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CHAIR'S MESSAGE

Thank you for the privilege of serving as the 2011-2012 Chair of the Section of Taxation of the State Bar of Texas. Surprisingly, I am only the third woman Chair in the long history of our Tax Section, following in the footsteps of Cindy Ohlenforst, who was the 2000-2001 Chair, and Kathryn Henkel, who was the 1992-1993 Chair. I am excited that these numbers will soon be doubling, with Tina Green as our Chair-Elect. The other officers of the Tax Section this year are Elizabeth Copeland as Secretary and Andrius Kontrimas as Treasurer. With their efforts, as well as the efforts of all of our Council members, Committee Chairs and Vice Chairs, and the many other members who volunteer, we are well underway to another productive year!

Continuation of New Programs. We find ourselves this year in the fortunate position of carrying out new programs begun under the leadership of our immediate past Chair, Patrick O'Daniel.

- ***Leadership Academy***. We will be selecting about 15 to 20 young tax lawyers as the inaugural class of the Tax Section's Leadership Academy. The Leadership Academy will allow young tax lawyers to develop their leadership skills as well as network with other tax lawyers throughout the state. The Criteria for Selection are as follows:

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

  The tentative meeting dates and cities are as follows:

    - March 22-23, 2012 – San Antonio, TX
    - June 14-15, 2012 – Houston (in conjunction with the State Bar of Texas Annual Meeting)
    - September 20-21, 2012 – Austin, TX
    - January 17, 2013 – Dallas, TX

  Look for a link to the application on the Tax Section's website starting November 15, 2011. Applications will be due January 20, 2012. Many thanks to David Colmenero for his efforts in spearheading the Leadership Academy. If you have any questions, please contact David at 214-744-3700 or dcolmenero@meadowscollier.com.

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

- ***Tax App***. The Tax Section is working with the Computer & Technology Section to develop a "Tax App" to access Federal and Texas state tax materials on your IPhone, IPad, and IPod Touch. There will also be a web-based app. The Tax App will be the first of its kind and will give you fingertip access to the Internal Revenue Code, Treasury Regulations, tax treaties, AFRs, IRS guidance, cases, Texas Tax Code, Texas Administrative Code, and much more!

Refocus on Core Programs. This year, we will also be refocusing on core programs of the Tax Section that were started under the leadership of other past Chairs, including David Wheat, Bill Bowers, Gene Wolf, Kevin Thomason, Dan Micciche, and Tyree Collier.

- ***COGS Projects***. The Section continuously seeks to improve the substance and administration of state and federal tax laws through its Committee on Government Submissions ("COGS") process. The COGS process also enhances the profile of our members within the tax community and furthers the national reputation of the Texas tax bar. Under the leadership of our COGS Chair, Stephanie Schroepfer, we have already submitted two COGS projects this year regarding (i) IRS Notice 2011-62 proposed revisions to procedures relating to *ex parte* communications between Appeals and other IRS functions, and (ii) the application of section 10101(d) of the Patient Protection and Affordable Care Act, P.L. 111-148, nondiscrimination standards to insured employer group health plans. Many thanks to the Tax Controversy Committee and Joel Crouch, Robert Probasco, Stephanie Mongiello, and Emily Parker and to the Employee Benefits Committee and Susan Wetzel, Henry Talavera, and Felecia Finston. If you wish to get involved with on ongoing project or have ideas for leading one yourself, please contact Stephanie Schroepfer at (713) 651-5591 or sschroepfer@fulbright.com.

- ***24/7 Free CLE Library***. The Tax Section has implemented a 24/7 library of free CLE Webcast programs accessible at any time to Section members through the Tax Section website. We now have over 35 CLE audio and video programs available free of charge to our members through the Tax Section's website, including:

  - Choice of Entity
  - Getting Along with the IRS
  - Fundamentals of Oil and Gas Taxation
  - The Texas Sales and Use Tax: The Basics
  - Aggressive Tax Planning, Unethical Conduct or Tax Fraud (ethics credit!)
  - Issues to Consider When Drafting Partnership Agreements
  - An Introduction to Nonprofit Organizations Formation and Tax Exemption Issues

  Coming soon are videotaped interviews with Texas Tax Legends such as Buford Berry, Richard Freling, Ron Mankoff, Bob Davis, and former IRS Commissioner Larry Gibbs. If you have any questions, please contact J. Michael Threet, the head of our CLE Committee, at (214) 969-2795 or mthreet@akingump.com.

- ***Live CLE***. The Tax Section sponsors and conducts live CLE programs, including the Texas Federal Tax Institute which will be held at the Hyatt Hill Country in San Antonio on June 7 and 8, 2012, the annual Property Tax program, the annual International Tax program, and State and Local Tax committee events, including the recent Annual Briefing with Texas State Comptroller of Public Accounts. In addition, the Section co-sponsors various live CLE programs, including the Advanced Tax Law Program conducted by TexasBarCLE, which was held in Houston this year on August 17-19, the UTCLE Texas Margin Tax Conference which was held in September in Austin, Houston, and Dallas, and the Texas Society of CPAs Free CPE Day.

Mark your calendars for our 14th Annual International Tax Symposium to be held at The Center for American & International Law, 5201 Democracy Drive, Plano, Texas on November 4th, 2011. For further information, view the brochure on our website or contact the Vice-Chair of the International Tax Committee, Deidra Hubenak, at (713) 986-7000 or dhubenak@lrmlaw.com.

- ***Pro Bono, including the Tax Court Program***. The Tax Section assists pro se taxpayers during Tax Court calendar calls in Dallas, Houston, Lubbock, El Paso, and San Antonio. Check the calendar on the Tax Section's website for the next calendar call in your city and contact our Pro Bono Chair Gerald Brantley at 512 - 637-1045 or gerald@geraldbrantley.com to assist. The Tax Section also provides support to appropriate charitable and governmental programs such as Texas C Bar and VITA.

- ***Texas Tax Lawyer***. Thanks to the hard work of Lisa Rossmiller and Rob Morris, the Tax Section publishes three issues of *The Texas Tax Lawyer* each year. The *Texas Tax Lawyer* is distributed to members electronically and, upon request, in hardcopy. The issues include articles on hot topics, substantive outlines from Committee Webcasts, COGS submissions, and annotated forms. Please contact Lisa at lrossmiller@fulbright.com if you would like to submit an article.

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

  Congratulations to Stas Getmanenko of the SMU Dedman School of Law for winning first prize in our Annual Paper Competition for his paper on "Consequences of Carried Interest Reform for the Private Investment Industry." We will be presenting the award to Stas at the Dallas Bar Tax Section meeting on November 7, 2011, at noon at the Belo Mansion. Second place is awarded to John Sokatch, also of the SMU Dedman School of Law, for his paper on "Transfer-Pricing with Software Allows for Effective Circumvention of Subpart F Income: Google's „Sandwich' Costs Taxpayer Millions." Third place goes to Bryan Dotson of the Texas Tech University School of Law for "Be Careful What You Wish For: Judicial Deference to Treasury Regulations After *Mayo Foundation for Fedical Education & Research v. United States*." And we give an honorable mention to Ronald Rucker of the SMU Dedman School of Law for his paper on "The Revised Texas Franchise Tax: Planning Opportunities and Pitfalls."

Many thanks to Ron Adzgery for running this year's paper competition and to Professor Christopher Hannah of the SMU Dedman School of Law for his support. The deadline for submitting papers for the 2011-2012 competition is June 1, 2012. Please see the Tax Section's website for more details.

- ***Outstanding Texas Tax Lawyer***. Congratulations to Professor Stanley M. Johanson of the University of Texas School of Law for being selected as our Outstanding Texas Tax Lawyer award for 2011. Professor Johanson entertained us all with a song and dance after being presented with the award at this year's Texas Federal Tax Institute. This year's nomination form is on our website and is included in this issue of the *Texas Tax Lawyer*. Nominations must be made by January 15, 2012. Please take a few minutes and consider nominating a worthy individual for this award.

- ***Annual Meeting and Tax Legends Lunch***. At our annual meeting held on June 24, 2011, we presented Special Recognition Awards to Robert D. Probasco for Exemplary Service and to William D. Elliott, Creator and Historian of the Texas Tax Legends Research Program. Mark your calendar now to attend the Tax Section's Annual Meeting on June 15, 2012, in Houston, Texas. The Annual Meeting will include CLE programs and our Tax Legends Lunch. Many thanks to Matt Larsen for coordinating the Annual Meeting and to Bill Elliott for the time and energy he puts into spotlighting a Texas Tax Legend for us.

More information about these activities is available on our website: www.texastaxsection.org).

Tax Patents

The Tax Section recognizes the efforts of one of its past Chairs, Kevin Thomason, in contributing to the passage of Section 14 of the Leahy-Smith America Invents Act, which prohibits the patenting of tax strategies. This law aims to keep the ability to interpret the tax law and to implement such interpretation in the public domain, available to all taxpayers and their advisors.

Nominating Committee

The Tax Section's nominating committee for 2011-2012 consists of Dan Micciche as Chair and Tyree Collier, Patrick O'Daniel, and me as an ex officio member. Nominations for Chair-Elect, Secretary, Treasurer, or an Elected Council Member position can be submitted to any member of the nominating committee or to any Officer of the Section at any time on or before March 1, 2012.

Get Involved

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

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

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

Mary A. McNulty
2011-2012 Chair

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18. **Leadership Academy**	**David E. Colmenero** Meadows, Collier, Reed, Cousins & Blau, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) dcolmenero@meadowscollier.com	**Ryan Gardner** Kent, Good, Anderson & Bush, P.C. Woodgate I, Suite 200 1121 E.S.E. Loop 323 Tyler, Texas 75701 903-579-7510 903-581-3701 (fax) rgardner@tyler.net **Alyson Outenreath** Texas Tech University School of Law 1802 Hartford Ave. Lubbock, Texas 79409-0004 806-742-3990 806-742-1629 (fax) alyson.outenreath@ttu.edu

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2011-2012 CALENDAR

June 2011	
9-10	27th Annual Texas Federal Tax Institute – San Antonio
23-24	SBOT Annual Meeting – San Antonio
24	8:00 am – 1:30 pm 2011 Annual Members' Meeting – SBOT Section of Taxation – San Antonio 2:00 pm – 5:00 pm Council Retreat
July 2011	
22-23	Bar Leaders Conference – New Chair Orientation Westin Galleria – Houston **Officer's Retreat?**
August 2011	
17	Nuts & Bolts of Tax Workshop - Houston
18-19	29th Annual Advanced Tax Law Course – Houston
26 (or Sept. 23)	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Thompson & Knight LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214-969-1700
September 2011	
12	Pro Bono Committee Calendar Call Assistance United States Tax Court Dallas, Texas
29	Deadline for submitting articles for the Fall 2011 issue of the *Texas Tax Lawyer*
October 2011	
3	Pro Bono Committee Calendar Call Assistance United States Tax Court Lubbock, Texas
6	Pro Bono Committee Calendar Call Assistance United States Tax Court El Paso, Texas
17	Pro Bono Committee Calendar Call Assistance United States Tax Court Houston, Texas
20-22	ABA Section of Taxation 2011 Joint Fall CLE Meeting – Denver, CO

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24	Pro Bono Committee Calendar Call Assistance United States Tax court Houston, Texas
31	Fall 2011 Issue of the *Texas Tax Lawyer*
November 2011	
4	14th Annual International Tax Symposium The Center for American and International Law 5201 Democracy Drive Plano, Texas 75024
11	10:30 a.m. – 12:30 p.m. Council Meeting Thompson & Knight LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214-969-1700
14	Pro Bono Committee Calendar Call Assistance United States Tax Court Houston, Texas
December 2011	
12	Pro Bono Committee Calendar Call Assistance United States Tax Court Houston, Texas Pro Bono Committee Calendar Call Assistance United States Tax Court San Antonio, Texas
January 2012	
27	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting Thompson & Knight LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214-969-1700
February 2012	
3	Final Deadline for submitting articles for the Winter 2012 issue of the *Texas Tax Lawyer*
16-18	ABA Section of Taxation 2012 Midyear Meeting – San Diego, CA
27	Winter 2012 Issue of the *Texas Tax Lawyer*
March 2012	
-	- - -
April 2012	
6	10:30 a.m. – 12:30 p.m. Council Meeting Thompson & Knight LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214-969-1700

13	Deadline for submitting articles for the Spring 2012 issue of the *Texas Tax Lawyer*
May 2012	
10-12	ABA Section of Taxation 2012 May Meeting – Washington, DC
11	Spring 2012 Issue of the *Texas Tax Lawyer*
June 2012	
TBD	28th Annual Texas Federal Tax Institute – San Antonio
14-15	SBOT 2012 Annual Meeting - Houston
15	8:00 am – 1:30 pm 2011 Annual Members' Meeting – SBOT Section of Taxation – Houston 2:00 pm – 5:00 pm Council Retreat

NOMINATING COMMITTEE
FOR 2011 – 2012

The following Tax Section members will serve on the 2011-2012 Nominating Committee:

- Daniel J. Micciche, Dallas, Texas, Nominating Committee Chair
- Patrick O. O'Daniel, Austin, Texas
- Tyree Collier, Dallas, Texas
- Mary A. McNulty, Dallas, Texas, Ex-Officio Member

Any Tax Section member may submit nominations by March 1, 2012, to any member of the Nominating Committee for the offices of Chair-Elect, Secretary, Treasurer, and the three Elected Council members for the 2012-2013 fiscal year.

