Medicare program, Children's Health Insurance Program (CHIP), state workers' compensation program, or TRICARE military health system as a provider of health care services."

b. Recommendation

1. We recommend that Proposed Rule 3.587(e)(10)(A)(i) be amended to read: "under the Medicaid program, Medicare program, Indigent Health Care and Treatment Act (Health and Safety Code, Chapter 61), and Children's Health Insurance Program (CHIP), <u>including all co-payments or indirect payments from a third-party agent or administrator</u>."

2. We also recommend that Proposed Rule 3.587(b)(4) be amended to read:

> Health care provider—Any taxable entity that participates in the Medicaid program, Medicare program, Children's Health Insurance Program (CHIP), state workers' compensation program, or TRICARE military health system as a provider of health care services. <u>The determination of whether a taxable entity is a health care provider is made on a combined group basis. A combined group will be treated as a health care provider if any member of the combined group provides health care services in the Medicaid program, Medicare program, Children's Health Insurance Program (CHIP), state workers' compensation program, or TRICARE military health system and any member of the combined group receives payment for such services</u>.

c. Explanation

1. Proposed Rule 3.587(e)(10)(A)(i) indicates the intent for all payments under the Medicaid and Medicare programs, as well as several other similar programs, to be excluded from the total revenue of a taxable entity that is a health care provider. Our proposed language clarifies the scope of this exclusion.

2. Due to the nature of the insurance industry, in many situations, the entity that actually provides the services will not directly receive payment. Often, entities that provide health care services will use a collection affiliate to receive payments. The intent of the statute and the Proposed Rule is to exclude from revenue payments for health care services rendered under an enumerated list of government programs. Our second recommendation above furthers the intent of the rule by explicitly providing that the determination of whether an entity is a health care provider is made on a combined group basis. Assuming that this recommendation is adopted, Medicare payments that are made to an entity that is in the same combined group as the entity that provides health care services would be covered by the exclusion.

7. <u>Flow-through Funds</u>

a. Language at Issue

Section 171.1011(g) of the Texas Tax Code states the following:

> A taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), only the following flow-through funds that are mandated by contract to be distributed to <u>other entities</u>: (1) sales commissions to nonemployees, including split-fee real estate commissions; (2) the tax basis as determined under the Internal Revenue Code of securities underwritten; and (3) subcontracting payments handled by the taxable entity to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property.

b. Recommendation

Proposed Rule 3.587(e)(2) restates section 171.1011(g), without offering further guidance. We recommend that the reference to "other entities" be clarified under Proposed Rule 3.587(e)(2) to include "other entities <u>or persons</u>" to make clear that payment of any of the items listed in section 171.1011(g) may be excluded from total revenue regardless of whether the recipient is an entity or a natural person.

c. Explanation

Section 171.1011(g) currently suggests that a taxable entity may exclude from total revenue only amounts mandated under contract to be distributed to other <u>entities</u>. However, the recipient of those payments may be a natural person. Indeed, the reference to payment of sales commissions to "nonemployees" appears to contemplate payments to natural persons. An amendment to Proposed Rule 3.587(e)(2) supplementing the reference to "other entities" with "other persons" would remove the risk that a taxable entity would not be permitted an exclusion for payment of flow-through funds to natural persons.

8. Revenue From Affiliated Group Members

a. Language at Issue

Proposed Rule 3.587(c)(7) states: "Revenue from affiliated group members. If the taxable entity belongs to an affiliated group, the taxable entity may not exclude from the calculation of total revenue any payments described by subsection (e)(1)-(6) of this section that are made to entities that are members of the affiliated group."

b. Recommendation

We recommend that Proposed rule 3.587(c)(7) be amended to read: "Revenue from affiliated group members. If the taxable entity receiving payment belongs to an affiliated group, the recipient taxable entity may not exclude from the calculation of total revenue any payments described by subsection (e)(1)-(6) of this section that are made to it by entities that are members of the affiliated group."

c. Explanation

The intent of the subsection appears to be that the receipt of payments described by subsection (e)(1)-(6) may not be excluded by a taxable entity receiving such payments from another member of an affiliate group. Our proposed language reflects and clarifies this intent.

H. Proposed Rule 3.588, Margin: Cost of Goods Sold

1. Production

a. Language at Issue

Proposed Rule 3.588(b)(7) reads: "Production—Construction, manufacture, installation occurring during the manufacturing process, development, mining, extraction, improvement, creation, raising, or growth."

b. Recommendation

We recommend that Proposed Rule 3.588(b)(7) be rewritten to read: "Production includes construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth."

c. Explanation

The language in Proposed Rule 3.588(b)(7) appears to be more restrictive than the statutory language of section 171.1012(a)(2) of the Texas Tax Code . The statutory term of installation is replaced under the proposed rule by "installation occurring during the manufacturing process." Our recommendation is to repeat the language of the statute.

2. Direct and Necessary Costs

a. Language at Issue

Section 171.1012(c) of the Texas Tax Code defines the cost of goods sold to include all direct costs of acquiring or producing goods. The cost of goods sold is further defined to include certain other direct costs such as the cost of renting or leasing equipment, facilities, or real property directly used for the production of the goods, the cost of repairing and maintaining equipment, facilities, or real property directly used for the production of the goods, costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods and the cost of utilities, including electricity, gas, and water, directly used in the production of the goods. In addition, depreciation, depletion and amortization, "to the extent associated with and necessary for the production of goods" qualify as costs of goods sold. § 171.1012(c)-(d). Proposed Rule 3.588 reiterates those statutory references to the term "direct" without providing additional guidance regarding the application of the term.

b. Recommendation

We recommend that Proposed Rule 3.588 clarify the proximity that must exist between the costs at issue and the goods produced. For example, is a cost of goods sold deduction for equipment used in production only available for equipment that causes a chemical or physical change to the produced product? With respect to real property used in production, it may be unclear as to whether a cost of goods sold deduction is available only for property used in the actual manufacturing process (as opposed to for property used in office facilities, for example). Moreover, with respect to the cost of utilities, it may similarly be unclear as to whether the cost of goods sold deduction is limited only to utilities used in the manufacturing area and only during the actual production of property, although it seems appropriate that it be available for other locations such as office and support facilities? We recommend that the Comptroller provide regulatory guidance, perhaps by way of example, illustrating that the interpretation of the term "direct" (and similar terms) for cost of goods sold purposes will not be constrained by the interpretation of similar terms for purposes of the sales tax manufacturing exemption.

c. Explanation

We believe that references to "direct," "associated with," and "necessary" are vague and are likely to generate disputes between taxpayers and the Comptroller. Considerable controversy has arisen in interpreting similar terms for purposes of the sales tax manufacturing exemption. *See, e.g., Comptroller v. Tyler Pipe*, 919 S.W.2d 157 (Tex. App.—Austin 1996).

We recommend that the Comptroller provide regulatory guidance illustrating that the interpretation of the term "direct" (and similar terms) for cost of goods sold purposes will not be constrained by the interpretation of similar terms for purposes of the sales tax manufacturing exemption. In keeping with the requirement that exemptions from tax should be narrowly construed, the sales tax definitions are quite restrictive.

Deductions from the margin tax, by contrast, are intended to produce an accurate measurement of a taxpayer's margin, making an extremely restrictive approach to calculating the deductions less appropriate. In addition, the sales tax concepts were developed in the limited context of manufacturing or processing of tangible personal property, while the margin tax cost of goods sold concept must apply to a much broader range of business activities.

3. LIFO Taxpayers

a. Language at Issue

Section 171.1012(g) of the Texas Tax Code provides that a taxable entity that is allowed a cost of goods sold deduction and that is subject to sections 263A, 460, or 471 of the Internal Revenue Code may capitalize that cost in the same manner and to the same extent that the taxable entity capitalized that cost on its federal income tax return or may expense those costs, except for costs excluded under Subsection (e), or in accordance with subsections (c), (d), and (f).

b. Recommendation

Proposed Rule 3.588(c)(1) restates section 171.1012(g), without offering further guidance. We recommend that Internal Revenue Code § 472, related to LIFO, be added to the referenced sections of the Internal Revenue Code, to make clear that taxable entities that follow LIFO (last-in, first-out method of inventorying goods) for federal income tax purposes may capitalize their costs in the same manner and to the same extent that the taxable entity capitalized that cost on its federal income tax return.

c. Explanation

Section 171.1012(g) and Proposed Rule 3.588(c)(1) are unclear as to whether taxable entities that use LIFO for federal income tax purposes and elect to capitalize costs for Texas franchise tax purposes should do so in the same manner and to the same extent that the taxable entity capitalized costs on its federal income tax return. Usage of LIFO is elective for federal income tax purposes, so it is unclear whether a taxpayer would be "subject to" Internal Revenue Code § 472, and it is also unclear whether a taxpayer that uses LIFO under § 472 is treated as "subject to" § 471. Under various interpretations of § 171.1012(g) and Proposed Rule 3.588(c)(1), a taxpayer may reach the conclusion that: (1) a taxpayer that elects to use LIFO under § 472, is not subject to § 471, and therefore would not be allowed to capitalize costs for Texas franchise tax purposes; (2) a taxpayer that elects to use LIFO under § 472 is still technically subject to § 471 and therefore may capitalize costs for Texas franchise tax purposes in the same manner and to the same extent that the taxable entity capitalized costs on its federal income tax return; or (3) a taxpayer that elects to use LIFO under § 472 is still technically subject to § 471 and therefore may capitalize costs for Texas franchise tax purposes, but does not need to do so in the same manner and to the same extent that the taxable entity capitalized costs on its federal income tax return. Adding reference to § 472 to Proposed Rule 3.588(c)(1) will remove such uncertainty.

4. COGS Deduction Elections for Capitalization or Expense

a. Language at Issue

Section 171.1012(g) of the Texas Tax Code states that a taxable entity that is allowed a subtraction for cost of goods sold and that is subject to sections 263A, 460, or 471 of the Internal Revenue Code may capitalize that cost in the same manner and to the same extent that the taxable entity capitalized that cost on its federal income tax return or may expense those costs, except for costs excluded under subsection (e), or in accordance with subsections (c), (d), and (f). Section 171.1012(g) further provides:

> If the taxable entity elects to capitalize costs, it must capitalize each cost allowed under this section that it capitalized on its federal income tax return. If the taxable entity later elects to begin expensing a cost that may be allowed under this section as a cost of goods sold, the entity may not deduct any cost in ending inventory from a previous report. If the taxable entity elects to expense a cost of goods sold that may be allowed under this section, a cost incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold. If the taxable entity elects to expense a cost of goods sold and later elects to capitalize that cost of goods sold, a cost expensed on a previous report may not be capitalized.

b. Recommendation

Proposed Rule 3.588(c)(1) restates section 171.1012(g), without offering further guidance. We recommend that Proposed Rule 3.588(c)(1) be modified to provide further clarity as to the operation of the taxable entity's election to either capitalize or expense costs. Specific examples illustrating the Comptroller's view as to how cost of goods sold provisions are to be interpreted would be very useful.

c. Explanation

Section 171.1012(g) and Proposed Rule 3.588(c)(1) can be interpreted in various and contradictory ways. Proposed Rule 3.588(c)(1)(A) provides that a taxable entity that is allowed a subtraction for cost of goods sold and that is subject to sections 263A, 460, or 471 of the Internal Revenue Code may capitalize that cost in the same manner and to the same extent that the taxable entity capitalized that cost on its federal income tax return or may expense those costs, except for costs excluded under subsection (e), or in accordance with subsections (c), (d), and (f). It is unclear why reference is made to "that cost" and "those costs." Are these intended to mean different costs or the same costs? The reference to "that cost" implies that a taxpayer may make an election to capitalize each individual cost. The alternative interpretation is that the taxpayer make an election either to (i) capitalize all costs that were capitalized on the federal return or (ii) expense all costs.