CALL FOR NOMINATIONS FOR
OUTSTANDING TEXAS TAX LAWYER AWARD

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

Nominations should be submitted to Mary McNulty, either by email (Mary.McNulty@tklaw.com) or fax (214-880-3182) no later than January 31, 2012. The award will be presented at the 2012 Texas Federal Tax Institute in San Antonio on June 8, 2012.

NOMINATION FOR OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Mailing Address: ____

____

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

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

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COMMITTEE SELECTION FORM
Section of Taxation
State Bar of Texas

NAME: ____ DATE: __________________________

FIRM: ____

ADDRESS: ____

CITY STATE ZIP CODE

TELEPHONE NO: (_____)________________________ E-MAIL: _______________________________

BAR CARD.: __________________________________

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

	COMMITTEE	CHAIR
☐	**Corporate Tax**	Jeffry M. Blair Hunton & Williams LLP 1445 Ross Avenue, Suite 3700 Dallas, Texas 75202-2799 214-468-3306 214-468-3599 (fax) jblair@hunton.com
☐	**Employee Benefits**	Susan A. Wetzel Haynes & Boone 2323 Victory Ave., Ste. 700 Dallas, Texas 75219 214-651-5389 214-200-0675 (fax) susan.wetzel@haynesboone.com
☐	**Energy and Natural Resources Tax**	Sean R. O'Brien Jackson Walker L.L.P. 1401 McKinney Street, Suite 1900 Houston, Texas 77010 713-752-4544 713-752-4221 (fax) sobrien@jw.com
☐	**Estate & Gift Tax**	Amanda M. Gyeszly Fizer, Beck, Webster, Bentley, Scroggins, P.C. 1330 Post Oak Blvd., Suite 2900 Houston, Texas 77056 713-840-7710 AGyeszly@FizerBeck.com
☐	**General Tax Issues**	Julie C. Sassenrath Winstead PC 5400 Renaissance Tower 1201 Elm Street Dallas, Texas 75270 214-745-5887 214-745-5390 (fax) jsassenrath@winstead.com
☐	**International Tax**	Melinda R. Phelan Baker & McKenzie LLP 711 Louisiana, Suite 3400 Houston, Texas 77002 713-427-5012 713-427-5099 (fax) melinda.phelan@bakermckenzie.com

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☐	**Partnership/Real Estate**	Dan G. Baucum Shackelford, Melton & McKinley, LLP 3333 Lee Parkway, Tenth Floor Dallas, Texas 75219 214-780-1470 214-889-9770 (fax) dbaucum@shacklaw.net
☐	**Property Tax**	Mary A. Van Kerrebrook Van Kerrebrook & Assoc., P.C. 1125 Lyric Centre 440 Louisiana Houston, Texas 77002 713-425-7150 713-425-7159 (fax) Mary@vkalawyers.com
☐	**Solo and Small Firm**	Catherine C. Scheid 4301 Yoakum Blvd. Houston, Texas 77006 713-840-1840 713-840-1820 (fax) ccs@scheidlaw.com
☐	**State & Local Tax**	Alyson Outenreath Texas Tech University School of Law 1802 Hartford Ave. Lubbock, Texas 79409-0004 806-742-3990 Ext. 238 806-742-1629 (fax) alyson.outenreath@ttu.edu
☐	**Tax Controversy**	David E. Colmenero Meadows, Collier, Reed, Cousins & Blau, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) dcolmenero@meadowscollier.com
☐	**Tax-Exempt Finance**	Victoria Ozimek Vinson & Elkins LLP 2801 Via Fortuna, Ste. 100 Austin, Texas 78746 512-542-8856 vozimek@velaw.com
☐	**Tax-Exempt Organizations**	Terri Lynn Helge Texas Wesleyan School of Law Associate Professor of Law 1515 Commerce Street Fort Worth, Texas 76102-6509 817- 429-8050 thelge@law.txwes.edu

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

State Bar of Texas
Tax Section

Annual Law Student Tax Paper Competition

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

Awards: First Place - $2,500 and plaque

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

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

Subject: Any federal or state tax topic

Entry Deadline: Friday, June 1, 2012

Competition Rules:

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

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

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

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

Eligible Papers:

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

b. Only one paper per student.

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

d. Paper must be written after May 15, 2011.

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

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

Submission:

a. All entries must be received after January 15, 2012, and before Saturday, June 2, 2012.

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

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

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

A. Title of the paper;

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

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

ii Paper in Microsoft Word or other word processing format.

iii. Paper in Adobe Acrobat pdf format.

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

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

Judging: Papers will be evaluated, and prizes awarded, at the sole discretion of a panel of Tax Section members who will have no knowledge of the authors, law schools, or sponsors of the papers.

Evaluation Criteria without specific weighting:

a. legal analysis;

b. legal research;

c. organization and writing style; and

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

Notification: Winners will be notified in July or August of 2012 and an e-mail will be sent to all entrants shortly after the winners are notified.

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

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

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

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Let the State Bar of Texas Tax Section Help You

Take Your Tax Career to the Next Level

Leadership Academy Application Deadline January 20, 2012 (application attached)

Tentative Program Dates:

1. March 22-23, 2012
   San Antonio
2. June 14-15, 2012
   Houston
   (in conjunction with SBOT annual meeting)
3. Sept. 20-21, 2012
   Austin
4. January 17, 2013
   Dallas

The Tax Section of the State Bar of Texas is pleased to announce the 2012-2013 Leadership Academy developed to assist the next generation of Texas tax lawyers with taking ownership of their careers by providing:

- *Networking opportunities*
- *Educational programs on topics every successful tax lawyer should know (CLE credit provided for some topics)*
- *Mentoring from seasoned Texas tax lawyers*
- *Opportunities to get involved in the State Bar of Texas Tax Section leadership committees*

Tax Section of the State Bar of Texas
2012-2013 Leadership Academy

Application Form

Eligibility Requirements:

- Must have three to six years experience regardless of age.
- Must be a member of the State Bar of Texas in good standing.
- Must be a member of the Tax Section of the State Bar of Texas. (If not a member, must join prior to the commencement of the Leadership Academy.)
- Must be willing to commit to attending all four sessions.

Tentative Meeting Dates and Cities:

- March 22-23, 2012 – San Antonio, TX
- June 14-15, 2012 – Houston, TX (in conjunction with the State Bar of Texas Annual Mtg.)
- September 20-21, 2012 – Austin, TX
- January 17, 2013 – Dallas, TX

Cost and Payment:

- The admission fee for the SBOT Tax Section Leadership Academy is $750.00.
- Payment will be requested for each applicant upon notification of acceptance to the program.
- Scholarships are available, on a limited basis, for qualified applicants to cover the admission fee.
- Each participant is responsible for their travel and hotel expenses.

Application Process: **<u>DEADLINE: JANUARY 20, 2012</u>**

To apply for the SBOT Tax Section Leadership Academy either:

- Download application, complete, scan application and attachments and email to:
- shouse@meadowscollier.com.
- Download application, complete application and mail with attachments to:

SBOT Tax Section Leadership Academy
901 Main Street, Suite 3700
Dallas, TX 75202

- The Leadership Academy committee will consider and respond in writing to all applications received.

Application Form

Section I – Personal Information

____

First Name | Middle Initial | Last Name

____

Firm

____

Firm Mailing Address

____

City | State | Zip Code

____

Work Telephone Number | Mobile Number

____

Email Address

____

State Bar Number

Gender: ☐ Male ☐ Female

Section II – Work Experience

Number of years working as an attorney: _________

Areas of expertise ____

____

Include a summary of your work experience or attach a copy of your resume. _________

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Section III – Recommendation

Attach a letter of recommendation from your Supervisor, Manager or Partner/Shareholder or other attorney with prior approval from the Leadership Development Committee. To obtain approval for a letter of recommendation from someone other than a Supervisor, Manager or Partner, please contact Susan House by email or by phone at shouse@meadowscollier.com or 214/749-2411.

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Section IV – Personal Statement

Why are you interested in participating in the Tax Section of the State Bar of Texas Leadership Academy? (Attach additional pages, if necessary.) ____________________
____
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____
____

Section V – Participant Commitment

I commit to actively participate in the Tax Section of the State Bar of Texas Leadership Academy (LA) and attend each session.

____
Applicant's Signature

________________________________ ____________________
Print Name Date

TAX PLANNING OPPORTUNITIES AND PITFALLS FOR TROUBLED COMPANIES

By: William H. Caudill and Zhusong Yang[1]

When it comes to a financially troubled company (i.e., a failing company), the often conflicting interests of the company and its creditors and shareholders and the sometimes confusing interplay of tax law, bankruptcy law and state corporate law tend to make the development of a business restructuring plan a daunting task. Tax planning can be said to be one of the key concerns in any business restructuring plan. It provides opportunities for a failing company to preserve its beneficial tax attributes and manage its debt obligations in preparation for its later recovery, yet at the same time, it also provides pitfalls where the unintended tax consequences could add insult (i.e., the extra tax dollars) to injury (i.e., the already lost investment) and accelerate a failing company's plunge into a failed company. The purpose of this article and my presentation today is to point out and explain several key tax issues concerning a troubled company's interested parties (i.e., the creditors, the shareholders, and the company itself), in the hope that such issues, when presented, can be identified and dealt with properly to maximize opportunities and minimize pitfalls in planning the restructuring of a troubled company.

I. TAX ATTRIBUTES PRESERVATION.

A troubled company typically has substantial net operating loss ("NOL") carryovers, capital loss carryovers and excess credit carryovers. To be able to preserve these beneficial tax attributes in a plan of business restructuring and to be able to utilize such tax benefits pursuant to the restructuring are crucial for the potential turn-around of a failing company.

A. General Rules.

To prevent "trafficking" in troubled companies' NOLs, Section 382 was initially added to the Internal Revenue Code of 1954 and then completely rewritten in 1986.[2] Section 382 is applicable to NOLs. The current version of Section 382 imposes a mechanical rule commonly known as the "Section 382 limitation" upon an "ownership change," which is deemed to occur when the percentage of stock of the loss corporation held by one or more 5% shareholders increases by more than 50 percentage points from the shareholder's lowest percentage point during a three-year period.[3] Upon an "ownership change," a loss corporation's ability to use its pre-change NOLs is subject to an annual limitation that is based on the value of the stock or equity of the old corporation immediately prior to the "ownership change" multiplied by the long-term tax-exempt interest rate (which is 4.30% for July 2011).[4] Because a troubled company's stock or equity value is typically small, the Section 382 limitation, in practice, often

[1] William H. Caudill and Zhusong Yang are tax lawyers in the Houston office of Fulbright & Jaworski L.L.P.

[2] Unless otherwise indicated, all "Section" references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the regulations promulgated thereunder, as most recently amended and adopted.

[3] Section 382(g)(1).

[4] Section 382(b)(1); Rev. Rul. 2011-14, 2011-27 I.R.B. 31.

significantly reduces or effectively eliminates a loss corporation's potential utilization of its pre-change NOLs.

Section 383 is applicable to capital loss carryovers and excess credit carryovers. It practically applies the Section 382 rule to limit a loss corporation's use of pre-change capital loss and excess credit carryovers upon an "ownership change." The combined effect of Sections 382 and 383 is to make sure that a loss corporation would not be acquired solely because it has a large amount of losses that would offset the income of a profitable acquirer.

B. Bankruptcy Exception to Section 382.

There is a "bankruptcy exception" to the 382 limitation rule. Under Section 382(l)(5), when a Title 11 reorganization results in a continued ownership of at least 50% (tested by vote and value) on the part of the corporation's shareholders and historic creditors (i.e., creditors that either have held their claims for the 18-month period preceding the filing of the Title 11 proceeding or have been beneficial owners of claims arising in the ordinary course of the trade or business of the old loss corporation[5]), Section 382 is not triggered and pre-change NOLs can be used without limitation after the "ownership change." The Section 382(l)(5) bankruptcy exception applies automatically unless the loss corporation elects otherwise.

There are, however, two caveats to the Section 382(l)(5) bankruptcy exception. First, there is a price tag for the unlimited use of pre-change NOLs provided under the bankruptcy exception. When the bankruptcy exception is applicable, Section 382(l)(5)(B) would kick in and reduce the old corporation's pre-change losses and excess credits by the dollar amount of any interest deduction taken, in the three tax years preceding, and the pre-change part of, the year of the ownership change, on debt exchanged for equity in the Title 11 reorganization. Second, if, during the two-year period immediately following an ownership change to which the bankruptcy exception applies, an ownership change of the new loss corporation occurs, the bankruptcy exception does not apply to the second ownership change and the Section 382 limitation with respect to the second ownership change is zero.[6] Because losses attributable to the pre-bankruptcy period are treated as pre-change losses with respect to both ownership changes,[7] carryovers that arose before the first ownership change would be effectively eliminated by the second ownership change.[8]

Because of the above two caveats, the application of the bankruptcy exception is not always advantageous to a corporation undergoing a Title 11 restructuring. Such corporations, however, can elect out of Section 382(l)(5) treatment (hereafter referred to as the "elect-out") under Section 382(l)(6). Upon the elect-out, a bankrupt corporation is permitted to use a grossed-up amount to calculate its stock value in determining the Section 382 limitation.[9] Specifically, a bankrupt corporation that elects out of the bankruptcy exception can adjust the

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[5] Section 382(l)(5)(E).

[6] Section 382(l)(5)(D).

[7] Treas. Reg. § 1.382-5(d)(1).

[8] Treas. Reg. § 1.382-9(n).

[9] Section 382(l)(6).

pre-change stock value of the corporation to reflect any increase in value resulting from the surrender or cancellation of creditors' claims in the Title 11 restructuring, as a result of which the Section 382 limitation would be correspondingly increased.

Given the potential disadvantages in claiming the bankruptcy exception and the potential increase in the Section 382 limitation with an elect-out, a troubled company should meticulously calculate and compare NOLs that could be utilized and interest deductions that would be denied with the application of the bankruptcy exception, keeping in mind that an elect-out may also provide substantial benefits to the company. Moreover, the sale or exchange of the corporation's stock should be monitored carefully to prevent a second ownership change within two years of the first ownership change. In particular, if the bankruptcy reorganization plan anticipates the creditors' later conversion of their notes into stock, the timing and scale of the conversion should be watched closely to make sure that it would not trigger a subsequent ownership change in two years. In addition, the bankrupt corporation should also consider the filing of a protective injunction preventing the assignment of stock or claims that would jeopardize the value of the corporation's NOLs or other tax attributes.[10]

C. Consolidated Group Section 382 Rule.

In the consolidated group context, the Section 382 limitation is determined under a single entity approach, where if the parent company of the loss group experiences an ownership change, the Section 382 limitation applies to pre-change NOLs of the entire loss group.[11] The Treasury currently has not drafted any regulations regarding the application of the Section 382(l)(5) bankruptcy exception and Section 382(l)(6) elect-out to a consolidated loss group.[12]

II. DEBT MANAGEMENT.

A troubled company almost never has sufficient cash flow to meet its debt obligations, and debt restructuring is normally an inevitable step in a troubled company's overall business restructuring plan. Debt restructuring can present a number of significant tax issues to the troubled company and its creditors, and such tax considerations must be taken into account in balancing the desirability of different restructuring plans available to the company.

A. Debt Modification.

Whenever the terms of a debt instrument are planned to be modified, efforts should be engaged to determine if such modifications are "significant modifications" within the meaning of Treas. Reg. § 1.1001-3(e) which would trigger a deemed satisfaction of the old debt with the deemed issue price of the new debt (i.e., the debt with the modified terms). The deemed exchange of debts upon a "significant modification" could not only generate taxable gain or loss to the creditors, measured by the difference between the deemed issue price of the new debt and the creditor's adjusted basis in the old debt,[13] but also create cancellation of debt ("COD")

[10] *See In re Prudential Lines Inc.*, 928 F.2d 565 (2nd Cir. 1991).

[11] Treas. Reg. § 1.1502-91(a)(1).

[12] Treas. Reg. § 1.1502-97.

[13] Treas. Reg. § 1.1001-1(a).

income to the debtor (i.e., the troubled company) if the deemed issue price of the new debt is less than that of the old debt.[14] Therefore, in any debt restructuring plan, "significant modifications" of the troubled company's debt obligations should be avoided whenever possible, because the immediate adverse tax consequences resulting from the deemed exchange of debts are likely to swallow any potential benefits that are intended under the debt restructuring.

The determination of a "significant modification" involves a two-step inquiry. Any modifications to the terms of a debt instrument must first be confirmed as "modifications" for Treas. Reg. § 1.1001-3 purposes, and then the significance of the modification will be tested under five specific rules as well as a general facts-and-circumstances test.

1. *Modifications*. Ordinarily, almost any alteration to the terms of a debt instrument constitutes a modification for Treas. Reg. § 1.1001-3 purposes, with only limited exceptions for certain alterations that occur by operation of the debt instrument,[15] a debtor's failure to perform its obligation under the debt,[16] and a party's failure to exercise an option under the debt instrument.[17] Please note that when a modification occurs pursuant to a plan of reorganization under Title 11 or similar cases, the modification occurs upon the effective date of the plan. In other words, there is no modification unless the restructuring plan becomes effective.[18]

2. *Significant modifications*. Once an alteration is determined to be a modification for the purposes of Treas. Reg. § 1.1001-3, its significance will be tested under the following general and specific tests.

a. *Change in yield*. A change in the yield of a debt instrument is a significant modification if the yield changes by more than the greater of (i) 0.25% or (ii) 5% of the annual yield of the unmodified instrument.[19]

b. *Change in timing of payments*. A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in a material deferral of scheduled payments.[20] There is a safe-harbor rule where the material deferral is deemed not to exist if the deferral payments are unconditionally payable by the end of the safe-harbor period, which starts on the due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of 5 years or 50% of the original term of the instrument.[21]

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[14] Section 108(e)(10)(A).

[15] Treas. Reg. §§ 1.1001-3(c)(1)(ii), (c)(2).

[16] Treas. Reg. § 1.1001-3(c)(4).

[17] Treas. Reg. § 1.1001-3(c)(5).

[18] Treas. Reg. § 1.1001-3(c)(6)(iii).

[19] Treas. Reg. § 1.1001-3(e)(2).

[20] Treas. Reg. § 1.1001-3(e)(3)(i).

[21] Treas. Reg.§ 1.1001-3(e)(3)(ii).

c. Change in obligor or security. A modification is a significant modification if it (i) substitutes a new obligor on a *recourse* debt instrument unless the substitution occurs in a Section 381(a) transaction or through an acquisition by the new obligor of substantially all assets of the old obligor,[22] (ii) adds or deletes a co-obligor on a debt instrument if the addition or deletion results in a change in payment expectations,[23] (iii) changes a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a *nonrecourse* debt instrument,[24] (iv) changes the collateral for, or a guarantee on, or other form of credit enhancement for a *recourse* debt instrument when such change results in a change in payment expectations,[25] or (v) changes the priority of the debt instrument when it results in a change in payment expectations.[26]

d. *Change in the nature of a debt instrument*. A modification is a significant modification if it (i) results in the instrument being not debt for federal income tax purposes,[27] (ii) changes the nature of the debt from nonrecourse to recourse,[28] or (iii) changes the nature of the debt from recourse to nonrecourse unless the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectation.[29]

e. *Change in accounting or financial covenants*. A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification.[30]

f. *General facts-and-circumstances test*. A modification is a significant modification if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[31]

It is worth noting that although a particular alteration may not by itself be a significant modification, it can be combined with other alterations over the period (normally not exceeding 5 years) to constitute a significant modification.[32] This cumulative test, however, solely applies

[22] Treas. Reg. §§ 1.1001-3(e)(4)(i)(A), (B), and (C).

[23] Treas. Reg. § 1.1001-3(e)(4)(iii).

[24] Treas. Reg. § 1.1001-3(e)(4)(iv)(B).

[25] Treas. Reg. § 1.1001-3(e)(4)(iv)(A).

[26] Treas. Reg. § 1.1001-3(e)(4)(v).

[27] Treas. Reg. § 1.1001-3(e)(5)(i).

[28] Treas. Reg. § 1.1001-3(e)(5)(ii)(A).

[29] Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(*2*).

[30] Treas. Reg. § 1.1001-3(e)(6).

[31] Treas. Reg. § 1.1001-3(e)(1).

[32] Treas. Reg. § 1.1001-3(f)(3).

to modifications of a single term of the debt instrument over time; it does not apply to modifications of different terms of a debt instrument.[33]

B. <u>COD Income</u>.

A troubled company's COD income may be created in a number of ways including significant modification of debt, creditors' transfer of debt at a discount, creditors' write-off or discharge of debt, creditors' contribution of debt to the debtor company, or debtor company's transfer of assets to creditors in satisfaction of debt. Under Section 61(a)(12), COD income is included in a taxpayer's gross income, although there are exceptions to this general rule.

1. *Bankruptcy exception*. When a debtor is in a Title 11 proceeding (not in other types of insolvency proceedings, such as a receivership), its debt discharge is totally excluded from income without regard to its insolvency.[34] For a troubled company that is not very deeply insolvent, the unlimited COD income exclusion under the bankruptcy exception may be one of the reasons to seek bankruptcy protection as it may greatly help with the company's cash flow.

2. *Insolvency exception.* A taxpayer does not recognize COD income to the extent it is insolvent.[35] Insolvency refers to the excess of liabilities over the fair market value of assets, determined immediately prior to the debt discharge.[36] Any debt discharge in excess of the insolvency amount, however, will result in COD income recognition.[37] There are issues and uncertainties regarding how intangible assets (*e.g.*, goodwill), nonrecourse liabilities and contingent liabilities are treated in determining a troubled company's insolvency.

3. *Tax attributes reduction*. The price tag for the COD income exclusion under the bankruptcy exception and the insolvency exception is the reduction of the debtor company's beneficial tax attributes such as NOLs and business credits.[38] In particular, the tax attributes are reduced in the following order: (i) NOLs, (ii) general business credits, (iii) minimum tax credits, (iv) capital loss carryovers, (v) basis reduction (on both depreciable and non-depreciable assets), (vi) passive activity loss and credit carryovers, and (vii) foreign tax credit carryovers.[39]

Apart from the above ordering rule, a debtor company can make a "special basis election" under which the company's bases in depreciable assets would be reduced before decreasing its other tax attributes.[40] The amount to which the election applies, however, is limited to the aggregate adjusted bases of the depreciable assets held by the debtor at the

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[33] Treas. Reg. § 1.1001-3(f)(4).

[34] Section 108(a)(1)(A).

[35] Section 108(a)(1)(B).

[36] Section 108(d)(3).

[37] Section 108(a)(3).

[38] Section 108(b)(1).

[39] Section 108(b)(2).

[40] Section 108(b)(5)(A).

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beginning of the year following the year of discharge.[41] So timing-wise, the special basis election may generate gain (or additional gain) to the debtor company upon its later disposition of the depreciable assets, and a portion of such gain may be taxed as ordinary income under the Section 1245/1250 recapture rule. Keeping the potential gain recognition in mind, the special basis election should still be considered if the debtor company wants to preserve its NOLs and other tax attributes for business restructuring.

4. *Contribution of debt.* Debt discharge sometimes occurs when a shareholder-creditor or an outside creditor contributes the debtor company's indebtedness to the capital of the company. An outside creditor normally gets equity back in exchange for such debt contribution, while a shareholder-creditor may or may not receive additional stock for such contribution (if no additional stock is received, the shareholder-creditor's basis in its existing stock in the debt company would be increased). Different rules apply in determining the resulting COD income, if any, depending upon whether the contributing creditor is a shareholder in the troubled company and whether any stock of the troubled company is issued for such debt contribution.

a. *Section 108(e)(6)*. This provision provides that when a debtor corporation acquires its indebtedness from a shareholder-creditor as a capital contribution, COD income equals the excess of the adjusted issuance price of the debt over the shareholder-creditor's adjusted basis in the debt.