Proposed Rule 3.588(c)(1)(A)(ii) provides that if a taxable entity initially elects to capitalize certain costs and then later elects to begin expensing a cost that may be allowed under this section as a cost of goods sold, the entity may not deduct any cost in ending inventory from a previous report. This subsection again implies that a taxable entity can pick and choose what costs it elects to capitalize and what costs it elects to expense. This is contradictory to the requirement that a taxable entity must capitalize each cost allowed under section 171.1012 that it capitalized on its federal income tax return.

Proposed Rule 3.588(c)(1)(B)(i) provides that if a taxable entity elects to expense a cost of goods sold that may be allowed under this section, a cost incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold. It is unclear whether those costs incurred in prior periods are lost or are still available to the taxable entity to deduct on a later franchise tax report if the taxpayer switches back from expensing costs to capitalizing costs. For example, a taxable entity may purchase a $15 million machine that will be depreciated $1 million a year for 15 years. If that taxable entity capitalizes costs for Texas franchise tax purposes for Years 1-5, then elects to expense costs for Years 6-10, and then elects to capitalize costs again beginning in Year 11, would the taxable entity be able to capitalize any costs related to the machine for years 11-15? If so, would the taxable entity be able to deduct $1 million a year over the last five years of the machine's useful life or $2 million (the $10 million of costs yet to be capitalized spread over the last five years of its useful life)? Further clarification in Proposed Rule 3.588(c)(1) would help to resolve such ambiguity.

5. Issues Related to Ownership of Goods

a. Language at Issue

Section 171.1012 of the Texas Tax Code permits a deduction for cost of goods sold. The term "goods" for purposes of the cost of goods sold deduction is defined as real or tangible personal property sold in the ordinary course of business. § 171.1012(a)(1). Proposed Rule 3.588(c)(6) implements section 171.1012(i) in providing that "[a] taxable entity may make a subtraction under this section in relation to the cost of goods sold only if that entity owns the goods." Proposed Rule 3.588(c)(6)(A), mirroring section 171.1012(i), provides:

> A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in [Rule] 3.357 of this title (relating to Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance)), of real property is considered to be an owner of that labor or materials and may include the costs, as allowed by this section, in the computation of goods sold.

b. Recommendation

We recommend that Proposed Rule 3.588(c)(6) be modified to provide:

> A taxable entity may make a subtraction under this section in relation to the cost of goods sold only if that entity is treated as the owner of the goods for purposes of this section (c). The determination of whether a taxable entity is an owner for purposes of this section (c) is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity.

We recommend that the following new sentence be added to the end of Proposed Rule 3.588(c)(6):

> If the various benefits and burdens of ownership result in the taxable entity recognizing the cost of sales for financial statement purposes under generally accepted accounting principles, such taxable entity shall be presumed owner of the goods for purposes under generally accepted accounting principles, of this section (c), even if the taxable entity does not take legal title to such goods.

In addition to, or as an alternative to, the preceding paragraph, we recommend that the following new sentence be added to the end of Proposed Rule 3.588(c)(6): "A taxable entity shall be treated as the owner of goods for purposes of this section (c) if it possesses equitable title to the goods and is subject to risk of loss of the goods."

We recommend that the language in Proposed Rule 3.588(c)(6)(A) be amended to read as follows:

> A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in [Rule] 3.357 of this title (relating to Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance)), of real property is considered to be an owner of such labor or materials for purposes of this section (c) and may claim a cost of goods sold deduction for the costs allowed by section 171.1012 that relate to the furnishing of such labor or materials. ~~is considered to be an owner of that labor or materials and may include the costs, as allowed by this section, in the computation of goods sold~~.

c. Explanation

Our recommendations serve to clarify that an entity may be considered the owner of goods for purposes of the cost of goods sold deduction in certain situations in which the entity may not have ownership for all legal purposes (for example, where the entity has equitable but not legal title). These recommendations are consistent with the provision in the statute and Proposed Rule 3.588(c) that ownership is determined based on all facts and circumstances, while providing specific examples where the facts and circumstances are indicative of ownership. Moreover, in administrative rulings interpreting the expiring earned surplus and taxable capital components, the Comptroller has recognized that the Texas franchise tax should be computed by treating the owner of equitable title of assets for state law purposes as the owner of the assets for franchise tax computation purposes. We recommend that the language in Proposed Rule 3.588(c)(6)(A) implementing the currently identified example of ownership where some legal indicia of ownership are not present, that of entities providing certain real property services, be modified to conform to our recommended additions to Proposed Rule 3.588(c)(6). Our other recommendations address situations (such as contract manufacturing arrangements) where an entity assumes the economic burdens of ownership, risk of loss, and/or equitable title without having legal title.

6. Transactions Between Members of an Affiliated Group

a. Language at Issue

Proposed Rule 3.588(c)(1), mirroring section 171.1012(l), provides: "Notwithstanding any other provision of this section, a payment made by one member of an affiliated group to another member of that affiliated group not included in the combined group may be subtracted as a cost of goods sold only if it is a transaction made at arm's length." While such payments are explicitly deductible, no provisions specify the consequences of a transaction that is not made on an arm's-length basis to another member of that affiliated group not included in the combined group.

b. Recommendation

We recommend that Proposed Rule 3.588(c)(1) be modified as follows:

> Notwithstanding any other provision of this section, a payment made by one member of an affiliated group to another member of that affiliated group not included in the combined group may be subtracted as a cost of goods sold, <u>but only to the extent of the amount that would have been paid if the transaction had been entered into on an arm's length basis between unrelated parties</u>.

c. Explanation

Section 171.1012(l) results in uncertainty regarding the consequences of a payment made by one member of an affiliated group to another member of that affiliated group not included in the combined group where the payment is not made on an arm's-length basis. Specifically, should a deduction for the payment be disallowed in full, or should a deduction be permitted to the extent that an arm's length price can be established? We believe that allowance of a deduction to the extent that an arm's length price can be established represents the intended and most equitable approach. In many instances, the differential between an arm's length price and the price paid between related members of an affiliated group may not be dramatically different. Disallowing the deduction in its entirety would result in unduly harsh consequences to the payor entity.

7. Officer's Compensation

a. Language at Issue

Proposed Rule 3.588(g)(12) excludes officers' compensation from the cost of goods sold.

b. Recommendation

We recommend that Proposed Rule 3.588(g)(12) be amended to add a definition of "officer." Such definition should exclude a person who is both an officer and the sole employee of a taxable entity.

c. Explanation

Proposed Rule 3.588(g)(12) does not provide a definition of an officer, which has historically been a point of disagreement under the expiring earned surplus component of the franchise tax. For purposes of the add-back of officer compensation under the expiring earned surplus component of the franchise tax, section 171.110(i) of the Texas Tax Code defines "officer" as any person that holds an office created by the board of directors or under the corporate charter or bylaws and has legal authority to bind the corporation with third parties by executing contracts or other legal documents." Furthermore, in the event that a taxable entity only has a single employee, that employee will be both an officer and the only person available to the taxable entity to conduct many other activities on behalf of the taxable entity. To the extent that the person's activities would otherwise be deductible for franchise tax purposes, the taxable entity should be allowed to deduct such expenses; the taxable entity should not be punished for being a "one-man shop." Our proposed definition of an "officer" would prevent such inequitable treatment.

I. Proposed Rule 3.589, Margin: Compensation

1. Definition of Wages and Cash Compensation

a. Language at issue

Section 171.1013(b)(1) of the Texas Tax Code allows a deduction for "wages and cash compensation" paid by a taxable entity to its officers, directors, owners, partners, and employees. Section 171.1013(a) provides that "wages and compensation" means "the amount entered in the Medicare wages and tips box of Internal Revenue Service W-2 or any subsequent form with a different number or designation that substantially provides the same information." Proposed Rule 3.589(b)(9)(A), in turn, mirrors section 171.1013(a) by defining the term "wages and compensation" in the exact same way. Proposed Rule 3.589(d), however, excludes certain items from the term "compensation." Specifically, Proposed Rule 3.589(d)(1) excludes from the term "compensation" payments made to independent contractors on Form 1099.

b. Recommendation

We recommend that Proposed Rule 3.589(b)(9)(A) be amended to include payments made to officers, directors, owners, partners and employees (other than independent contractors) on Form 1099-MISC. This could be accomplished by amending Proposed Rule 3.589(b)(9)(A) as follows:

> (A) the amount entered in the Medicare wages and tips box of Internal Revenue Service Form W-2 or any subsequent form with a different number or designation that substantially provides the same information, <u>and the amount reported on Form 1099-MISC as to any officer, director, owner, partner, or employee (but not an independent contractor) or any subsequent form with a different number or designation that substantially provides the same information</u>.

c. Explanation

The recommended change to Rule 3.549(b)(9)(A) is necessary even if it was the legislature's intent not to include payments made to independent contractors as part of the compensation deduction. This is because certain payments made to individuals listed in section 171.1013(b)(1) (that is, officers, directors, owners, partners, and employees), to which the compensation deduction is specifically allowed, are required by the IRS to be reported on Form 1099-MISC, box 7 (nonemployee compensation) rather than on Form W-2. For example, the IRS requires certain director fees and other remuneration to be reported in box 7 of Form 1099-MISC. Without the recommended change, any such payments that are not made in the form of stock awards or stock options would be ineligible for the compensation deduction. We do not believe that such a result was intended.

2. Net Distributive Share of Income

a. Language at Issue

Section 171.1013(b)(1) of the Texas Tax Code states that an entity that elects to subtract compensation for the purpose of computing its taxable margin under section 171.101 may include in that amount all wages and compensation paid by the taxable entity to its officers, directors, owners, partners, and employees. Section 171.1013(a)(1) defines the term "wages and compensation" in part to include (i) "net distributive income from partnerships and from trusts and limited liability companies treated as partnerships for federal income tax purposes, but only if the person receiving the distribution is a natural person," and (ii) "net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes, but only if the person receiving the distribution is a natural person."

Proposed Rule 3.589(b)(9)(B) essentially mirrors the above statutory provisions by providing that the term "wages and compensation" includes the "amount of net distributive income" from one of the following entities to partners or owners if the person receiving the amount is a natural person: (i) taxable entities treated as partnerships for federal income tax purposes; (ii) limited liability companies and corporations treated as S corporations for federal income tax purposes; and (iii) limited liability companies treated as sole proprietorships for federal income tax purposes. Proposed Rule 3.589(b)(5) defines "net distributive income" as "[t]he net amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable to the owners for the tax year of the entity."

b. Recommendation

We recommend that Proposed Rule 3.589 be clarified to provide that a compensation deduction for an owner's distributive share of income is permitted for all pass-through owners regardless of whether actual distributions are made. This could be accomplished by amending Proposed Rule 3.589(b)(9)(B) to read as follows: "(B) the amount of net distributive income, <u>regardless of whether cash or property pertaining to such income is actually distributed</u>, from one of the following entities to partners or owners during the accounting period but only if the person receiving the amount is a natural person."

We further recommend that Proposed Rule 3.589(b)(5) be clarified to state: "(5) Net distributive income—The net amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable <u>for federal income tax purposes</u> to the owners for the tax year of the entity."

c. Explanation

Although the definition of "net distributive income" as amounts "reportable" to owners suggests that actual distributions are not necessary for a compensation deduction, we believe that there is currently uncertainty with respect to whether a partnership or other pass-through entity is required to make an actual distribution of income in the form of cash or other property to an owner to qualify that owner's distributive share of income as wage and cash compensation for purposes of the compensation deduction under section 171.1013. Both section 171.1013 and Proposed Rule 3.589 make reference to the "distributive share" of income from various pass-through entities suggesting that actual distributions of cash or other property are not required. However, the Texas Comptroller previously issued instructions to its tax returns under the margin tax requiring actual distributions in order for such amounts to qualify for the available deduction.[1]

Allowing a deduction for an amount equal to an owner's distributive share of income in the year that the income is generated regardless of whether any actual distributions of cash or property occur is the only way to guarantee matching the deduction with the income that generated it. In contrast, requiring actual distributions creates a number of issues, including for example, whether the deduction is available for distributions of cash or other property pertaining to current year income only or is also available for distributions pertaining to a prior year's undistributed income. If the deduction is available with respect to prior year undistributed income, then it is quite possible that the benefit of the deduction may be lost or significantly diminished if the cash or property distribution is made in a later year in which the taxable entity has little or no taxable margin.

3. Management Companies

a. Language at Issue

Section 171.1013(g) of the Texas Tax Code allows a compensation deduction to a taxable entity that is a managed entity for reimbursements made to the management company for wages and compensation as if the reimbursed amounts had been paid to employees of the managed entity. Proposed Rule 3.589(g)(2) similarly provides that "[a] taxable entity that is a managed entity may subtract wages and cash compensation that are reimbursed to the management company."

Section 171.0001(11) defines the term "management company" to mean a limited liability entity "that conducts all or part of the active trade or business of another entity in exchange for (A) a management fee; and (B) reimbursement of specified costs incurred in the conduct of the active trade or business of the managed entity, including 'wages and cash compensation' as determined under [s]ections 171.1013(a) and (b)." Proposed Rule 3.589(b)(3) essentially mirrors section 171.0001(11) by providing that the term "management company" means the following:

> A corporation, limited liability company or other limited liability entity that conducts all or part of the active trade or business of another entity (the managed entity) in exchange for: (A) a management fee; and (B) reimbursement of specified costs incurred in the conduct of the active trade or business of the managed entity.

b. Recommendation

We recommend that the term "active trade or business" be defined in Proposed Rule 3.589(b) for purposes of determining whether an entity is acting as a "management company" within the meaning of section 171.0001(11) and Proposed Rule 3.589(b)(3).

c. Explanation

The only definition of the term "active trade of business" is in section 171.0004 and corresponding Proposed Rule 3.582 relating to passive entities. Notably, Proposed Rule 3.582(b)(1) states that the definition of "active trade or business" as provided in that section is to be used for the purposes of that section only. Accordingly, an alternative definition of "active trade or business" should be provided in Proposed Rule 3.589(b)(3).

4. Benefits Deductible for Federal Income Tax Purposes

a. Language at Issue

Section 171.1013(b)(2) of the Texas Tax Code allows a deduction for "the cost of all benefits, to the extent deductible for federal income tax purposes, the taxable entity provides to its officers, directors, owners, partners, and employees, including workers' compensation benefits, health care, employer contributions made to employees' health savings accounts, and retirement." Proposed Rules 3.589(e)(2) and (3) then provide a list of items that do not fall within the definition of the term "benefits." In part, this list includes: (i) discounts on the price of the taxable entity's merchandise or services sold to the taxpayer's employees, officers, or directors, partners, or owners that are not available to other customers (see Proposed Rule 3.589(e)(2)(B)); (ii) working condition amounts provided so employees can perform their jobs (see Proposed Rule 3.589(e)(2)(D)); and (iii) amounts paid by an employee (see Proposed Rule 3.589(e)(3)).

b. Recommendation

We recommend that Proposed Rules 3.589(e)(2) and (3) be amended to allow a deduction with respect to the amounts listed therein if such amounts are allowed to be deducted for federal tax purposes. This could be accomplished by revising the lead-in provisions of Proposed Rules 3.589(e)(2) and (3) to read as follows: "(2) The term 'benefits' does not include the following (unless such amounts are deductible by the taxable entity for federal tax purposes, in which case such amounts are considered benefits)" and "(3) The cost of benefits does not include the amount paid by an employee (unless such amounts are deductible by the taxable entity for federal tax purposes, in which case such amounts are considered benefits)."

c. Explanation

We believe the intent of the legislature was to allow a compensation deduction for all benefits if, in fact, such benefits are allowed to be deducted by the taxable entity for federal tax purposes. Certain items listed in Proposed Rules 3.589(e)(2) and (3) may be allowed to be deducted by a taxable entity for federal tax purposes. As such, we believe the legislature intended for these benefits to be deductible as compensation for margin tax purposes as well.

J. Proposed Rule 3.590, Margin: Combined Reporting

1. Pass-through and Disregarded Entities

a. Language at Issue

Proposed Rule 3.590(b)(2)(D) states: "pass-through entities (including partnerships), limited liability companies taxed as partnerships under federal law, limited liability companies that are disregarded under federal law, and S corporations must be included in a combined group."

b. Recommendation

We recommend either deleting this section or clarifying it to state that pass-through and disregarded entities and S corporations are included in a combined group if they otherwise satisfy the criteria for combined reporting (i.e., if they are domestic entities that are part of an affiliated and unitary group). One possible revision would read: "Pass-through entities (including partnerships), limited liability companies taxed as partnerships under federal law, limited liability companies that are disregarded under federal law, and S corporations that satisfy the criteria for combined reporting must be included in a combined group."

c. Explanation

The language in Proposed Rule 3.590(b)(2)(D) suggests that all pass-through and disregarded entities and S corporations must always be included in a combined group, regardless of whether they otherwise qualify as members of a combined group. We do not believe this was the intention of the Proposed Rule, and certainly that interpretation would not appear consistent with the intent of the Texas Tax Code.

2. Examples Relating to Definition of Controlling Interest

a. Language at Issue

The examples in Proposed Rule 3.590(b)(4)(B) address a number of scenarios each involving variations of a controlling interest. Examples (i) and (iii) make clear that an entity that owns a controlling interest in another entity will be deemed to own 100% of that entity's ownership interest in a third entity for purposes of determining if a controlling interest exists. Example (ii) involves the inverse scenario where the parent entity does not own a controlling interest in its subsidiaries. It reads as follows:

> Corporation A owns 10% of Limited Liability Company C and 15% of Corporation B, which owns 90% of Limited Liability Company C. Corporation A does not have controlling interest in Limited Liability Company C and does not have a controlling interest in Corporation B. Corporation B has a controlling interest in Limited Liability Company C.

It is not clear from this example what percentage ownership Corporation A is deemed to have in Limited Liability C. In particular, is Corporation A deemed to own only 10% of Limited Liability Company C, or is it deemed to own 13.5% (10% + (15% x 90%))? In this example, it doesn't matter because either way the control test is not satisfied. But in other scenarios it would matter (see below).

b. Recommendation

We recommend addressing a variation of the scenario in Example (ii) as follows: "Corporation A owns 10% of Limited Liability Company C and 45% of Corporation B, which owns 90% of Limited Liability Company C."

c. Explanation

The issue presented by this scenario that is not addressed in any of the other examples is whether a pro rata portion of Corporation B's ownership of Limited Liability Company C should be attributed to Corporation A notwithstanding that Corporation A does not own more than 50% of Corporation B. Under the above example, if Corporation A is deemed to own a pro rata portion of Limited Liability Company C through its ownership interest in Corporation B, it would own 50.5% of Company C (10% + (45% x 90%)). If, on the other hand, Corporation A is not deemed to own a pro rata portion of Limited Liability Company C through its ownership in Corporation B, then it would only own 10% of Limited Liability Company C. This obviously makes a difference as to whether a common controlling interest exists as between Corporation A and Limited Liability Company C.

3. Presumption of Unity

a. Language at Issue

The last sentence in Proposed Rule 3.590(b)(6)(B) states, "All affiliated entities are presumed to be engaged in a unitary business."

Proposed Rule 3.590(b)(6)(C) reads as follows: "When a taxable entity acquires another entity, a presumption exists for finding a unitary relationship during the first reporting period. Any party may rebut such presumption by proving that the taxable entities were not unitary. If such presumption is rebutted, then the taxable entities shall not be considered unitary as of the date of acquisition. When a taxable entity forms another taxable entity, a unitary relationship exists as of the date of formation unless the business is not unitary on a longer term basis."

b. Recommendation

We recommend that the last sentence in Proposed Rule 3.590(b)(6)(B) be removed.

We also recommend that the first three sentences of Proposed Rule 3.590(b)(6)(C) be deleted.

c. Explanation

We find no language in the Texas margin tax provisions, as enacted by the Texas Legislature, that would support the Comptroller's position that all affiliated entities are presumed to be engaged in a unitary business. On the contrary, section 171.0001(17) of the Texas Tax Code states that "[i]n determining whether a unitary business exists, the comptroller shall consider any relevant factor, including whether . . . ." This language suggests that the Comptroller must make an affirmative determination that a unitary business exists, rather than relying on a presumption that one exists. The presumption also increases the risk of litigation, controversy, and cost to both taxpayers and the Comptroller by removing any obligation on the part of the auditor to do anything more than determine that an affiliated group exists in determining if combined reporting applies.

We also find it inappropriate to presume that a unitary relationship exists immediately anytime a taxable entity acquires another entity. In that event, the businesses will generally have had no past opportunity for establishing the various elements of a unitary relationship. Furthermore, if integration, interdependence and interrelationships are expected to occur, the changes often take time. For these reasons, we believe that a presumption of a unitary relationship immediately upon the acquisition of a business is inappropriate.

4. Reporting Entity

a. Language at Issue

Proposed Rule 3.590(b)(5) states that the "reporting entity" for a combined group may be "[t]he combined group's choice of an entity that is the parent entity, if it is part of the unitary business, or the entity that (A) is included within the combined group; (B) is subject to Texas' taxing jurisdiction; and (C) has the greatest Texas business activity during the first year that a combined report is required to be filed, as measured by the total revenue for that year."

b. Recommendation

1. Depending on the Comptroller's intent, we recommend that the language "[t]he combined group's choice of an entity that is the parent entity, if it is part of the unitary business . . ." be changed to read as follows: "The parent entity of the combined group if it is part of the unitary business . . . ." Alternatively, the language could be changed to read as follows: "The combined group's choice of an entity that is part of the unitary business . . . ."