In practice, if a shareholder-creditor is using a cash method of accounting for accrued compensation, its basis in the debt should be zero, and thus COD income would always be created upon the debt contribution. On the other hand, if the shareholder-creditor is using the accrual method, its adjusted basis in a debt tends to be equal to the outstanding balance of the debt, in which case COD income would be created for the debtor company only with respect to the amount of accrued but untaxed interest. COD income created as a result of accrued interest, however, is excludible from income for the debtor company under Section 108(e)(2) because the payment of such interest would give rise to a deduction on the part of the debtor company. So in practice, an accrual-method shareholder-creditor's contribution of debt into the debtor company under Section 108(e)(6) often results in no COD income to the debtor company.

b. *Section 108(e)(8)*. This provision provides that if a debtor company transfers stock to a creditor in satisfaction of an indebtedness,[42] COD income equals the excess of the adjusted issuance price of the debt over the fair market value of the stock transferred. In reality, the value of a troubled company's stock tends to be very low, if not zero, as a result of which a contribution of debt for equity would usually generate COD income for the debtor company.

Section 108(e)(6) and 108(e)(8) both apply to the contribution of indebtedness by a shareholder-creditor of a troubled company, and the determination as to which provision applies appears to be based on form only, i.e., whether stock is issued in return for the shareholder-creditor's debt contribution. Accordingly, whenever a debt-for-equity swap is suggested in a business restructuring plan, caution should be exercised with respect to the shareholder-creditor's

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[41] Section 108(b)(5)(B).

[42] Section 108(e)(8) also applies to a partnership's transfer of partnership interests in satisfaction of its indebtedness.

method of accounting. If the shareholder-creditor is on an accrual basis, it is recommended that the troubled company not issue stock in return for the debt contribution so as to fall into the scope of Section 108(e)(6), the simple act of which may generate much less COD income to the debtor company.

5. *Property transfer to satisfy debt.* As part of a business restructuring plan, a troubled company often faces the option to satisfy its debt by transferring company assets to the creditors. Such transfer is treated as a sale of the assets for the principal amount of the debt and may generate a capital gain (or a capital loss) to the troubled company if the principal amount of the debt is greater (or less) than the company's basis in the transferred assets. Moreover, if the principal amount of the debt is more than the fair market value of the transferred assets, there would be COD income to the troubled company associated with the transfer, in addition to any capital gain or loss that may be realized from the deemed sale.

III. BAD DEBT/WORTHLESS SECURITIES DEDUCTION.

Shareholders of a troubled company may take a worthless securities deduction under Section 165(g) when the stock of the company no longer has any recognized value. Similarly, creditors of a troubled company are eligible to deduct their troubled loans, either as a bad business debt under Section 166 or as a worthless security under Section 165(g)(2)(C). The bad debt deduction and the worthless securities deduction are generally exclusive of each other, with the worthless securities deduction taking precedence if a debt instrument is evidenced by a security.[43]

A. Worthless Securities Deduction.

Under Section 165(g), if any security which is a capital asset becomes worthless during a taxable year, the resulting loss shall be treated as a capital loss realized on the last day of the taxable year. Conversely, if any security which is not a capital asset becomes worthless during a taxable year, the resulting loss shall be deducted under Section 165(a) as an ordinary loss.[44] For Section 165(g) purposes, the term "security" includes stock and debt instruments issued with interest coupons or in registered form.[45]

To claim a worthless securities deduction, the crucial factual inquiries are (i) whether the security is held as a capital asset, and (ii) whether the security is truly worthless. A security is worthless for tax purposes only if it is in fact totally worthless; no loss deduction is allowed for partial worthlessness or for mere market fluctuation in the value of the security.[46]

1. *Intercompany exception.* The fact that most shareholders and creditors hold their stock and debt receivables as capital assets makes a Section 165(g) worthless securities deduction less desirable because it would result in capital losses, which is not as easily absorbed

[43] Section 166(e).

[44] Treas. Reg. § 1.165-5(c).

[45] Section 165(g)(2).

[46] Treas. Reg. §§ 1.165-5(f), 1.165-4.

as ordinary losses. There is, however, an "intercompany exception" for this capital loss treatment. Under Section 165(g)(3), a U.S. corporation (i.e, the parent) can claim an ordinary loss deduction for worthless securities in an "affiliated" subsidiary corporation. A corporation is an affiliated subsidiary if (i) the parent owns directly at least 80% of the corporation's stock value and voting power and (ii) more than 90% of the corporation's aggregate gross receipts of all years are from non-passive sources.[47] In other words, so long as the ownership test and the gross receipts test are satisfied, a U.S. parent company can take an ordinary loss on the stock of, or debt owed by, its insolvent operating subsidiary.

2. ***Deemed stock acquisition.*** If a shareholder owning at least 50% of the troubled company's stock at any time during a three-year period (hereafter referred to as a "50% shareholder") takes a worthless stock deduction on the troubled company's stock during a taxable year and continues to hold such stock until the close of the taxable year, the 50% shareholder, for Section 382 purposes, is treated as having acquired the stock in the year following the deduction year and is deemed to have held no troubled company stock in prior periods.[48] In other words, whenever a 50% shareholder of a troubled company takes a worthless stock deduction, it would be deemed as a triggering event for Section 382 purposes. Without caution, the shareholder's simple act of taking a worthless stock deduction could eliminate the troubled company's NOLs. This could also be the subject of a bankruptcy court protective injunction.[49]

B. Bad Debt Deduction.

If a debt instrument does not qualify as a "security" for Section 165(g) purposes, the creditor should consider whether it is eligible to take a bad debt deduction under Section 166. Different from a worthless securities deduction, a bad debt deduction can be taken on debt only partially worthless.[50] When a debt is only partially worthless, a deduction for the portion that is worthless can be taken in the year the portion of the debt is charged off on the financial books of the creditor.[51] Note that when there is a significant modification of debt, the creditor may be eligible to take a bad debt deduction on the "deemed charged-off" amount of the original (unmodified) debt.[52] The amount of a bad debt deduction, however, is limited to the holder's basis in the debt.[53]

IV. CONCLUSION.

As discussed above, the two single most important tax issues facing a troubled company in planning its business restructurings are (i) how to preserve their beneficial tax attributes like

[47] Section 165(g)(3).

[48] Section 382(g)(4)(D).

[49] *See In re Prudential Lines Inc.*, 928 F.2d 565 (2nd Cir. 1991).

[50] With respect to a non-business debt of a non-corporate creditor, the bad debt deduction is available only if such debt is wholly worthless.

[51] Treas. Reg. § 1.166-3(a)(2)(ii).

[52] Treas. Reg. § 1.166-3(a)(3).

[53] Section 166(b).

NOLs and (ii) how to manage their debt restructuring so that their debt obligations can be reduced or released without incurring substantial COD income. In the meantime, the shareholders and creditors of a troubled company have their own means of getting rid of a bad investment and the means they use may have an impact on the troubled company's goals to preserve tax attributes and manage debt obligations. Any misstep in the tax planning concerning any interested party of a troubled company could put the company into more trouble. Conversely, if these tax issues could be understood and taken care of, the chances for a troubled company to succeed in its business restructuring would be enhanced. All in all, it is worth the trouble to make tax planning an integral part of any troubled company's overall business restructuring plan.

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IRS GIVES EMPLOYERS A FRESH START OPPORTUNITY FOR MISSCLASSIFIED EMPLOYEES

By Karen E. Hughes and Shawn R. O'Brien[1]

The IRS recently launched a new program to give employers a "fresh start" for prior acts of misclassifying "employees" as "independent contractors" by allowing employers to pay minimal taxes and avoid penalties and interest. The Voluntary Classification Settlement Program ("***VCSP***") was announced on September 21, 2011,[2] providing employers an opportunity to voluntarily reclassify independent contractors as employees, if appropriate. Many businesses, tax-exempt organizations and government entities currently misclassify their workers as independent contractors, and by doing so, these employers are subjecting themselves to substantial taxes, penalties and interest if uncovered by the IRS. Under the IRS' new program, eligible employers may obtain substantial relief from taxes, penalties and interest for prior tax years if such employers agree to properly classify workers as employees on a prospective basis.

Participation in the VCSP assures that an eligible employer: (i) will pay only 10 percent of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year; (ii) will not be liable for any penalties and interest on such tax liability; and (iii) will not be subject to an employment tax examination with respect to the worker classification of such workers for prior tax years.

VCSP Program Eligibility and Requirements

Employers are eligible to participate in the VCSP if such employer:

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[2] IRS Announcement 2011-64 *available at* http://www.irs.gov/pub/irs-drop/a-11-64.pdf and IRS News Release, IR-2011-95, Sept. 21, 2011, *available at* http://www.irs.gov/newsroom/article/0,,id=246203,00.html.

1. Consistently treated workers as independent contractors or other nonemployees;

2. Filed all required Forms 1099 for such independent contractors and other nonemployees for the previous three years (although the IRS guidance does not require that such Forms 1099 be filed timely);

3. Is not currently under audit by the IRS;

4. Is not currently under audit concerning the classification of such independent contractors and other nonemployees by the Department of Labor or by a state governmental agency; and

5. Is in compliance with the results of any previous audit by the IRS or the Department of Labor concerning the classification of independent contractors and/or other nonemployees (*i.e.*, a previous audit concerning employee classification will not necessarily cause an employer to be ineligible to participate in the VCSP).

If an employer meets such eligibility requirements, the employer must then:

1. File IRS Form 8952, Application for Voluntary Classification Settlement Program (VCSP) at least sixty (60) days prior to when the employer would like to begin classifying any independent contractors as employees;

2. Prospectively treat the subject class of workers as employees for future tax periods;

3. Extend the period of limitations on assessment of employment taxes for three years for the first, second and third calendar years beginning after the date on which the employer has agreed to begin treating such workers as employees; and

4. Enter into an IRS VCSP Closing Agreement.

Additionally, the IRS will contact a taxpayer whose application has not been accepted, and if a VCSP application has been rejected because the taxpayer is not eligible to participate, the taxpayer may reapply. Payment of any amounts due under the VCSP must be made when the taxpayer returns the signed VCSP closing agreement to the IRS.

VCSP Program Specifics

Certain questions about, for instance, how a business may differentiate between workers who are reclassified as employees and those who are not, payment calculations, and identification of eligible and ineligible entities, are currently answered in IRS guidance.[3] The VCSP does permit taxpayers to reclassify some or all of their workers, but once a taxpayer chooses to reclassify certain of its workers as employees, all workers in the same class must be treated as employees for employment tax purposes. The following example is included in the FAQs on the VCSP to illustrate the required consistency:

> ABC Company is a construction firm that currently contracts with its drywall installers, electricians and plumbers to perform services at housing construction sites. ABC Company determines it wants to voluntarily reclassify its drywall installers as employees. ABC Company submits an application, is accepted into the VCSP and enters into a closing agreement with the IRS. Once the VCSP closing agreement is executed, ABC Company must treat all drywall installers as employees for employment tax purposes.

What is unclear about this example, however, is whether the drywall installers have the same working relationship with ABC Company. From this example, it appears that "all workers in the same class" means all workers who provide similar services to ABC Company, rather than all workers who maintain the same type of working relationship with ABC Company.

With respect to payment calculations, payment under the VCSP is 10 percent of the amount of employment taxes calculated under the reduced rates of section 3509(a) of the Internal Revenue Code for the compensation paid for the most recent tax year to the workers being reclassified under the VCSP. Under section 3509(a), the effective tax rate for compensation up to the Social Security wage base is 10.68 percent in 2010, 10.28 percent in 2011 and 3.24 percent for compensation above the Social Security wage base. The amount due under the VCSP is calculated based on compensation paid in *the most recently closed* tax year, determined at the time the VCSP application is filed. Accordingly, the 10.68 percent effective rate applies under

[3] Voluntary Classification Settlement Program (VCSP) Frequently Asked Questions, *available at* http://www.irs.gov/businesses/small/article/0,,id=246014,00.html.

the VCSP in 2011, since the most recently closed tax year is 2010. These effective rates are the sum of the various rates calculated under section 3509(a), and include federal income tax withholding, employee Social Security tax, employer Social Security tax, employee Medicare tax and employer Medicare tax.

The following examples are included in the FAQs to illustrate the calculation of the payment under the VCSP:

> In 2010 you paid $1,500,000 to workers that are the subject of the VCSP. All of the workers that are the subject of the VCSP were compensated at or below the Social Security wage base (*e.g.*, under $106,800 for 2010). You submit the VCSP application on October 1, 2011, and you want the beginning date of the quarter for which you want to treat the class or classes of workers as employees to be 1/01/12. You look to amounts paid to the workers in 2010 for purposes of calculating the VCSP amount, since 2010 is the most recently completed tax year at the time the application is being filed. Under section 3509(a), the employment taxes applicable to $1,500,000 would be $160,200 (10.68% of $1,500,000). Under the VCSP, your payment would be 10% of $160,200, or $16,020.
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> The facts are the same as in the example above, except that some of the workers that are the subject of the VCSP were compensated above the Social Security wage base in the amount of $250,000. Under section 3509(a), the employment taxes applicable to $1,250,000 would be $133,500 (10.68% of $1,250,000) and the employment taxes applicable to the other $250,000 would be $8,100 (3.24% of $250,000). Under the VCSP, your payment would be 10% of $141,600 ($133,500 plus $8,100), or $14,160.