2. We recommend changing the language in Proposed Rule 3.590(b)(5)(C) to read as follows: "has the greatest amount of revenue apportioned to Texas during the first year that a combined report is required to be filed, applying the apportionment formula in section 171.106."

c. Explanation

1. The language, "[t]he combined group's choice of an entity that is the parent entity, if it is part of a unitary business," seems internally inconsistent. The first part of the sentence suggests that the combined group may choose an entity as its reporting entity, subject only to the requirement that it be part of the unitary business. The reference to "the parent entity" in the same sentence, however, suggests that the choice can only be the parent entity of the group, which really makes this no choice at all. The proposed language would provide some clarity.

2. Proposed Rule 3.590(b)(5)(C) requires that the reporting entity be the entity with the greatest Texas business activity during the first year that a combined report is required to be filed, as measured by the total revenue for that year." The language assumes that "Texas business activity" can be measured by total revenue alone, which is not necessarily the case given that total revenue includes all revenue, not just the portion attributable to Texas. The proposed revision would provide a mechanism for using total revenue as a measure of Texas activity by requiring that it be apportioned using the same apportionment formula set forth in section 171.106 for apportioning margin *(i.e.*, Texas receipts/gross receipts).

K. Proposed Rule 3.591, Margin: Apportionment

1. Sourcing of Services Provided by Subcontractors.

a. Language at Issue

Proposed Rule 3.591(e)(26) provides in part that "[r]eceipts from a service are apportioned to the location where the service is performed."

b. Recommendation

We recommend that Proposed Rule 3.591(e)(26) be modified to clarify that the determination of where a service is performed is not limited to activities performed directly by a taxable entity, as follows: "Receipts from a service are apportioned to the location where the service is performed whether the service is performed by a taxable entity or by a subcontractor of the taxable entity."

c. Explanation

A taxable entity that sells services does not receive a cost of goods sold deduction or a compensation deduction for costs incurred to engage a subcontractor to perform revenue generating services. Therefore, a taxable entity service provider in effect must pay tax on revenues generated by subcontractors, even if the compensation paid to the subcontractors would be deductible in computing federal taxable income.

Because the taxable entity in effect must pay tax on total revenues generated by subcontractors' activities, the gross receipts attributable to these revenues should be sourced based on where the subcontractors perform the services to avoid unintended and unjust results.

L. Proposed Rule 3.592, Margin: Additional Tax

1. Due Date For Final Return When Loss of Nexus Activities

a. Language at issue

Section 171.0011(a) of the Texas Tax Code imposes an additional tax (commonly referred to as an "exit tax") on a taxable entity "that for any reason no longer becomes subject to the tax imposed under this chapter." Proposed Rule 3.592(a), in turn, provides that the additional tax imposed under section 171.0011 applies "to a taxable entity which no longer has sufficient nexus with Texas to be subject to the franchise tax." Proposed Rule 3.592(b) then provides:

> A final report and payment of the additional tax are due within 60 days after the taxable entity no longer has sufficient nexus with Texas to be subject to the franchise tax. However, an estimated return and payment may need to be filed and paid before a taxable entity will receive clearance from the comptroller to terminate, dissolve, merge, or withdraw. As long as the proper amount is paid and an amended return, if needed, is filed within 60 days after the taxable entity terminates, dissolves, merges, or withdraws, then no penalty or interest will be assessed.

b. Recommendation

We recommend that Proposed Rule 3.592 be amended to specifically provide the mechanics for filing a final report and making payment of additional tax due when a taxable entity ceases engaging in Texas nexus creating activities (versus terminating, dissolving, merging, or withdrawing).

If consistent with the Comptroller's intention, we suggest amending Proposed Rule 3.592(b) to add the following emphasized language:

> (b) Due Date. A final report and payment of the additional tax are due within 60 days after the taxable entity no longer has sufficient nexus with Texas to be subject to the franchise tax. However, an estimated return and payment may need to be filed and paid before a taxable entity will receive clearance from the comptroller to terminate, dissolve, merge, or withdraw. As long as the proper amount is paid and an amended return, if needed, is filed within 60 days after the taxable entity terminates, dissolves, merges, or withdraws, then no penalty or interest will be assessed. <u>If the taxable entity again engages in any activity sufficient to create nexus for Texas franchise tax purposes after the filing of a final report but before January 1 of the next report year, then (i) an amended return reporting additional tax due, if any, must be filed if the nexus creating activities once more cease on or before December 31, such amended report being due within 60 days after December 31, or (ii) the next regular report due for the taxable entity must report the additional amount due, if any, computed as between the date the final report was filed and December 31, 2007. As long as the proper amount is paid on either the amended return or regular report (as applicable), then no penalty or interest will be assessed</u>.

c. Explanation

There are several situations that would require a taxable entity to file a final report and pay the exit tax. For example, the taxable entity could terminate, dissolve, merge, or withdraw its foreign qualification to do business in Texas. However, the taxable entity could become no longer subject to the Texas franchise tax solely by ceasing to engage in Texas nexus creating activities. This could be the case for (i) a foreign organized taxable entity that does not hold a Texas certificate of authority or (ii) a foreign organized taxable entity that does not have any connection with Texas other than holding a Texas certificate of authority. The confusion created by this issue can be seen by way of an example. Assume a Delaware organized limited liability company has nexus with Texas solely by way of having employees located in the state beginning January 15, 2008. Thereafter, the taxable entity ceases having employees in Texas as of October 15, 2008. Assuming the taxable entity has no other Texas nexus creating activities, it thereby ceases to have nexus for Texas franchise tax purposes as of October 15, 2008. Does the 60 day period for filing the taxable entity's final franchise tax report begin to run on October 15, 2008, or should it not begin to run until December 31, 2008, such that the Comptroller can ensure that no other nexus creating activities occur between October 15, 2008 and December 31, 2008 (i.e., employees came back into the state)? Since Texas nexus is not created solely by holding a certificate of authority to do business in Texas[2] and some foreign taxable entities do business in Texas without a Texas certificate of authority, the reference that Proposed Rule 3.592(b) makes to "withdraw" does not adequately address the issue.

2. Cross Reference to Passive Entities

a. Language at Issue

Relating to application of the exit tax as applied to passive entities, Proposed Rule 3.592(d) provides a cross reference to Proposed Rule 3.582 (Margin: Passive Entities).

b. Recommendation

We recommend that Proposed Rule 3.592(d) be amended to clarify the purpose of this specific cross reference. If the cross reference is meant to indicate that an exit tax is not imposed on a taxable entity that no longer becomes subject to franchise tax because it qualifies as a passive entity, which we believe to be the intent of the cross reference, then we suggest amending Proposed Rule 3.592(d) to read as set forth below since it is only section 171.0011(e) of the Texas Tax Code (not Proposed Rule 3.582) that provides that the exit tax is not imposed on a taxable entity that no longer becomes subject to franchise tax because the entity qualifies as a passive entity: "(d) Passive entities. *See* ~~3.582 of this title~~ section 171.0011(e) (relating to Margin: Passive Entities)."

c. Explanation

It is unclear whether the cross reference is meant to imply that there are special requirements that must be satisfied by passive entities when such entities terminate, dissolve, merge, or withdraw. Or, is the cross reference meant to indicate that an exit tax is not imposed on a taxable entity that no longer becomes subject to franchise tax because it qualifies as a passive entity? The proposed revision clarifies this ambiguity.

3. Cross Reference to Combined Groups

a. Language at Issue

Relating to application of the exit tax as applied to combined groups, Proposed Rule 3.592(e) provides a cross reference to Proposed Rule 3.590 (Margin: Combined Groups).

b. Recommendation

We recommend amending Proposed Rule 3.590 to add new subsection (j):

> (j) A taxable entity that was part of a combined group and had nexus for Texas franchise tax purposes, but which subsequently ceased having sufficient nexus with Texas to be subject to the franchise tax on either a combined group or separate entity basis must file a final report in accordance with the provisions of 3.592. Any reports that are required to be filed under 3.592 must be filed by the taxable entity and not the reporting entity (unless the subject taxable entity is also the reporting entity). If during any report year, a taxable entity no longer has sufficient nexus with Texas but continues to be included in a combined group return, the reporting entity shall include in the numerator of the apportionment formula as provided in 3.591 only those gross receipts earned while the taxable entity had nexus with Texas.

c. Explanation

Proposed Rule 3.590 does not provide any guidance as to what special requirements exist, if any, with respect to taxable entities subject to the exit tax that are part of a combined group. For example, does a taxable entity that is subject to the exit tax and was previously a member of a combined group (i.e., prior to filing the final report) file a separate entity return for exit tax purposes, or does the reporting entity file on behalf of such taxable entity? The proposed amendment helps to provide some clarity on this issue.

M. Proposed Rule 3.594, Margin: Temporary Credit

1. Election Requirements

a. Language at Issue

Proposed Rule 3.594 appears to impose two separate election requirements with respect to the temporary credit: (i) notice first to provide intent to preserve the right to claim the temporary credit for business loss carryforwards; and (ii) actual election to claim the credit on each report originally due on or after January 1, 2008 and before September 1, 2027.

b. Recommendation

If the above interpretation of Proposed Rule 3.594 is correct, we recommend that the proposed rule be amended to allow taxpayers to make both elections on the taxpayer's first report originally due after January 1, 2008, including extensions. We suggest amending Proposed Rule 3.594(d)(1)(A) as follows:

> A notice of intent to preserve the right to claim the temporary credit for business loss carryforwards must be submitted to the comptroller ~~on or before May 15, 2008, on a form prescribed by the comptroller. The postmark date (or meter-mark date, if there is no postmark) on the envelope in which the form is received determines the date of filing~~. on the taxable entity's first report due after January 1, 2008. Such report must be timely filed, including extensions.

c. Explanation

It is not clear whether Proposed Rule 3.594 mandates two separate election procedures. Without clarification, a taxable entity could miss the deadline for providing notice to the Comptroller of the intent to take the temporary credit. To avoid administrative burdens on the part of both the Comptroller and taxpayers, we recommend that the Comptroller allow the taxable entity's first return originally due after January 1, 2008, including extensions, to be used to meet both the "intent-to-claim" election and the first election to claim the temporary credit.

2. Combined Group Application As Currently Drafted is Overbroad

a. Language at Issue

Section 171.111 of the Texas Tax Code creates a temporary credit against tax due on taxable margin. Proposed Rule 3.594(c)(3), in turn, provides that "[i]f a member of a combined group changes combined groups after June 30, 2007, the business loss carryforward of that member will no longer be included in the temporary credit calculation of the group and the related share of any temporary credit carried over from a previous year is lost to the group." Pro-ration of the credit while the taxable entity was part of the combined group is not allowed. In addition, Proposed Rule 3.594(c)(3) provides that the temporary credit does not follow the member to a separately filed report or to another combined group. And if the member dissolves, terminates, or otherwise leaves the group, the business loss carryover of that member is no longer eligible for use. However, if a member of the group merges into another member of the group, that member's business loss carryforward is allowed to remain in the group. We understand that the purpose of these limitations is to ensure that any business loss carryforwards are not conveyed, assigned or otherwise transferred to another taxable entity, as is disallowed pursuant to section 171.111(d).

b. Recommendation

We recommend that Proposed Rule 3.594(c)(3) be amended to allow certain "outside" changes in a combined group (i.e., by way of outside merger or new members joining the group) without any loss of the business loss carryforward. We propose amending Proposed Rule 3.594(c)(3) to add the language emphasized below:

> (A) Unless 3.594(c)(3)(B) applies, if member of a combined group changes combined groups after June 30, 2007, the business loss carryforward of that member will no longer be included in the temporary credit calculation of the group and the related share of any temporary credit carried over from a previous year is lost to the group. There is no proration for a partial year. In addition, the business loss carryforward does not follow the member to a separately filed report or another combined group. If a member merges into another member of the group, that member's business loss carryforward will remain with the group. If the member dissolves, terminates, or otherwise leaves the group, the business loss carryover of that member is no longer eligible for use.
>
> (B) 3.594(c)(3)(A) shall not apply if the addition of a taxable entity to an existing combined group or the removal of a member from an existing combined group would not allow business loss carryforwards of any member of the existing combined group to be utilized where such business loss carryforwards would not have otherwise been utilized if the existing combined group had remained unchanged. Each report due under 3.584 shall include a statement and schedule with information sufficient to the comptroller showing the applicability of this section.

c. Explanation

We understand that Proposed Rule 3.594(c)(3) is intended to carry out the purpose of section 171.111(d), such that business loss carryforwards are not effectively conveyed, assigned or otherwise transferred to another taxable entity by way of a combined group changing members where the addition or removal of a member would allow business loss carryforwards to be utilized when such business loss carryforwards could not have otherwise been utilized if the combined group had remained unchanged. While Proposed Rule 3.594(c)(3) carries out this purpose, we believe it is overbroad in a way that could not have been intended.

It is not practical in the context of large corporate businesses for a combined group to stay stagnant with no change. Rather, in the large corporate atmosphere, entities are acquired and sold on a constant and consistent basis solely for business (not for tax) reasons. As the majority of the entities having business loss carryforwards likely are these large corporate businesses, we do not believe disallowance of any "outside" combined group changes could have been intended to carry out the purpose of section 171.111(d) in such cases where the tax effect of the combined group change is neutral – that is, any business loss carryforwards could be utilized and absorbed by the existing combined group, and the addition or removal of any entity would not have any impact whatsoever on the utilization of any losses. For example, consider the fact pattern where A, B, and C comprise a combined group and A merges into X with X being the surviving entity. X is a shell company with no income or assets. A has a business loss carryforward of $2,000,000.

Under Proposed Rule 3.594(c)(3), the combined group would lose A's business loss carryforward because A has left the combined group by way of its merger into X. However, since X is a shell company with no income or assets, the merger of X into A would not impact the combined group's utilization of A's business loss carryforwards. X has no assets or income and, accordingly, no taxable margin to offset any losses. Accordingly, the merger of X into A would not allow any business loss carryforwards to be utilized that would not have otherwise been utilized had the combined group remained unchanged. As indicated above, we believe Proposed Rule 3.594(c)(3) can be amended to ensure "outside" changes of members within a combined group are not utilized for the purpose of transferring temporary credits amongst entities. Without such a change, Proposed Rule 3.594(c)(3) is impractical from a business operational standpoint.

3. Loss Offset Requirement When No Tax Was Due in Prior Years Under Earned Surplus

a. Language at Issue

For the temporary credit to apply, Proposed Rule 3.594(b)(1) requires that business losses must have been used to offset any positive amount of earned surplus even in years when no tax was due.

b. Recommendation

We recommend that this language be stricken in its entirety. Accordingly, we recommend that

Proposed Rule 3.594(b)(1) be amended to read as follows:

(1) Business loss—Any negative amount of earned surplus after apportionment and allocation but before any deductions for solar energy devices under Tax Code, § 171.107, clean coal project under Tax Code, § 171.108, or investment in an enterprise zone under Tax Code, § 171.1015. ~~Business losses must have been used to offset any positive amount of earned surplus even in years when no tax was due~~.

c. Explanation

Section 171.111(b)(1) of the Texas Tax Code provides that the temporary credit is computed by "determining the amount of the business loss carryforwards of the taxable entity under section 171.111(e), as that section applied to annual reports originally due before January 1, 2008, that were not exhausted on a report originally due under this chapter before January 1, 2008." There is no statutory authority or legislative intent to impose the requirement that business losses must have been used to offset any positive amount of earned surplus even in years when no tax was due.

4. Tying Allowable Business Losses to Those Created on 2003 Reports or Thereafter

a. Language at Issue

Proposed Rule 3.594(b)(2) provides that the term "business loss carryforward" means "unused and unexpired amounts of business losses created on the 2003 and subsequent franchise tax report years."

b. Recommendation

We recommend that the language requiring that business loss carryforward constitute only those created from a taxable entity's 2003 or subsequent tax report year be stricken in its entirety. Accordingly, we recommend that Proposed Rule 3.594(b)(2) be amended as follows: "(2) Business loss carryforward—Unused and unexpired amounts of business losses. ~~created on the 2003 and subsequent franchise tax report years~~."

c. Explanation

Section 171.111(b)(1) of the Texas Tax Code provides the temporary credit is computed by "determining the amount of the business loss carryforwards of the taxable entity under section 171.111(e), as that section applied to annual reports originally due before January 1, 2008, that were not exhausted on a report originally due under this chapter before January 1, 2008." There is no statutory authority or legislative intent to impose the requirement that, to be a business loss, such loss must have been created from the taxable entity's 2003 or subsequent tax report year.

5. Taxable Entity Leaving Combined Group and Becoming a Single-Entity Filer

a. Language at Issue

Proposed Rule 3.594(c)(3) provides, in part, that "the business loss carryforward does not follow the member to a separately filed report or another combined group."

b. Recommendation

We recommend that this language be amended to allow business loss carryforwards to follow a member to a separately filed report, at least in certain non-tax motivated circumstances. We recommend that Proposed Rule 3.594(c)(3) be amended as set forth above in Part 2.b of our comments, with the following additional addition as emphasized:

(B) 3.594(c)(3)(A) shall not apply if the addition of a taxable entity to an existing combined group or the removal of a member from an existing combined group would not allow business loss carryforwards <u>or any member of the existing combined group to be utilized where such business loss carryforwards would not have otherwise been utilized if the existing group had remained unchanged or if a member of a combined group leaves the combined group to become a single-entity filer due to such entity leaving the combined group because it no longer meets the requirements for combined group reporting under 171.1014 or for some other non-tax motivated reason sufficiently shown to the satisfaction of the comptroller</u>.

c. Explanation

We understand that the intent of this provision is to carry out the purpose of section 171.111(d) of the Texas Tax Code, such that business loss carryforwards are not effectively conveyed, assigned or otherwise transferred to another taxable entity. However, we believe Proposed Rule 3.594(b)(2) is overbroad, and there is no statutory support for its implementation. There are many non-tax reasons why a taxable entity may go from being part of a combined group for Texas margin tax purposes to a single-entity filer. For instance, the business operations of the taxable entity could change in character such that the taxable entity is no longer considered unitary with the other group members. A taxable entity should not be punished by having to relinquish its business loss carryforwards in such instances where the change to single-entity status was not tax motivated.

6. Temporary Credit Utilization Using E-Z Method Computation

a. Language at Issue

Proposed Rule 3.594(e)(3) provides the following: "A taxable entity that uses the E-Z Computation to report and pay its franchise tax may not elect to take the business loss carryforward in that year. The unused credit may not be carried over to subsequent years."

b. Recommendation

We recommend that this language be amended to clarify that the amount of the unused credit that cannot be carried over to a subsequent year is that portion of the unused credit that would have been available for the year that the taxable entity is reporting and paying tax under the E-Z Computation method. This could be accomplished by amending Proposed Rule 3.594(e)(3) to read as follows:

> (3) A taxable entity that uses the E-Z Computation to report and pay its franchise tax may not elect to take the business loss carryforward credit in that year. The portion of the unused credit that would have been available for use for the report year that the taxable entity reports tax using the E-Z Computation may not be carried over to subsequent years.

c. Explanation

Proposed Rule 3.594 in general provides certain instances in which business loss carryforwards may be lost in their entirety. Proposed Rule 3.594(e)(3) should cause disallowance of a taxable entity's business loss carryforwards only for the portion related to the report year that the taxable entity is filing under the E-Z Computation. Our proposed amendment would accomplish this result.

ENDNOTES

1 The Comptroller's instructions stated: "Net distributive income for the calculation of compensation is the amount of guaranteed payments and distributions made during the accounting period . . ." See Texas Comptroller, Instructions For Completing Texas Franchise Information Report Due February 15, 2007.

2 *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App.—Austin 2000, pet. denied).

OFFICERS' CERTIFICATES IN TAX-FREE REORGANIZATIONS

Robert W. Phillpott[1]
Ronald J. Scharnberg

In a transaction intended to qualify as a tax-free reorganization (i.e., a "reorganization" within the meaning of Section 368(a)[2]), the obligations of the acquiring corporation and the target corporation to close the transaction are often conditioned upon the receipt by each of an opinion from its tax counsel that the transaction will qualify as such. In order to render such an opinion, tax counsel must determine that each of the legal requirements for the applicable type of reorganization is met, which will depend on the applicable facts.

Not all of the facts needed to render the opinion can be obtained from the transaction documents. As such, tax counsel generally receives representations and certifications as to factual matters required for the opinion in officers' certificates from the acquiring corporation and the target corporation. The representations and certifications to be included in the certificates will depend on the particular facts of the transaction.

Below is an example of such a certificate to be provided by the acquiring corporation in a merger of a target corporation with and into a limited liability company that is disregarded as an entity separate from the acquiring corporation for U.S. federal tax purposes. For purposes of the certificate below, it is assumed that the acquiring corporation and the target corporation are publicly traded, the merger is intended to qualify as an "A" reorganization by application of Treasury regulations section 1.368-2(b), and for purposes of the "continuity of interest" requirement of Treasury regulations section 1.368-1(e), the "signing date rule" in Temporary Treasury regulations section 1.368-1T(e)(2) applies.

The representations and certifications tax counsel needs to obtain from the acquiring corporation and the target corporation in order to render its opinion that the transaction qualifies as a reorganization will depend on the applicable facts and circumstances. Accordingly, some of the representations and certifications in the form below may not be applicable, and in other situations, additional representations and certifications may be required. Tax counsel must determine the appropriate representations and certifications it needs in order for it to render its opinion that a transaction qualifies as a reorganization.