With respect to eligible entities, the FAQs are quite clear that exempt organizations and government entitites are eligible to participate in the VCSP if all eligibility requirements are met. One specific circumstance for which the VCSP is not available, however, is for state and local government employers for workers covered under a Section 218 agreement. The VCSP is available to state and local government employers, however, for workers not provided Social Security coverage under a Section 218 agreement. Additionally, an exempt organization that is currently under a Form 990 series examination is considered to be "under audit by the IRS" and is, therefore, ineligible to participate in the VCSP.

Evaluating Participation in the VCSP

Secretary of Labor Hilda Solis recently signed memoranda of understanding with the IRS and several states aimed at improving state and federal cooperation and coordination on employee misclassification compliance and education. While the VCSP provides participating employers with amnesty and resolves the classification issue for federal employment tax purposes, it remains unclear whether agencies other than the IRS will offer amnesty opportunities to reclassify employees prospectively. It is also unclear what information the IRS intends to share with other agencies; typically, such agencies share information relevant to law enforcement initiatives and investigations.

Some specific considerations to take into account when evaluating participation in the VCSP include, but are not limited to, state tax issues, potential vicarious tort liability, wage-hour implications, union-related issues, the effect on employee benefits (including qualified retirement plans), leaves of absense eligibility, worker's compensation coverage, risks with respect to workers who may not be disclosed in the VCSP and timing of participation. While the federal tax cost of participation in the VCSP is potentially quite low for many employers, it is possible that the non-tax considerations may ultimately be the deciding factor as to whether an employer should participate in the VCSP. Accordingly, employers who utilize independent contractors or other nonemployees and who are interested in participating in the VCSP should consult with their tax advisors as well as their labor and employment attorneys to discuss the potential consequences.

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TAX BENEFITS AND ALLOCATION ISSUES IN ROLLOVERS TO ROTH IRAS

By Brian Giovannini*

For taxable years beginning before January 1, 2010, those individuals who stood to benefit most from a 401(k) plan to a Roth IRA rollover—individuals with a modified adjusted gross income exceeding $100,000—were precluded from making a qualified rollover contribution to a Roth IRA.[1] Starting in 2010, this cap on income was eliminated, thus making qualified rollover contributions available to higher-income participants in 401(k) and other employer defined contribution plans (assuming such participants were otherwise eligible to take a distribution).[2]

Both Republican and Democratic senators are pushing to simplify the Internal Revenue Code by eliminating many of the special-purpose deductions while simultaneously lowering the overall tax rate across brackets. Despite this bipartisan sentiment, in 2010, the sunset of the lower tax brackets was extended to only December 31, 2012—meaning the tax cuts that were enacted under President Bush are set to expire in the lame duck session following the 2012 presidential election. At this time, it's unclear whether the lower tax brackets will again be extended or will be allowed to expire. This situation has resulted in investor uncertainty regarding future income tax rates over the long term. As a result, there has been a new interest in rolling over retirement funds into Roth IRAs as a means to lock in lower tax rates, and tax professionals are finding a growing market for advice on the tax consequences of a rollover into a Roth IRA.

The goal of this analysis is to provide practitioners with an overview of the potential retirement and estate planning benefits of rollovers from a 401(k) plan into a Roth IRA, as well as to alert practitioners to the impact that common 401(k) plan distribution rules will have on the tax benefits of such a rollover in light of the current IRS allocation rules.

Roth IRA vs Traditional IRA. The key difference between Roth IRAs and traditional IRAs is the tax treatment of the amounts invested in the IRA. Pre-tax amounts invested in a traditional IRA are fully taxable when withdrawn, whereas there is no tax liability when either earnings or principal is withdrawn from a Roth IRA, provided that the participant has attained age 59½ and

* I wish to acknowledge the contributions to this article made by my fellow attorneys at Haynes and Boone, LLP, Jesse Gelsomini and James Williamson.

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has held the Roth IRA for at least five years.[3] Distributions become mandatory after attaining age 70½ in a traditional IRA. By contrast, with a Roth IRA, there are no mandatory lifetime distributions at any age.[4] Consequently, earnings in a Roth IRA can be allowed to grow both (1) on a tax-free rather than tax-deferred basis and (2) for a longer period of time than in a traditional IRA.

Availability of Rollovers to a Roth IRA. An individual who is the distributee of an eligible rollover distribution[5] must be permitted to make a direct trustee-to-trustee rollover into the eligible retirement plan[6] of his choice, including, if he so chooses, a direct rollover into a Roth IRA, subject to the direct rollover rules.[7] Additionally, the administrator of the 401(k) plan must permit the recipient to elect to split the eligible rollover distribution into two parts—with one part directly rolled over into an eligible retirement plan and the remainder paid to the recipient.[8] The two-year deferral requirement that applies to the withdrawal of employer contributions[9] does *not* apply to after-tax deferrals.[10]

Retirement and Estate Planning Benefits of a Rollover to a Roth IRA

Transfer into a Roth IRA allows an increased amount to be tax-sheltered. The primary advantage of rolling over an account balance from a 401(k) plan into a Roth IRA, rather than into a traditional IRA, is that it allows an individual to transfer more real wealth—more value when compared on an after-tax basis—into the Roth IRA than could be transferred into the traditional IRA.[11] Unfortunately, this advantage is often lost because it arises only if the tax liability upon transfer to a Roth IRA is paid from outside the transferred amount.

This advantage is demonstrated in the following example:

> <u>Example 1:</u> Assume an individual has a $50,000 pre-tax balance in a 401(k) plan and $17,500 after-tax dollars in a non-tax sheltered portfolio. Assume that the rate of return for all accounts remains fixed at a modest 5% and that the effective tax rate is 35% for all years.
>
> *Option 1*: If the pre-tax balance from the 401(k) plan is rolled over into a traditional IRA, and the balance is withdrawn after ten years, it will have a pre-withdrawal value of $81,444.73, from which $28,505.66 will be owed as taxes upon withdrawal thus resulting in a net balance of $52,939.08. The outside account would have grown to $24,095.65 for a total after-tax portfolio of <u>$77,034.73</u> ($52,939.08 + $24,095.65).
>
> *Option 2*: If the pre-tax balance from the 401(k) plan is rolled over into a Roth IRA *with the taxes paid out of the rollover*, and the balance is withdrawn after ten years, it will have a pre-withdrawal value of $52,939.08, with a $0 tax liability upon withdrawal. The outside account would have grown to $24,095.65 for a total after-tax portfolio of <u>$77,034.73</u>.
>
> *Option 3*: If the pre-tax balance from the 401(k) plan is rolled over into a Roth IRA *but with the taxes paid from outside the rollover*, and the

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balance is withdrawn after ten years, it will have a pre-withdrawal value of \$81,444.73, with a \$0 tax liability upon withdrawal. The outside account was consumed in paying the initial tax liability and would thus remain at \$0 for a total after-tax portfolio of \$81,444.73.

In the example, the difference between rolling over into a Roth IRA (with the taxes paid from an outside account) and into a traditional IRA is \$4,410.01 after 10 years and \$20,330.75 after 25 years. The amount from the outside account that is used to pay taxes essentially functions as an additional contribution to the Roth IRA. In both Option 1 and Option 2, a portion of the original \$50,000 goes to pay for taxes—either up-front or on the back end—but in Option 3, nothing comes out of the \$50,000 for taxes. Earnings on the *entire* \$50,000 is thus allowed to grow tax-free.

The additional tax-free growth in earnings makes a transfer into a Roth IRA exceptionally attractive if the effective tax rate is projected to increase. What many people fail to realize is that, due to the additional earnings being allowed to grow tax-free, a rollover into a Roth IRA could still be a prudent choice even if the individual's effective tax rate is projected to *decline* by a moderate amount. This is shown in the following example:

Example 2: Assume an individual has a pre-tax balance of \$200,000 in a 401(k) plan and \$100,000 in a non tax-sheltered portfolio. Assume an annual rate of return of 5% in all accounts. Also assume that the effective tax rate for the individual this year is 35% and, due to legislation to simplify the tax code, in 10 years it will decrease to 32% and in 20 years it will further decrease to 30%. Also, assume that no estate tax is applicable.

In addition, assume that the individual will die in 25 years without withdrawing any amounts. If this individual transfers his 401(k) account balance into a Roth IRA, paying the taxes out of his non-tax-sheltered account, his beneficiaries would receive \$677,270.99 in the Roth IRA and \$68,703.57 in the non-sheltered account for a total of \$745,974.55 in after-tax dollars. If the individual instead elects to transfer the entire amount into a traditional IRA, his beneficiaries would receive \$677,270.99 in the traditional IRA and \$229,011.89 in the non-sheltered account. Amounts in the traditional IRA would still be subject to taxation upon distribution and have an after-tax value of only \$474,089.69. The total after-tax value transferred to the beneficiaries would be only \$703,101.58. Rolling over the 401(k) plan balance into a Roth IRA thus results in an extra \$42,872.97 in after-tax dollars for the beneficiaries despite the effective income tax rate *having declined* by five percent.

There are no required minimum distributions of amounts in a Roth IRA. The above examples did not take into consideration required minimum distributions. If, as in Example 2 above, the intended purpose of the tax-sheltered account is to serve as a wealth-transfer vehicle at death, then the Roth IRA has an additional wealth creation advantage over the traditional IRA. There is no required minimum distribution from a Roth IRA during the participant's lifetime, whereas a rollover amount in a traditional IRA or an amount in a Roth 401(k) account is required to distribute a minimum amount to the participant each year after he has attained age 70½.

> Example 3: Assume an individual, age 60, has a pre-tax balance of \$200,000 in the 401(k) plan and \$100,000 in a non tax-sheltered portfolio. Assume an annual rate of return of 5% in all accounts and an effective tax rate of 35% for all years. Also assume that any required minimum distributions are invested into the non-tax-sheltered portfolio and no estate tax is applicable. This individual does not intend to use this amount in retirement, but rather would like to transfer the entire balance to his children upon death. The individual subsequently dies at age 80.
>
> *Option 1:* If the individual transfers the amounts into a Roth IRA at age 60, paying the taxes from his non-sheltered account, the value of his accounts at death will be \$530,659.54 in the Roth IRA and \$56,875.14 in his non-sheltered account, for a total after-tax value of \$587,534.68.
>
> *Option 2:* If the individual transfers the amounts into a traditional IRA at age 60, the value of his accounts (taking into account the payment of required minimum distributions from his traditional IRA into his non-sheltered account) will be \$334,938.84 in pre-tax dollars in the traditional IRA (after-tax value \$217,710.25) and \$307,573.50 in the non-sheltered account, for a total after-tax value of \$525,283.74.
>
> When taking into consideration required minimum distributions, the total after-tax value transferred to the individual's beneficiaries after rolling over the balance into a traditional IRA is \$62,250.94 less than it would have been if the amounts had been rolled over into a Roth IRA.
>
> Only rolling over the amounts into a Roth IRA confers the advantage of avoiding required minimum distributions. A rollover into a Roth 401(k) account in an employer plan, for example, would still be subject to required minimum distributions.

Tax advantages exist for transfer of after-tax amounts from a 401(k) into a Roth IRA. The tax advantages described above also apply to after-tax amounts in a 401(k) plan. Although the principal amount of an after-tax contribution may be rolled-over into a Roth IRA tax-free, the earnings portion of an after-tax contribution is taxed when distributed from the 401(k) plan. By rolling over the amount from the after-tax portion of a 401(k) plan into a Roth IRA, an individual can thus convert deferred taxes on future earnings into tax-free future earnings.

> Example 4: An individual is age 45 and has \$75,000 in a non tax-sheltered account and \$100,000 in an after-tax account in a 401(k) plan. Of the \$100,000 in the 401(k) plan's after-tax account, \$80,000 is attributable to principal and \$20,000 is attributable to earnings. The annual effective tax rate remains level at 35% each year. The annual rate of return is 5% each year.