[Acquiring corporation's Letterhead]

_____________, 200__

[Name and address of Acquiring's counsel]

[Name and address of Target's counsel]

Re: The Merger of **[name of Target]** with and into **[name of Merger Sub]**

Ladies and Gentlemen:

We have been asked to make certain representations and certifications (a) in connection with the opinions to be delivered by you pursuant to the Agreement and Plan of Merger, dated as of ___________ (the "Merger Agreement"), by and among the **[name of acquiring corporation]**, a __________ corporation ("Acquiring"), **[name of limited liability company]**, a ________________ limited liability company whose sole member is Acquiring ("Merger Sub"), and **[name of target corporation]**, a ____________ corporation ("Target"), and (b) in connection with the opinions to be delivered by you which will be included in the filing with the Securities and Exchange Commission of Registration Statement No. _____________ on Form S-4 (the "Registration Statement"). Unless otherwise defined herein, capitalized terms shall have the meanings ascribed to them in the Merger Agreement.

The undersigned certifies and represents on behalf of Acquiring and Merger Sub, and as to Acquiring and Merger Sub, after due inquiry and investigation, as follows:

1. The facts relating to the contemplated merger (the "Merger") of Target with and into Merger Sub pursuant to the Merger Agreement, as described in the Merger Agreement, and the documents described in the Merger Agreement are, insofar as such facts pertain to Acquiring and Merger Sub, true, correct, and complete in all material respects. The Merger will be consummated strictly in accordance with (a) the Merger Agreement and none of the material terms and conditions therein has been or will be waived or modified, (b) the **[name of the corporate act of the state in which the Merger will occur]** and the [name of the limited liability company act of the state in which the Merger will occur], and (c) the descriptions contained in the Registration Statement. The facts contained in the Registration Statement and the documents referred to therein, to the extent that they pertain to Acquiring or Merger Sub or were provided by Acquiring or Merger Sub or their agents, are true, correct, and complete in all material respects, and all other facts and documents referred to therein are, to the best of the knowledge of the management of Acquiring, true, correct, and complete in all material respects.

Comment: With this representation, tax counsel can rely on the facts and information contained in the Merger Agreement and the Registration Statement in rendering its opinion, many of which will be necessary in determining whether the requirements for the Merger to qualify as a reorganization are met. Specifically, the third sentence of this representation provides that all of the facts contained in the Registration Statement are true, correct, and complete. This is important because in order for the Merger to qualify as a reorganization, the Merger must be effected for bona fide business purposes and not for the purpose of tax avoidance. *See* Treas. Reg. §§ 1.368-1(b), -1(c), -2(g); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Laure v. Commissioner*, 653 F.2d 253 (6th Cir. 1981). Acquiring's and Target's business reasons for effecting the Merger will generally be described in the Registration Statement. As such, with this representation, tax counsel may rely on the business reasons for the Merger described in the Registration Statement to determine whether the business purpose requirement will be met. A similar representation would generally be obtained from Target in its certificate, with applicable changes being made.

2. The Merger Agreement, the documents described in the Merger Agreement, the information statement/proxy statement/prospectus (the "Information Statement/Proxy Statement/Prospectus") included as part of the Registration

Statement filed with the Securities and Exchange Commission, and the Registration Statement represent the entire understanding (a) between or among Acquiring and its subsidiaries, on the one hand, and Target and its subsidiaries, on the other, and (b) to the best of the knowledge of the management of Acquiring, between or among such entities and the affiliates and stockholders of Acquiring and Target with respect to the Merger. Additionally, there are no other written or oral agreements regarding the Merger other than those expressly referred to in the Merger Agreement, the documents described in the Merger Agreement, the Information Statement/Proxy Statement/Prospectus, and the Registration Statement.

Comment: This representation supplements the first representation. By obtaining this representation, tax counsel can determine whether the Merger qualifies as a reorganization based solely on the transaction documents described in the representation, and therefore, tax counsel does not need to consider whether there are other agreements that could impact whether the Merger qualifies as a reorganization. A similar representation would generally be obtained from Target in its certificate, with applicable changes being made.

3. The Merger is being effected for bona fide business reasons, including those described in the Registration Statement, and not for the purpose of tax avoidance.

Comment: As described above, a requirement for the Merger to qualify as a reorganization is that the Merger must be effected for bona fide business reasons and not for the purpose of tax avoidance. *See* Treas. Reg. §§ 1.368-1(b), -1(c), -2(g); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Laure v. Commissioner*, 653 F.2d 253 (6th Cir. 1981). This representation provides tax counsel with the facts to ensure that the business purpose requirement is met and specifically identifies the reasons described in the Registration Statement, which have been represented as being true, correct, and complete in the first representation. A similar representation would generally be obtained from Target in its certificate.

4. The fair market value of the shares of voting common stock, par value $___ per share, of Acquiring ("Acquiring Common Stock"), determined as of the last business day prior to the date of the Merger Agreement (the "Valuation Date"), and cash to be received by each stockholder of Target in the Merger was approximately equal to the fair market value of the shares of common stock, par value $___ per share, of Target ("Target Common Stock"), determined as of the Valuation Date, to be surrendered by such stockholder in the Merger. The Merger Consideration (defined hereinafter) to be received in the Merger by holders of Target Common Stock was determined by arm's-length negotiations between the managements of Acquiring and Target.

Comment: With this representation, tax counsel is provided with the fact that each Target stockholder will receive its fair market value share of the Merger Consideration, which precludes any recharacterization of the exchange. For example, if a shareholder-employee were to receive a premium for his or her shares as compared to non-employee shareholders, part of the Merger Consideration paid for those shares in the Merger could be treated as additional compensation. As discussed below, the Valuation Date is used because the continuity of interest requirement is being determined using the "signing date rule." A similar representation would generally be obtained from Target in its certificate.

5. To the best of the knowledge of the management of Acquiring, Target's only outstanding stock (as that term is used for purposes of Section 368 of the Code) is the Target Common Stock.

Comment: In order to determine whether the continuity of interest requirement is met, tax counsel must know the securities and rights that comprise the proprietary interests of Target for U.S. federal tax purposes. For example, purported debt of Target may be treated as equity of Target. This representation provides tax counsel with the fact that it only needs to consider the Target Common Stock in determining whether the continuity of interest requirement is met. A similar representation would generally be obtained from Target in its certificate, but the knowledge qualification should not be necessary since that fact should be within Target's control.

6. In the Merger, holders of shares of Target Common Stock will receive shares of Acquiring Common Stock and cash in exchange for their shares of Target Common Stock in accordance with the Merger Agreement (the "Merger Consideration"), and no holder of shares of Target Common Stock will receive in exchange for shares of Target Common Stock, directly or indirectly, any consideration from Acquiring or any corporation related (within the meaning of Treasury regulations section 1.368-1(e)(4)) to Acquiring other than the Merger Consideration.

Comment: With this representation, tax counsel can rely on the fact that only consideration described in the Merger Agreement will be delivered by Acquiring in exchange for shares of Target Common Stock. This is necessary for two reasons. First, tax counsel may be requested to also render its opinion that Acquiring will not recognize gain in the Merger. If the Merger Consideration included appreciated property other than shares of Acquiring Common Stock, Acquiring could recognize gain with respect to that property in the exchange. See Section 1001; Rev. Rul. 69-6, 1969-1 CB 104 (describing that a merger shall be treated for U.S. federal tax purposes as (a) a transfer of assets by the target corporation in exchange for the merger consideration and (b) then a distribution by target corporation of such consideration to its stockholders in liquidation of their interests in target corporation). Second, if Target stockholders were to receive consideration in the Merger that is not described in the Merger Agreement, the continuity of interest requirement could be jeopardized because a proprietary interest in Target is not preserved in the Merger to the extent that cash or property other than proprietary interests in Acquiring are provided in the Merger. Treas. Reg. § 1.368-1(e)(1)(i). A similar representation would generally be obtained from Target in its certificate.

7. Stockholders of Target will receive in the Merger shares of Acquiring Common Stock with a value, determined as of the Valuation Date, equal to at least forty percent (40%) of the total value, determined as of the Valuation Date, of all of the shares of Target Common Stock outstanding on the Valuation Date. For purposes of this representation, shares of Target Common Stock that were redeemed, sold, or otherwise transferred, directly or indirectly, in connection with the Merger to Target, Acquiring, or any corporation related (within the meaning of Treasury regulations section 1.368-1(e)(4)) to Target or Acquiring will be treated as outstanding shares of Target Common Stock on the Valuation Date.

Comment: To qualify as a reorganization, the continuity of the interest requirement must be met, which requires that a substantial part of the value of the propriety interests in Target be preserved in the Merger. Treas. Reg. § 1.368-1(e)(1)(i). A proprietary interest in Target is only preserved by exchanging such proprietary interest for a proprietary interest in Acquiring. If cash or property other than proprietary interests of Acquiring is used to redeem or purchase shares of Target Common Stock in transactions that occur prior to the Merger, that consideration may be treated as being issued in the Merger, and therefore, the shares redeemed or purchased need to be treated as if they were outstanding on the Valuation Date for purpose of determining whether the continuity of interest requirement is met. *See* Treas. Reg. §§ 1.368-1(e)(1)(i), -1(e)(1)(ii). Because tax counsel may not be aware of all transactions before the Merger that could affect whether the continuity of interest requirement is met, this representation provides tax counsel with the fact that, taking into account all pre-Merger redemptions and sales to Acquiring, Target, and related corporations, the continuity of interest requirement will be met in the Merger. A similar representation would generally be obtained from Target in its certificate.

It is important to note that a continuity of interest threshold of 40% is used in this representation. In *John A. Nelson Co. v. Helvering*, the Supreme Court held that the continuity of interest requirement was met where only 38% of the target corporation's proprietary interest was preserved in the merger. 296 U.S. 374 (1935). However, many practitioners have traditionally required a higher percentage for opinion purposes. This higher threshold was based in part on the Internal Revenue Service's requirement that taxpayers provide a representation for ruling purposes that at least 50% of the target corporation's proprietary interest would be preserved in the purported reorganization. *See* Rev. Proc. 86-42, 1986-2 CB 722; Rev. Proc. 77-37, 1977-2 CB 568. However, an example in recently promulgated Temporary Treasury regulations provides that the continuity of interest requirement is met where 40% of the proprietary interest in the target corporation is preserved in proprietary interest of the acquiring corporation. *See* Temp. Treas. Reg. § 1.368-1T(e)(2)(v), example 1.

Additionally, this representation makes reference to the "Valuation Date," which is defined as the last business day prior to the signing of the Merger Agreement. This date is used because recently promulgated Temporary Treasury regulations allow parties, if the merger agreement constitutes a binding contract and provides for fixed consideration, to value the consideration provided in exchange for target stock as of the last business day prior to the date the merger agreement was signed to determine if the continuity of interest requirement is met. *See* Temp. Treas. Reg. § 1.368-1T(e)(2).

8. Except for cash paid for Dissenting Shares and in lieu of fractional shares of Acquiring Common Stock, neither Acquiring nor any corporation related (within the meaning of Treasury regulations section 1.368-1(e)(4)) to Acquiring will, in connection with the Merger, (a) be under any obligation or will have entered into any agreement or understanding to redeem or repurchase, directly or indirectly, any shares of Acquiring Common Stock issued to stockholders of Target in the Merger or to make any distributions, other than regular, ordinary dividends, in respect of such shares of Acquiring Common Stock, or (b) have any plan or intention to acquire or reacquire, directly or indirectly, any shares of Acquiring Common Stock (i) in an amount in excess of those outstanding prior to the Effective Time or (ii) to be issued in the Merger. After the Merger, no dividends or distributions will be made to the former Target stockholders by Acquiring other than regular, normal dividends, or distributions made to all holders of shares of Acquiring Common Stock in a manner consistent with Acquiring's historic dividend practice.

Comment: Similar to transactions that occur prior to the Merger, which are covered in the representation above, transactions that occur following the Merger could also impact the continuity of interest requirement. For example, a redemption or repurchase of shares of Acquiring Common Stock issued in the Merger by Acquiring or a corporation related (within the meaning of Treasury regulations section 1.368-1(e)(4)) to Acquiring will count against continuity if such transactions occur "in connection with" the Merger. Treas. Reg. §§ 1.368-1(e)(1)(i), -1(e)(3). Where Acquiring Common Stock is widely held and actively traded, however, redemptions that do not exceed the amount of shares of Acquiring Common Stock that were outstanding prior to the Merger or the amount of shares to be issued in the Merger, the redemption should generally not be determined to occur "in connection with" the Merger. See Rev. Rul. 99-58, 1999-2 CB 701 (determining that an open market share repurchase program that was not negotiated with target stockholders did not occur "in connection with" the merger). Accordingly, since any such post-Merger transaction will be unknown at the time tax counsel's opinion is rendered, tax counsel needs Acquiring to represent to tax counsel that no such post-Merger transaction will occur. Since post-Merger transactions will be solely within the control of Acquiring, a similar representation is not required from Target.

9. Acquiring has no plan or intention to sell or otherwise dispose of any of the assets of Target acquired in the Merger, except for dispositions made in the ordinary course of business or transfers described in Treasury regulations section 1.368-2(k)(1).

Comment: This representation is required for purposes of determining whether the continuity of business enterprise requirement is met. *See* Treas. Reg. § 1.368-1(b). The continuity of business enterprise requirement generally requires that Acquiring, directly or indirectly, continue Target's historic business or utilize a significant portion of Target's historic assets in a business after the Merger. Treas. Reg. § 1.368-1(d). A disposition of Target's assets not in the ordinary course of business or a transfer of assets not described in Treasury regulations section 1.368-2(k)(1) could cause the Merger to not qualify as a reorganization if such disposition causes the continuity of business enterprise requirement to not be met. *See, e.g., Laure v. Commissioner*, 70 T.C. 1087 (1978) (holding that continuity of business enterprise requirement was not met where assets acquired in a merger were sold shortly after the merger); *Standard Realization Co. v. Commissioner*, 10 T.C. 708 (1948) (finding that a transaction failed to qualify as a reorganization when the acquiring corporation disposed of assets acquired in a purported reorganization to unrelated parties). Accordingly, in order to render its opinion, tax counsel needs to know that Acquiring will not sell, dispose, or transfer Target's assets, other than transfers described in Treasury regulations section 1.368-2(k)(1). Since these post-Merger facts will be solely within the control of Acquiring, a similar representation is not required from Target.

10. Following the Merger, Acquiring, Merger Sub, or a member of Acquiring's "qualified group" (as defined in Treasury regulations section 1.368-1(d)(4)(ii)) will continue, directly or through a partnership meeting the requirements of Treasury regulations section 1.368-1(d)(4)(iii), Target's historic business within the meaning of Treasury regulations

section 1.368-1(d)(2) or use a significant portion of Target's historic business assets in a business within the meaning of Treasury regulations section 1.368-1(d)(3).

Comment: The purpose of this representation is to address the continuity of business enterprise requirement. As described above, the continuity of business enterprise requirement requires that Acquiring or a member of its "qualified group" continue Target's historic business or use a significant portion of Target's historic business assets in a business directly or through a partnership (if certain requirements are met). Treas. Reg. § 1.368-1(d). At the time tax counsel renders its opinion that the Merger qualifies as a reorganization, tax counsel cannot know whether Acquiring will continue Target's historic business or will use a significant portion of Target's historic business assets in a business after the Merger. Accordingly, such facts must be provided to tax counsel in order for it to determine that the continuity of business enterprise requirement will be met. Since these post-Merger facts will not be within the control of Target, a similar representation, if requested from Target, should include a knowledge qualification. Additionally, Target would generally provide a representation that it will be conducting its historic business within the meaning of Treasury regulations section 1.368-1(d)(2) or using a significant portion of the Company's historic business assets in a business within the meaning of Treasury regulations section 1.368-1(d)(3).

11. To the best of the knowledge of the management of Acquiring, the liabilities of Target to be assumed by Merger Sub in the Merger and the liabilities to which the assets of Target to be transferred to Merger Sub in the Merger are subject were incurred by Target in the ordinary course of its business.

Comment: If Target incurred indebtedness prior to the Merger and distributed the proceeds to the Target shareholders as a dividend, the dividend could be treated as additional consideration paid in the Merger. This would be economically similar to Acquiring paying additional cash in the Merger, which could impact whether the continuity of interest requirement is met. A similar representation would generally be obtained from Target in its certificate, but the knowledge qualification would not be necessary since those facts should be within Target's control.

12. At all times prior to and after the Effective Time, Merger Sub has been and will be disregarded as an entity separate from Acquiring for U.S. federal tax purposes pursuant to Treasury regulations section 301.7701-2(c) (a "<u>Disregarded Entity</u>"); no election to be classified as an association taxable as a corporation for U.S. federal tax purposes has been or will be made under Treasury regulations section 301.7701-3(c) with respect to Merger Sub; and neither Acquiring nor Merger Sub has any plan or intention to take any action or fail to take any action that would result in Merger Sub being classified as an entity that is not a Disregarded Entity for U.S. federal tax purposes.

Comment: Under Treasury regulations section 1.368-2(b)(1), the Merger will qualify as a reorganization even if a limited liability company that is disregarded as an entity separate from Acquiring for U.S. federal tax purposes is used by Acquiring to acquire Target in the Merger. For U.S. federal tax purposes, Acquiring will be treated as acquiring the assets of Target directly. *See* Treas. Reg. § 1.368-2(b)(1)(iii), example 2. However, to rely on Treasury regulations section 1.368-2(b)(1), Merger Sub must be disregarded as entity separate from Acquiring for U.S. federal tax purposes. If Merger Sub had an additional member (or members) that were recognized for U.S. federal tax purposes or made an election to be classified as an association taxable as a corporation for U.S. federal tax purposes, then Merger Sub would not be disregarded as an entity separate from Acquiring, and the Merger might not qualify as a reorganization. *See* Treas. Reg. § 301.7701-2(c). This representation allows tax counsel to rely on Treasury regulations section 1.368-2(b)(1) in rendering its opinion that the Merger qualifies as a reorganization. Since these facts are not within the control of Target, a similar representation from Target is not necessary.

13. Acquiring does not have any plan or intention to sell or otherwise dispose of its limited liability company interests in Merger Sub to any person that is not a member of Acquiring's "qualified group" (as defined in Treasury regulations section 1.368-1(d)(4)(ii)).

Comment: As discussed above, to qualify as a reorganization, the continuity of business enterprise requirement must be met. Treas. Reg. §§ 1.368-1(b), -1(d). If Target's historic business or a significant portion of Target's historic business assets remain in Merger Sub after the Merger and Acquiring sells or disposes of its limited liability company interests in Merger Sub to a person not within its "qualified group" following the Merger, the Merger could fail to meet the continuity of business enterprise requirement and, as a result, fail to qualify as a reorganization. See Treas. Reg. § 1.368-1(d); *Laure v. Commissioner*, 70 T.C. 1087 (1978) (holding that continuity of business enterprise requirement was not met where assets acquired in a merger were sold shortly after the merger); *Standard Realization Co. v. Commissioner*, 10 T.C. 708 (1948) (finding that a transaction failed to constitute a reorganization when the acquiring corporation disposed of assets acquired in a purported reorganization to unrelated parties). This representation provides tax counsel with the fact that there will not be a post-Merger sale or disposition of Merger Sub that could impact whether the continuity of business enterprise requirement is met. Since these post-Merger facts are not within the control of Target, a similar representation from Target is not necessary.

14. The payment of cash in the Merger to stockholders of Target in lieu of fractional shares of Acquiring Common Stock does not represent separately bargained for consideration, but is undertaken solely for the purpose of avoiding the expense and inconvenience to Acquiring of issuing and transferring fractional shares, and the total cash consideration that will be paid to the stockholders of Target in lieu of fractional shares of Acquiring Common Stock will represent less than one percent (1%) of the total value of the Merger Consideration. No Target stockholder will receive cash in an amount greater than the value of one full share of Acquiring Common Stock in exchange for fractional shares.

Comment: As long as the payment of cash in lieu of fractional shares of Acquiring Common Stock does not represent separately bargained for consideration, then, for U.S. federal tax purposes, the fractional shares will be treated as if they were issued and then redeemed by Acquiring for the cash paid. Rev. Rul. 66-365, 1966-2 CB 116. Tax counsel will not be able to obtain all of the facts necessary to determine whether cash in lieu of fractional shares represents separately bargained consideration from the transaction documents; therefore, the first part of this representation provides tax counsel with those facts. A similar representation would generally be obtained from Target in its certificate.

Since the payment of cash in lieu of fractional shares will be treated, for U.S. federal tax purposes, as a redemption of Acquiring stock issued in the Merger, the cash paid in lieu of such fractional shares will count against the continuity of interest requirement. *See* Treas. Reg. § 1.368-1(e)(1)(i) (providing that a proprietary interest in the target corporation is not preserved if, in connection with the merger, acquiring stock issued in the merger is redeemed). Accordingly, the remainder of this representation provides tax counsel with the fact that any cash paid in lieu of fractional shares of Acquiring Common Stock will only have a minimal effect on whether the continuity of interest requirement is met.

15. Acquiring, Target, and the holders of Target Common Stock will each pay their respective expenses, if any, incurred in connection with the Merger.

Comment: In the event that Acquiring paid the expenses of Target or Target stockholders in the Merger, the payment of expenses could be treated as additional consideration provided to Target or Target stockholders in the Merger. Additional consideration provided in the Merger that is not in the form of a proprietary interest in Acquiring could impact whether the continuity of interest requirement is met. *See* Treas. Reg. § 1.368-1(e)(1)(i). This representation provides tax counsel with the fact that additional consideration in the Merger will not be made in the form of payments for expenses. A similar representation would generally be obtained from Target in its certificate.

16. There is no and will be no intercorporate indebtedness existing between Acquiring or its subsidiaries, on the one hand, and Target or its subsidiaries, on the other, that was issued, acquired, or will be settled at a discount.