> The individual elects to roll over the $100,000 after-tax amount into a Roth IRA and pay any associated taxes from his non tax-sheltered account. The individual rolls over the $80,000 principal and it is not taxed at transfer. He rolls over the $20,000 earnings and pays the $7,000 tax out of the $75,000 non-sheltered account. After 20 years, the rollover to the Roth IRA has grown to $265,329.77. In addition, the non-sheltered account has grown from $68,000.00 to $128,916.98 in those 20 years. The total after-tax value of all accounts after 20 years is $394,246.75.
>
> Had the Participant instead left the $100,000 in the 401(k) plan's after-tax account, after 20 years, the $100,000 would have grown to $265,329.77, of which $185,329.77 would be pre-tax earnings subject to a tax of $64,865.42 (for a total after-tax value of $200,464.35). The $75,000 in the non-sheltered account would have grown to $142,187.84. The total after-tax value of the accounts would be only $342,652.19 which is $51,594.60 less than if those amounts had been transferred into the Roth IRA 20 years earlier.

Tax Treatment of Amounts Rolled Over into a Roth IRA

In light of the potential benefit of rolling over amounts from a 401(k) plan into a Roth IRA, it is important for both practitioner and client to understand some of the nuances of the tax and withholding treatment of the amounts being rolled over in order to make an informed decision. Some options may or may not be available, depending on the terms and the structure of the 401(k) plan holding the assets to be transferred, which can alter the analysis. Three critical areas that should be understood before making a decision to roll over amounts into a Roth IRA are (1) when and how transferred amounts will be taxed, (2) what tax withholding, if any, will be required, and (3) how pre-tax and post-tax amounts will be allocated to a transfer during either a partial distribution of an account balance or a full distribution of an account balance that is only partially rolled over.

To assist in understanding these tax issues, the examples in this section are based on a sample 401(k) plan that contains features common to many 401(k) plans. This sample 401(k) plan allows both employer and employee contributions. Employee contributions are subdivided into the following ledger accounts: (a) before-tax account; (b) after-tax account; (c) pre-tax rollover account, and (d) after tax rollover account. The sample 401(k) plan also contains a set of ordering rules which provide that any withdrawals of employee contributions will be allocated first from the participant's rollover accounts, then from the participant's after-tax account, and finally from the participant's before-tax account. In each case, assume that the individual is eligible under the terms of the sample 401(k) plan to take an eligible rollover distribution.

Taxation and Withholding Rules

When an eligible rollover distribution is rolled over from a 401(k) plan to a Roth IRA, the amount that must be included in the individual's gross income is the amount that does not represent a return of after-tax income.[12] Generally, a taxable early distribution from a 401(k)

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plan is subject to an additional 10% tax.[13] However, this additional 10% tax on early distributions does *not* apply to qualified rollovers into a Roth IRA.[14]

Taxation of Rollover Amounts. An amount rolled over to a Roth IRA from any account in a 401(k) plan, other than a Roth account, generally results in taxable income. Amounts that were originally pre-tax deferrals or pre-tax contributions (including allocable earnings on both pre-tax and after-tax amounts) will be taxed when they are rolled over while after-tax contributions will not be taxed. Amounts rolled over to a Roth IRA from a designated Roth account under a 401(k) plan are not includible in the distributee's gross income, regardless of whether the distribution includes contributions or earnings.[15]

		Rollover Destination		
		Traditional IRA	*Roth IRA*	*Roth 401(k) Account*
Rollover Source	Before-Tax Account (Principal)	Taxed at Withdrawal	Taxed at Transfer	Taxed at Transfer
	Before-Tax Account (Earnings)	Taxed at Withdrawal	Taxed at Transfer	Taxed at Transfer
	After-Tax Account (Principal)	Taxed at Withdrawal*	No Tax	No Tax
	After-Tax Account (Earnings)	Taxed at Withdrawal	Taxed at Transfer	Taxed at Transfer
	Roth 401(k) Account (Principal)		No Tax	No Tax
	Roth 401(k) Account (Earnings)		No Tax	No Tax

*Net of the after-tax basis in the account.

Withholding of Rollover Amounts. An eligible rollover distribution that the employee elects to have paid *directly to an eligible retirement plan* (including a Roth IRA) is *not* subject to mandatory tax withholding, even if the distribution is includible in his gross income.[16] By contrast, an eligible rollover distribution that is distributed to *an employee* is generally subject to 20% mandatory withholding, even if the employee intends to roll over the amount in a traditional rollover.[17]

The following examples demonstrate the basic tax treatment of rollovers from a sample 401(k) plan into a Roth IRA. These examples all assume that the amount being rolled over is an eligible rollover distribution from the 401(k) plan to the individual's Roth IRA:

> Example 5: Jan defers $500 *pre-tax* into her pre-tax account in the sample 401(k) plan. That amount in her pre-tax account grows to $600. In 2011, Jan decides to roll over the $600 into a Roth IRA. The entire amount is taxable to Jan when it is rolled over.

> Example 6: Tom contributes $500 *after-tax* into his after-tax account in the sample 401(k) plan. That amount in his after-tax account grows to $600. In 2011, Tom decides to roll over the $600 into a Roth IRA. The $500 after-tax contribution is rolled over tax-free. The $100 earnings is taxable to Tom when it is rolled over.

Example 7: Kathy defers $500 into her Roth account in the sample 401(k) plan. That amount in her Roth account grows to $600. In 2011, Kathy decides to roll over the $600 into a Roth IRA. The entire amount is not taxable to Kathy when it is rolled over.

Allocation Rules

If the entire amount of a 401(k) account is rolled over into a Roth IRA, an allocation analysis is not required because it is already known that 100% of all pre-tax contributions, after-tax contributions, designated Roth contributions, and earnings are being rolled over. However, if only a portion of an individual's 401(k) account balance is rolled over into a Roth IRA and a portion is retained in the 401(k) plan, or if a portion is rolled over and a portion is taken as a distribution, it becomes necessary to characterize the amounts that are rolled over. Examples applying these situations to the sample 401(k) plan illustrate the complexities of the characterization analysis.

Full distribution that is partially rolled over into a Roth IRA and partially retained by the individual. In the situation where an individual's distribution is part pre-tax and part after-tax, and the individual receives part of the distribution and rolls over part of the distribution, the model safe harbor notice in IRS Notice 2009-68 provides two different characterization rules depending on whether the rollover is a direct or indirect rollover.

According to the IRS model notice, if the individual directly rolls over a portion of the distribution and also receives payment of a portion of the distribution, then the after-tax amount is allocated *on a pro-rata basis* to the direct rollover and to the amount received directly by the individual. However, if the individual takes a distribution of the entire amount and then elects to roll over part of the payment he receives, all pre-tax amounts are applied to the rolled over portion *before* any after-tax amounts.

This difference in treatment for direct rollovers, as opposed to indirect rollovers, has a substantial tax effect on rollovers into a *traditional IRA* because it affects overall tax liability, but does not change the overall tax liability for a rollover into a *Roth IRA* (because in an after-tax account, the taxation of contributions and earnings is the same regardless of whether the amounts are rolled over into a Roth IRA or taken as a cash distribution). However, for a rollover to a Roth IRA, the difference in treatment will have a substantial impact on the amount of required tax withholding, which affects the out-of-pocket costs for the individual.

Example 8: Joe is 62 years old and has a balance of $20,000 in his after-tax account, of which $16,000 is after-tax contributions and $4,000 is earnings on the contributions. Joe also has another $100,000 in pre-tax contributions and earnings in his plan account. Joe decides he would like to withdraw the entire $120,000, of which he will roll $110,000 over into his Roth IRA and take $10,000 in cash.

Option 1: Joe takes a distribution of the entire amount, of which $16,000 is after-tax and $104,000 is pre-tax. In this situation, $20,800 (20% of earnings—the pre-tax portion of the distribution) is withheld. Joe receives

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a distribution of $99,200. To roll over $110,000, Joe must then write a check, within 60 days, to the trustee of his Roth IRA for the full $110,000, with the excess amount over $99,200 coming out-of-pocket.

The pre-tax portions will be considered to be rolled over first. Thus, after depositing the check, Joe will be deemed to have rolled over $104,000 in pre-tax amounts and $6,000 in after-tax amounts. Because the rollover was to a Roth IRA, taxes became due on the entire pre-tax amount that Joe rolled over.

Joe is $10,800 out-of-pocket, and has paid $20,800 toward his income tax liability on $104,000 in ordinary income.

Option 2: Joe takes a distribution of $10,000 and directs a trustee-to-trustee transfer of $110,000 into the Roth IRA. Each form of distribution is allocated a pro-rata portion of the after-tax amount. As a result, 13.33% ($16,000/$120,000) of each form of distribution is after-tax and 86.67% ($104,000/$120,000) is pre-tax.

Of the $10,000 that Joe elects to receive directly, $1,333.33 is after-tax and $8,666.67 is pre-tax. The plan administrator withholds $1,733.33 (20% of the $8,666.67 pre-tax portion). Of the $110,000 that is rolled over directly, $14,666.67 is after-tax and $85,333.33 is pre-tax. Because the rollover was to a Roth IRA, taxes became due on the entire pre-tax amount that Joe rolled over. Joe has pocketed $8,266.67 and has paid $1733.33 toward his income tax liability on $104,000 in ordinary income.

Under both Option 1 and Option 2, Joe rolled over $110,000 and has $104,000 in ordinary income. The critical difference shows up in Joe's cash flow. In Option 1, Joe has paid $10,800 out-of-pocket to the IRS, while in Option 2, Joe has pocketed $8,266.67 from the distribution. Of course, when his income tax return is due, in Option 1, Joe will already have $20,800 credited toward his tax liability, whereas in Option 2, he will only have $1,733.33 credited toward his tax liability.

Partial distribution that is rolled over into a Roth IRA. Although the model notice in IRS Notice 2009-68 did not explicitly address the application of allocation rules to a partial distribution to a Roth IRA, the IRS addressed the issue in the Spring 2010 *Employee Plans News*[18]. For pre-1987 after-tax contributions, an individual may choose to roll over *just the after-tax amounts* (without earnings) into a Roth IRA. However, for after-tax contributions made in 1987 and later, the amounts are rolled over on a pro-rata basis using the following formula:

$$\text{After-tax amount} = \frac{\text{after-tax contributions in your plan account(s)}}{\text{value of your plan account(s)}} \times \text{amount distributed}$$

For "value of your plan account(s)", the IRS defines "value" as being *"the total of your plan account(s) at the time of the distribution, but does not include the value of any of the plan's* *designated Roth accounts.*"[19] The most straightforward reading of this provision is that "value of your plan account(s)" includes the total amount in *all* of the participant's accounts in the plan at the time of the distribution, not just the specific account from which the withdrawal is being made. This interpretation mirrors the explanation for rollovers from IRAs which requires a participant to aggregate all of his IRAs when determining the ratio of pre-tax to after-tax amounts in his IRAs.[20] Unfortunately, this interpretation could create a potential conflict between the Plan's withdrawal ordering rules and the IRS' allocation rules. The following example illustrates the potential conflict using the ordering rules for the sample 401(k) plan:

> Example 9: Sue is 62 years old and has a balance of $10,000 in her after-tax account in the sample 401(k) plan, of which $7,000 is after-tax contributions (all made after 1986) and $3,000 is earnings on the contributions. She has a total of $200,000 in all her other accounts. The additional $200,000 is all pre-tax dollars, and she has no amount in any rollover account.
>
> Sue decides she would like to withdraw $5,000. According to the ordering rules, she must withdraw the $5,000 first from her after-tax account. Under the above interpretation, the formula would be applied as follows: After-tax amount = ($7,000 / $210,000) x $5,000 = $166.67
>
> With respect to the $5,000 distributed to Sue, $166.67 would be after-tax dollars and $4,833.33 would be pre-tax dollars. But there are only $3,000.00 pre-tax dollars (earnings) in her after-tax account, so some pre-tax dollars must come from a different ledger account, which would violate the 401(k) plan's ordering principles.

The IRS guidance does not indicate how such a conflict should be resolved. Instead, another way to interpret this provision is to have the provision apply *only to the account (or sub-account) from which amounts are actually withdrawn.* Under this second interpretation, the above calculation with respect to Sue would change as follows:

> Example 10: Sue is 62 years old and has a balance of $10,000 in her after-tax account of which $7,000 is after-tax contributions (all made after 1986) and $3,000 are earnings on the contributions. She has a total of $200,000 in all her other accounts. The additional $200,000 is all pre-tax dollars, and she has no amount in any rollover account.
>
> Sue decides she would like to withdraw $5,000. According to the ordering rules, she must withdraw the $5,000 first from her after-tax account. Under the above interpretation, the formula would be applied as follows: After-tax amount = ($7,000 / $10,000) x $5,000 = $3,500.
>
> With respect to the $5,000 distributed to Sue, $3,500 would be after-tax dollars and $1,500 would be pre-tax dollars. That would leave $3,500 in after-tax dollars and $1,500 in pre-tax dollars in the after-tax account.

Although the second interpretation resolves the conflict and is generally more tax-advantageous to the individual, it appears to conflict with the plain text of the IRS newsletter. Furthermore, other IRS guidance indicates that this treatment is permissible *only if* a 401(k) plan meets the "separate contract exception."[21] If the 401(k) plan cannot be shown to meet the separate contract exception (described below) then the individual may want to consider a rollover distribution of the entire account, rather than a partial distribution, in order to avoid allocation problems.

Separate Contract Exception. The separate contract exception allows *employee contributions* to be treated as a separate account for purposes of the allocation rules.[22] The following requirements must be met in order to qualify for this exception:[23] (i) employee contributions and their associated earnings (the "separate contract") must be accounted for *separately* from all other amounts in the participant's account (the "principal contract"); (ii) the plan may have *only one separate account*;[24] (iii) the plan may not retroactively create a separate account; and (iv) the plan (or plan procedures) must either specify the contract from which distributions are to be made or permit participants to designate the contract from which a requested distribution is to be made. Under the separate contract exception, the formula to be applied would be as follows:

$$\text{After-tax amount} = \frac{\text{after-tax contributions in the Separate Contract}}{\text{Total value of the Separate Contract}} \times \text{amount distributed}$$

The sample 401(k) plan could potentially meet the four requirements to qualify for the separate contract exception. It meets the first requirement that employee contributions and their associated earnings under the 401(k) plan are accounted separately.

The second requirement to qualify for the separate contract exception is that a 401(k) plan may have *only one separate account*. Although a Participant's benefit under the sample 401(k) plan is comprised of more than two ledger accounts, it could still be grouped as two contracts to comply with the separate contract exception[25] (*i.e.*, a separate contract consisting of the after-tax account and a principal contract comprised of all other ledger accounts or, alternatively, a separate contract consisting of the combined after-tax account and after-tax rollover account and a principal contract comprised of all other ledger accounts).

Note: A designated Roth account (which is aggregated with any Roth rollover account[26]) is considered to be a separate contract.[27] As a result, it appears that if the 401(k) plan had a Roth account, a separate contract consisting of the after-tax account would be considered a *second* separate account.

The end result of such a grouping under the sample 401(k) plan would be that (1) the after-tax account and any after-tax rollover subaccount are aggregated into the only separate contract, and (2) all other accounts are aggregated into the principal contract. The following two allocation formulas would then apply:

$$\text{After-tax amount} = \frac{\text{after-tax contributions in the separate contract}}{\text{total value of the separate contract}} \times \text{amount distributed}$$

$$\text{After-tax amount} = \frac{\text{after-tax contributions in the Principal Contract}}{} \times \text{amount distributed}$$

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total value of contributions in the Principal Contract

If the separate contract exception applies, the rollover rules for direct rollovers into a Roth IRA as described in the Spring 2010 *Employee Plans News* should not apply. The discussion of rollovers into Roth IRAs in the Spring 2010 *Employee Plans News* is informal guidance and is not a comprehensive treatment of the subject matter; consequently, its failure to include a discussion of the applicability of the separate contract exception does not necessarily mean that the separate contract exception is unavailable. Rather, because the separate contract exception is generally applicable to withdrawals from defined contribution plans, and there is no rule that excludes direct rollovers to Roth IRAs from using this exception, it may be reasonable to apply the separate contract exception to a direct rollover that is made from the sample 401(k) plan to a Roth IRA.

Conclusion

A rollover into a Roth IRA could offer a 401(k) plan participant the opportunity to significantly increase the earning potential of his account. The advantages of a Roth IRA are: (1) a rollover into a Roth IRA allows for more present-value wealth to be rolled over than does a rollover into a traditional IRA (the full amount can be rolled over on an after-tax basis with the taxes being paid from funds outside the transfer); (2) a rollover into a Roth IRA allows all future earnings to grow on a *tax-free* basis as opposed to *tax-deferred* basis as with future earnings in a traditional IRA; (3) a rollover into a Roth IRA allows earnings to grow for a longer period of time because the Roth IRA is not subject to the age 70½ minimum distribution rules that apply to traditional IRAs and qualified retirement plans.

To make an informed decision whether to elect a rollover into a Roth IRA, the individual should first understand how both the IRS's and the 401(k) plan's allocation rules will interact. These allocation rules will impact how the rollover amounts are taxed as well as the available cash flow of the individual. While the allocation rules are fairly straightforward for rollover amounts of the entire account balance, they can be tricky when there is only a rollover of a partial distribution or a partial rollover of a full distribution. The IRS, in informal guidance, has described the allocation rules that are likely to conflict with the ordering rules in most 401(k) plans. Because there are several ways to interpret the IRS's explanations in conjunction with its previous guidance in this area, individuals should proceed with caution when making a partial rollover or rollover of a partial distribution to a Roth IRA, particularly from a 401(k) plan with ordering rules.

[1] IRS Notice 2009-75, Part III Q&A-2(a).

[2] IRS Notice 2009-75, Part III Q&A-2(a).

[3]Code Section 408A(d)(2); *see* Code Section 408A(d)(2)(A) for additional situations that qualify as a qualified distribution.

[4] Code Section 408A(c)(5). Distributions are mandatory for the non-spousal beneficiary of an inherited Roth IRA.

[5] As defined in Code Section 402(f)(2)(A); (Generally, a distribution, including an in-service withdrawal, is an eligible rollover distribution unless it is (a) a hardship withdrawal, (b) a required minimum distribution under Code Section 401(a)(9) or (c) one of a series of substantially equal periodic payments for life or a specified period of ten years or more. With the exception of after-tax employee contributions, an eligible rollover distribution also does *not*

include the portion of any distribution that is not includable in gross income, as determined without regard to the exclusion for net unrealized appreciation with respect to any employer securities.).

[6] As defined in Code Section 402(c)(8)(B).

[7] Code Section 408A(e)(1)(B)(ii); Notice 2008-30 Q&A-4.

[8] Code Section 401(a)(31)(A); Treas. Reg. §1.401(a)(31)-1 Q&A-9.

[9] Treas. Reg. § 1.401-1(b)(1)(ii); Rev. Rul. 71-295; *See also* Rev. Rul. 73-553.

[10] *See* IRS Gen. Couns. Mem. 35,635, (Jan. 1, 1974), fn 2 ("There is no comparable tax abuse [of Treas. Reg. § 1.401-1(b)(1)(i)] when employees take distributions of their own mandatory contributions to a pension plan upon termination of their participation in the plan, since future benefits purchased by the employee contributions are purchased with 'after tax' dollars.")

[11] In other words, a $10,000 balance in a Roth IRA is more valuable than a $10,000 pre-tax balance in a traditional IRA; the Roth IRA has a present tax-adjusted withdrawal value of $10,000 whereas the traditional IRA has a present tax-adjusted withdrawal value of less than $10,000.

[12] *See* IRS Notice 2009-75, Sec. III., Q&A-1 ("...the amount included in gross income is equal to the amount rolled over, reduced by the amount of any after-tax contributions that are included in the amount rolled over..."); *see also* Joint Committee on Taxation, Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as passed by the House on July 28, 2006, and as considered in the Senate on August 3, 2006 (JCX-38-06), August 3, 2006, at 174.

[13] Code Section 72(t).

[14] Code Sec. 408A(d)(3)(A)(ii).

[15] IRS Notice 2009-75, Sec. III., Q&A-1.

[16] IRS Notice 2008-30 Q&A-6; Treas. Reg. § 1.401(a)(31)-1, Q&A 5.

[17] Code Section 3405(c); IRS Notice 2008-30 Q&A-6. In either a direct rollover to a Roth IRA or a distribution to the Participant, the Participant and the Plan Administrator could enter into a voluntary withholding agreement to withhold more than the required amount, but a Participant may not waive the mandatory 20% withholding when required. IRS Notice 2008-30 Q&A-6; Code Section 3402(p).

[18] Employee Plans News is only informal guidance that is published by the Internal Revenue Service Tax Exempt and Government Entities Division on a quarterly basis. While such guidance is not binding on the IRS or taxpayers, it may provide useful insight into how the IRS could interpret similar scenarios.

[19] *See*, Spring 2010 *Employee Plans News.*

[20] *See*, Spring 2010 *Employee Plans News.*

[21] Code Section 72(d)(2).

[22] Code Section 72(d)(2)("Treatment of employee contributions under defined contribution plans. For purposes of this section, employee contributions (and any income allocable thereto) under a defined contribution plan may be treated as a separate contract."). Under IRS Notice 87-13, Q&A-14, for purposes of applying the allocation rules to a defined contribution plan, "contract" means a separate account under the plan.

[23] IRS Notice 87-13 Q&A-14.

[24] With respect to this issue, IRS Notice 87-13 provides as follows: "A plan may have only one separate contract under section 72(e)(9). Thus, for example, if a plan is otherwise treated as a single contract under section 72, a plan may not be treated as comprising more than two contracts: a separate 72(e)(9) contract for employee contributions (and earnings thereon) and a contract for the remaining portion of the plan (including, for example, employer contributions (and earnings thereon), employer matching contributions (and earnings thereon), and any employee contributions (and earnings thereon) that have not been accounted for separately and thus are not included in the separate 72(e)(9) contract). Furthermore, a plan may not create a separate 72(e)(9) contract for the employee

contributions (and earnings thereon) for each year of plan participation." Note: The Technical and Miscellaneous Act of 1988 ("TAMRA") redesignated Code Section 72(e)(9) as Code Section 72(d).

[25] This type of grouping was permitted by the IRS under PLR 200243054. A Private Letter Ruling ("PLR") may not be relied upon as precedent by anyone other than the taxpayer that requested it. However, PLRs often provide useful insight as to the position the IRS may take in a similar tax matter.

[26] Treas. Reg. § 1.402A-1 Q&A-9(a).

[27] *See* Treas. Reg. § 1.402A-1 Q&A-3 "For this purpose, a designated Roth account is treated as a separate contract under section 72."

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By Richard A. Behrendt

Transfer of Interest in FLPs

Former auditor offers a renewed look at how the IRS identifies and develops issues in family limited partnership audits

Fewer estates are now subject to federal estate taxes, thanks to the $5 million federal estate tax exemption. Internal Revenue Service data indicates that only 8,239 estates larger than $5 million filed a federal estate tax return in 2009, the most recent year for which data is available.[1] In sharp contrast, more than 108,000 federal estate tax returns were filed nationwide as recently as 2001.

However, the smaller number of estate tax returns filed for deaths in 2011 and 2012 will be subject to a heightened level of government scrutiny as IRS auditors comb through a declining inventory of estate tax returns to audit. In particular, the estate tax returns filed for decedents who owned an interest in a family limited partnership (FLP) or similar discounted entity are now virtually guaranteed to receive a thorough examination.

Against this backdrop of increased IRS scrutiny of FLPs, a renewed look at how the IRS identifies and develops issues in FLP audits is warranted. In the following analysis, I'll attempt to draw on several dozen FLP audits I conducted during my tenure as an IRS auditor from 1994 through 2006 (note that the official title of an IRS auditor for estate and gift tax returns is "estate tax attorney.")

Initiating the Exam

Generally, FLP cases are assigned to journeymen IRS auditors who have at least five years of audit experience. These cases are among the most difficult field examinations, often requiring a year or more of factual development and research.[2] Throughout the examination process, the auditor's objective is to identify issues that may support an assertion of Internal Revenue Code Section 2036, the rule governing the transfer of assets with a retained life estate, to disregard the FLP for federal estate tax purposes.

An examination of an estate tax return that includes an FLP audit issue is typically initiated by mailing a five-to-10 page request for additional information to the taxpayer's representative. The auditor may request any of the following items that weren't attached to the original estate tax return:

- All correspondence, including emails, letters and memos discussing, recommending or explaining the estate tax savings or benefits of forming a partnership (or other discounted entity).[3]
- All billing records pertaining to any legal work performed for the decedent during the period beginning 12 months prior to the formation of the partnership and ending on the date-of-death.[4]
- The original partnership agreement and all amendments.
- If the general partner is a corporation or a limited liability company (LLC), the articles of incorporation or operating agreement of the general partner and all amendments.
- Date-stamped certificates of the limited partnership or similar documents prepared to meet state law requirements for the formation of the partnership.
- Date-stamped letters of authorization to create a partnership brokerage account and transfer securities to the partnership account.
- Letters of confirmation that securities were transferred to the partnership.
- Complete monthly brokerage statements for all assets transferred to the partnership, covering two years prior to formation of the partnership, through the funding of the partnership and continuing

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through the date of the request for additional information.