Comment: In addition to rendering the opinion that the Merger qualifies as a reorganization, tax counsel may also be requested to render its opinion that Acquiring will not recognize gain in the Merger. When Target is deemed to merge with and into Acquiring for U.S. federal tax purposes, any debt of Target owed to Acquiring will be extinguished. For U.S. federal tax purposes, the extinguishment will be deemed to have been paid with part of Target's assets deemed transferred in the Merger. Rev. Rul. 72-464, 1972-2 CB 214. Therefore, if Acquiring had purchased such debt at a discount, Acquiring would recognize such discount as gain in the Merger. *Id.* This representation allows tax counsel to rely on the fact that Acquiring will not have to recognize gain in the Merger as a result of any indebtedness purchased at a discount. A similar representation would generally be obtained from Target in its certificate.

17. Acquiring is not now and will not be at the Effective Time an "investment company" as defined in Section 368(a)(2)(F)(iii) and (iv) of the Code.

Comment: If two or more parties to a merger constitute an "investment company" as defined in Section 368(a)(2)(F)(iii) and (iv), the merger might not qualify as a reorganization with respect to such investment companies. Whether a party to a merger is an investment company cannot be ascertained from the transaction documents, and therefore, it is appropriate for tax counsel to request that this representation be made. Accordingly, with this representation, tax counsel can render its opinion that the Merger qualifies as a reorganization if the other requirements are met since it does not have to determine whether a party is an "investment company." A similar representation would generally be obtained from Target in its certificate.

18. None of the compensation to be received by any stockholder-employee of Target will be separate consideration for, or allocable to, any of such stockholder-employee's shares of Target Common Stock; none of the shares of Acquiring Common Stock to be received by any stockholder-employee of Target in connection with the Merger will be separate consideration for, or allocable to, the performance of services, or any employment, consulting, or similar agreement; and the compensation paid to any stockholder-employee of Target will be for services actually rendered and will be commensurate with amounts paid to third parties bargaining at arm's-length for similar services.

Comment: To determine whether the continuity of interest requirement is met, tax counsel needs to consider whether payments made in connection with the Merger are for shares of Target Common Stock or for other purposes, such as compensation. For example, if the continuity of interest requirement will not be met because too much cash is being paid in the transaction, the parties may try to treat part of the cash paid to shareholder-employees as additional compensation, rather than in exchange for their shares of Target Common Stock. *See* Treas. Reg. § 1.368-1(e)(1)(i) (a proprietary interest in target is not maintained if cash is received in the merger). Alternatively, if shares of Acquiring Common Stock are paid as additional compensation, the parties may attempt to treat those shares as being exchanged for Target Common Stock to increase the percentage of shares of Acquiring Common Stock delivered in the Merger. Generally, as long as the compensation paid to a stockholder-employee is for fair market value and is in connection with services provided, such compensation should not effect the qualification of the merger as a reorganization. *See* Rev. Rul. 77-271, 1977-2 CB 116 (providing that stock paid in satisfaction of an employment agreement will not cause a transaction to not constitute a Section 368(a)(1)(B) reorganization). Accordingly, this representation allows tax counsel to determine whether the continuity of interest requirement is met without having to determine whether there are any disguised payments to stockholder-employees of Target. A similar representation would generally be obtained from Target in its certificate.

19. To the best of the knowledge of the management of Acquiring, the fair market value of the assets of Target to be transferred to Merger Sub in the Merger will equal or exceed the sum of the liabilities assumed by Merger Sub in the Merger plus the amount of liabilities, if any, to which the transferred assets are subject.

Comment: If the sum of the liabilities of Target to be assumed plus the amount to which the transferred assets are subject exceeds the fair market value of Target's assets to be transferred, it raises an issue as to whether Target is insolvent at the time of the Merger. A merger involving an insolvent corporation can constitute a "reorganization" within the meaning of Section 368(a); however, in such a merger, the courts tend to treat the creditors as having effectively "stepped into the shoes" of the insolvent corporation's stockholders. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); *Atlas Oil & Refining Corp. v. Commissioner*, 36 T.C. 675 (1961), *acq*. 1962-2 CB 3. If the creditors received an insufficient amount of proprietary interest in the merger, this could cause the merger to fail the continuity of interest requirement. *See* Treas. Reg. § 1.368-1(e)(1)(i). Accordingly, this representation provides tax counsel with facts so that tax counsel does not need to determine whether any consideration paid to the creditors is part of the Merger Consideration that needs to be considered for the continuity of interest requirement. A similar representation would generally be obtained from Target in its certificate, but the knowledge qualification would not be necessary since those facts should be within Target's control.

20. Neither Acquiring nor Merger Sub will take any position on any federal, state, or local income or franchise Tax Return, or take any other tax reporting position that is inconsistent with the treatment of the Merger as a "reorganization" within the meaning of Section 368(a) of the Code or with any of the representations set forth herein, unless otherwise required by a final judgment, decree, or other order which addresses the Merger by a court of competent jurisdiction (and then only to the extent required by such applicable law). Neither Acquiring nor Merger Sub is aware of any facts that would cause the Merger to fail to constitute a "reorganization" within the meaning of Section 368(a) of the Code.

Comment: This representation may be stating the obvious and is probably covered by covenants, representations, or facts set forth in the Merger Agreement and the Registration Statement. However, tax counsel should get an affirmative statement from Acquiring that the Merger will be reported as a reorganization and that Acquiring is not aware of any facts that could impact the qualification. A similar representation would generally be obtained from Target in its certificate.

21. Neither Acquiring nor Merger Sub is now or will be at the Effective Time under the jurisdiction of a court in a "Title 11 or similar case." For purposes of the foregoing, a "Title 11 or similar case" means a case under Title 11 of the United States Code or a receivership, foreclosure, or similar proceeding in a federal or state court.

Comment: If a transaction intended to qualify as a reorganization involves a party that is under the jurisdiction of a court in a "Title 11 or similar case," the transaction is governed solely by Section 368(a)(1)(G) and could not qualify as a "reorganization" under Section 368(a)(1)(A). Section 368(a)(3)(C). This representation provides tax counsel with the fact that Acquiring will not cause the Merger to be controlled by the provisions of Section 368(a)(1)(G). A similar representation would generally be obtained from Target in its certificate.

22. Acquiring does not own, directly or indirectly, any stock of Target.

Comment: Whether Acquiring owns any shares of Target Common Stock could have an effect on the continuity of interest requirement and how the Merger is treated for U.S. federal tax purposes. *See* Treas. Reg. § 1.368-1(e)(3) (stating the a proprietary interest in the target corporation is not preserved in the merger if, in connection with merger, stock in the target corporation is acquired by a person related to the acquiring corporation); Treas. Reg. § 1.332-2(e), example (where a merger overlaps with the subsidiary liquidation rules of Section 332, generally Section 332 controls). This representation allows tax counsel to render its opinion without having to determine whether Acquiring's ownership of Target Common Stock could impact the qualification of the Merger as a reorganization or whether such ownership could have unintended tax consequences. A similar representation would generally be obtained from Target in its certificate, but a knowledge qualification may be appropriate, especially if Target is publicly traded.

23. Acquiring is a corporation duly organized, validly existing, and in good standing under the laws of the State of _____________. Merger Sub is a limited liability company duly organized, validly existing, and in good standing under the laws of the State of ____________. Acquiring directly holds one hundred percent (100%) of the limited liability company interests of Merger Sub.

Comment: As explained above, the Merger is intended to qualify as an "A" reorganization by application of Treasury regulations section 1.368-2(b). As such, in order to render its opinion that the Merger qualifies as a reorganization, tax counsel needs to be provided with the facts that Acquiring is a validly existing corporation and that Merger Sub is a validly existing limited liability company. A similar representation would generally be obtained from Target in its certificate.

24. The undersigned is authorized to make all the representations and certifications set forth herein on behalf of Acquiring and Merger Sub.

The undersigned acknowledges (a) that the opinions of **[name of Acquiring's counsel]** and **[name of Target's counsel]** will be based on (i) the accuracy of the statements, certifications, and representations and the compliance with the covenants set forth herein and in the representation letter from Target ("<u>Target's Certificate</u>"); (ii) the accuracy of the statements and other information contained in the Registration Statement and the other documents referred to therein; and (iii) the accuracy of the representations and warranties and the satisfaction of the covenants and obligations contained in the Merger Agreement and the various other documents related thereto; (b) that your opinions will be subject to certain limitations and qualifications including that it may not be relied upon if any such statements, certifications, representations, or warranties are not accurate or if any such covenants or obligations are not satisfied in all material respects; and (c) that your opinions will not address any tax consequences of the Merger except as expressly set forth in your opinions. For purposes of rendering your opinions, you may assume that the above representations and certifications and those in the Target's Certificate are true, correct, and complete as of the date hereof and as of the effective time without regard to any knowledge qualification.

We will promptly and timely inform you if, after signing this representation letter, we have reason to believe that any of the facts described herein or in the Registration Statement or any of the statements, certifications, representations, or warranties made herein, in the Merger Agreement, or in the Registration Statement are or have become untrue, incorrect, or incomplete in any respect, or any covenants or obligations set forth herein, in the Merger Agreement, or in the Registration Statement are not satisfied in all material respects.

Very truly yours,

ENDNOTES

1 Robert W. Phillpott is a partner and Ronald J. Scharnberg is an associate in the Houston office of Fulbright & Jaworski L.L.P.

2 All "Section" references herein are to the Internal Revenue Code of 1986, as amended.

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2007-2008 CALENDAR

July	
August	
17	Deadline for submitting articles for the October 2007 issue of the *Texas Tax Lawyer*
29	Nuts & Bolts of Tax Workshop - Houston
30-31	25th Annual Advanced Tax Law Course - Houston
September	
14	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Thompson & Knight LLP 1700 Pacific, Suite 3300 Dallas, Texas 75201 (214) 969-1700
27-29	ABA Section of Taxation 2007 Joint Fall CLE Meeting - Vancouver, British Columbia
October	
November	
2	10:30 a.m. – 12:30 p.m. Council Meeting Thompson & Knight LLP 1700 Pacific, Suite 3300 Dallas, Texas 75201 (214) 969-1700
7	Nuts & Bolts of Tax Workshop – Dallas (Video)
8-9	25th Annual Advanced Tax Law Course – Dallas (Video)
December	
14	Deadline for submitting articles for the February 2008 issue of the *Texas Tax Lawyer*

January	
17 – 19	ABA Section of Taxation 2008 Midyear Meeting – Lake Las Vegas, Nevada
25	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting Thompson & Knight LLP 1700 Pacific, Suite 3300 Dallas, Texas 75201 (214) 969-1700
February	
March	
14	Deadline for submitting articles for the May 2008 issue of the *Texas Tax Lawyer*
April	
18	10:30 a.m. – 12:30 p.m. Council Meeting Thompson & Knight LLP 1700 Pacific, Suite 3300 Dallas, Texas 75201 (214) 969-1700
May	
8 – 10	ABA Section of Taxation 2008 May Meeting – Washington, DC
June	
5-6	24th Annual Texas Federal Tax Institute – San Antonio
26-28	State Bar of Texas Annual Meeting – Houston
27	Members' Meeting of the Section of Taxation of the State Bar of Texas – Houston **July Future Dates - Tentative**
July	
17	Orientation for SBOT Section chairs/vice-chairs, treasurers and Committee chairs/vice-chairs – The Woodlands

2007-2008
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