- Complete monthly bank statements for all partnership accounts covering the period of formation of the partnership through the date of the request for additional information.
- All records of partnership meetings and copies of all meeting minutes.
- All of the tax returns prepared and filed on behalf of the partnership during its existence.
- A complete list of the decedent's recurring monthly expenses covering the period starting with the formation of the partnership and continuing through the date of death.
- Complete medical records of the decedent for up to two years prior to the partnership formation through the date of death.

It wouldn't be uncommon for this litany of requested items to yield several storage boxes full of additional documents. On rare occasions, an auditor will also request an interview with one or more of the decedent's surviving family members. As invasive as some of these requests may seem (particularly the request for medical records), they're authorized under the broad investigative powers conferred upon the IRS to examine books and witnesses.[5]

In the FLP audits I oversaw during my tenure at the IRS, it was rare that I wouldn't be able to cobble together a handful of "bad facts" to support an argument that IRC Section 2036 applied in any given case. Tax practitioners often fail to anticipate that no matter how strongly they coach or advise the client and family members to adhere to the formalities and bona fides of an arm's length relationship in all dealings with the entity, it only takes a few incidents of seemingly innocuous irregularities for the IRS to build a case that a transfer didn't meet the requirements for the bona fide sale exception to Section 2036.

Section 2036

By the mid-1990s, the IRS became concerned that FLPs were gaining popularity as the preferred technique for reducing federal estate taxes. Initially, the IRS asserted multiple theories to disregard FLPs, including common law doctrines such as gift-on-formation, step-transaction, lack of economic substance and substance over form, as well as IRC Sections 2036 and 2038 and the special valuation rules of IRC Sections 2703 and 2704. By the early 2000s, however, the IRS' effort against FLPs became more tightly focused on Section 2036.

By the early 2000s, the IRS' effort against FLPs became more tightly focused on Section 2036.

Section 2036 provides:

> (a) General Rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

The Tax Court's application of Section 2036 in FLP cases has evolved over the last 10 to 15 years. In early

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FLP cases, the court began its Section 2036 analysis by inquiring whether the decedent had retained the use or enjoyment of, or income from, the property transferred to the FLP. It was only after the use or enjoyment inquiry was completed that the court went on to inquire whether the bona fide sale exception to Section 2036 was applicable. (In the first FLP case decided by the Tax Court under Section 2036, *Schauerhamer v. Commissioner*,[6] the court focused exclusively on the retained use or enjoyment analysis and didn't discuss the bona fide sale exception.) Even as *Strangi v. Comm'r* made its way back and forth between the Tax Court and the U.S. Court of Appeals for the Fifth Circuit from 2000 through 2005, the analysis focused primarily on the "retained the use or enjoyment of" inquiry, with discussion of the bona fide sale test appearing only as an afterthought. A pivotal change occurred when the court reversed the ordering of its Section 2036 analysis and began leading with the inquiry whether the bona fide sale exception to Section 2036 applied to a subject case. The court initially adopted this approach in *Stone v. Comm'r*,[7] but it was in *Bongard v. Comm'r*, that the court fully embraced the efficiency of beginning its analysis with the bona fide sale test.

This *Bongard* framework of Section 2036 is a two-prong analysis; with each prong further divided into two respective subparts. Under this structure, lifetime transfers of property to an FLP are includible in the transferor's gross estate under Section 2036 if:

(1) the transfer was not
- a bona fide sale,
- for adequate consideration, and

(2) the decedent retained
- the use or enjoyment of the transferred property, or
- control over the transferred property.

The first prong provides an exception to the general rule of inclusion found in the second prong. If the facts and circumstances support a determination that the transfer satisfies the bona fide sale for adequate consideration exception, the transaction is removed from the ambit of Section 2036, and there's no need to further inquire whether the decedent retained the use or enjoyment of, or control over, the transferred property. Conversely, if it's determined that a transfer doesn't satisfy the bona fide sale exception, the Section 2036 analysis will continue, with the inquiry shifting to whether the decedent retained the use and enjoyment of, or the control over, the transferred property.

In practice, the adequate consideration issue is merely a sub-category of the broader bona fide sale inquiry. If each initial partner receives an ownership interest in the FLP proportionate to his capital contribution, adequate consideration is satisfied, but the transaction must still qualify as a bona fide sale. If ownership interests aren't proportionate to capital contributions, the transaction won't qualify as a bona fide sale.[8] In other words, the absence of adequate consideration will be problematic in an FLP controversy, but its presence doesn't substantively help circumvent Section 2036.

Also, while Section 2036(a)(2) could theoretically trigger inclusion of the transferred property in the decedent's gross estate if the decedent retained even a thin sliver of the general partnership or other controlling interest in the entity, it seems unlikely that the IRS will rely exclusively on Section 2036(a)(2) to disregard the partnership. Instead, the decedent's retention of some or all of the controlling interest will be treated as secondary to an argument that Section 2036(a)(1) is applicable.

Accordingly, we may pare Section 2036 down even further to its root elements as the following two-part test. Lifetime transfers of property to an FLP are includible in the transferor's gross estate under Section 2036 if:

- the transfer was not a bona fide sale, and
- the decedent retained the use or enjoyment of the transferred property.

This streamlined, two-prong application of Section 2036 represents something of a synthesis in the Tax Court's evolving application of Section 2036 to FLP controversies. Since it appears reasonably likely that the court will continue applying Section 2036 in this manner, an analysis of each separate component of this two-prong analysis may be instructive.[9]

Bona Fide Sale

The good news for taxpayers and practitioners is that starting the Section 2036 analysis with the bona fide sale provides an opportunity for an early exit from the ambit of the statute. The bad news is that the Tax Court

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has set the bar rather high regarding what facts and circumstances surrounding the formation, funding and administration of the entity will support a finding that the taxpayer has satisfied the bona fide sale test. In *Bongard*, the court stated that the bona fide sale test will be satisfied if the record shows that:

- there was a legitimate and significant non-tax reason for creating the partnership;
- the non-tax reason was a significant factor that motivated the partnership's creation; and
- the significant non-tax reason was an actual motivation, not just a theoretical justification.

This standard harkens back to the traditional business purpose doctrine of *Gregory v. Helvering*,[10] which has been described as "an instinctive judicial attitude that a transaction should not be given effect for tax purposes unless it serves a purpose other than tax avoidance."[11]

It can be argued that it's an example of judicial fiat for the Tax Court to read a business purpose into the bona fide sale exception, but the reality is that the IRS will follow the standard established by the court in *Bongard* and its progeny. The facts and circumstances surrounding the planning, formation, funding and administration of the entity will determine whether the bona fide sale exception is satisfied and the task of establishing legitimate and significant non-tax purposes for creating the entity will be especially challenging when the entity is funded primarily or exclusively with marketable securities and other liquid assets.

FLPs that are created for substantive non-tax purposes should have no trouble clearing the hurdle of the bona fide sale test. In so doing, they will avoid inclusion of the transferred assets in the decedent's gross estate at undiscounted values under Section 2036. In contrast, FLPs created solely to obtain valuation discounts on passive investments will continue to face IRS scrutiny. Moreover, boilerplate language in the governing instrument purporting that the entity was created for non-tax purposes shouldn't be expected to carry the day. Purported non-tax purposes that tend to appear more theoretical than actual include:

Centralized management. This may be an unpersuasive non-tax purpose for forming an FLP if the record indicates that the assets transferred to an FLP could have been managed just as efficiently in a common trust. In *Rosen v. Comm'r*, the Tax Court concluded,

> [A]s to petitioners' claim that the LRFLP was formed to create centralized management, decedent had centralized management through the Lillie Investment Trust. The Lillie Investment Trust held almost all of decedent's assets and allowed her (or a successor) to manage and control her assets in full.[12]

Furthermore, centralized management will ring particularly hollow as a non-tax motive for forming an FLP if the partnership is funded entirely with passive assets. Thus, in *Rosen*, the court added,

> [E]fficient management might count as a credible non-tax business purpose, but only if the business of the FLP required some kind of active management as in *Kimbell*. In that case, the Fifth Circuit concluded that the working interests in the decedent's oil and gas properties required active management, which the partnership enhanced because it allowed the participant family members to pool resources, reduce administrative costs and protect the family concern in case the decedent's son, who possessed the business expertise, grew too ill to manage the business.[13]

Recently, the court in *Mirowski v. Comm'r* accepted centralized management as a legitimate, non-tax purpose for forming a discounted entity; however, *Mirowski* might prove to be more of an anomaly than the "good facts" case that it was hailed as by several commentators.

I may be speculating, but it seems quite possible that the IRS in *Mirowski* failed to collect crucial evidence during the critical stage of developing its factual case at the examination level of the audit process. The auditor may have believed that this case was a "slam dunk" Section 2036 case when the following timeline was revealed. As indicated in the published opinion, the decedent executed an agreement to create a single member LLC on Aug. 27, 2001, was admitted to a hospital on Aug. 31, 2001, transferred over $60 million in marketable securities to the LLC on Sept. 5-7, 2001, gifted a

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16 percent interest in the LLC to each of her three daughters on Sept. 7, 2001 and died "unexpectedly" on Sept. 11, 2001.

On the surface, this timeline seems to point to a classic "death-bed" transaction, which may have lulled the auditor into thinking that obtaining a copy of medical records wasn't necessary. This oversight may have been a critical mistake allowing the estate's representatives to persuade the court that the decedent's death was unexpected. The court concluded that,

> [A]t no time before September 10, 2001, when Ms. Mirowski's condition unexpectedly deteriorated significantly, did Ms. Mirowski, her family or her physicians expect her to die and that consequently at no time did Ms. Mirowski and her daughters discuss or anticipate the estate tax and similar transfer taxes and other estate obligations that would arise only as a result of Ms. Mirowski's death.[14]

A skeptic would ask: If Mirowski's death was unexpected, what compelled lawyers to bring stacks of legal documents to her hospital room to implement a complicated strategy to create an LLC, transfer over $60 million dollars worth of assets to the entity and immediately gift 48 percent of the discounted LLC units to her three daughters, incurring nearly $12 million in gift taxes in the process?

Again, this is pure speculation, but if the auditor had obtained copies of the decedent's complete medical records, the government may have been able to make a stronger case that Mirowski's medical outlook was much more serious when she was admitted to Johns Hopkins Hospital on Aug. 31, 2001.[15] Without medical records, the government wasn't able to develop a strong nexus among the following facts: (1) Mirowski had been diagnosed with diabetes in 1989, (2) she developed foot blisters while wearing tight shoes on a walking tour through Europe in early 2001, (3) after the foot blisters turned to ulcers, her physician informed her that amputation was among the possible treatments if the ulcers failed to heal, (4) she informed her physician that amputation was out of the question, and (5) she subsequently died of sepsis (blood poisoning). The government's failure to establish a direct correlation between these facts and the creation, funding and gifting of the LLC is where the government's Section 2036 case was lost.

Creditor protection. This is among the most frequently cited non-tax reasons for forming an FLP, but may not succeed as a legitimate, non-tax motive for forming an FLP for two reasons. First, the IRS may reject creditor protection as a non-tax purpose for forming the FLP if there's no factual record indicating that the decedent had any substantive reason to be concerned about creditors. As the court stated in the *Rosen* case,

> As we understand petitioners' factual position as to this claim, the LRFLP was formed so that someone could not sue decedent and foreclose on her assets for payment of a judgment against her. From a factual point of view, however, the record is devoid of persuasive evidence that the LRFLP was formed with any such intent. Nor do we find that Feldman informed either of decedent's children, before they signed the LRFLP agreement, that the LRFLP was meant to limit the liability of decedent or any other limited partner ... While Feldman stated that decedent, like any other individual, always faced the risk that she could be sued on account of her actions, we are unpersuaded by this statement of mere general applicability that limiting decedent's personal liability was an actual purpose for forming the LRFLP. Instead, we hear that statement as nothing more than a theoretical justification for the formation of a limited partnership.[16]

Similarly, in *Bigelow v. Comm'r*, the decedent was bedridden and a resident of an assisted living facility when the partnership was formed. This led the Ninth Circuit to determine that the decedent had no "genuine exposure to liability that might have validated the partnership formation for a non-tax purpose."[17]

Second, several reported bankruptcy decisions have called into question the basic premise that an FLP (or LLC) provides any creditor protection at all to its limited partners.[18] Careful drafting that adds additional layers of protection in the partnership agreement might negate this latter point, but that would do

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nothing to address the former point, that is, creditor protection falls flat as a non-tax purpose if there's no factual record indicating that the transferor reasonably anticipated having substantive creditor concerns.

Gifting. Although a reasonable argument can be made that an FLP facilitates gifting, particularly in the situation in which a donor is making gifts to a large pool of donees that might include grandchildren and even great grandchildren, gifting doesn't appear to rise to the level of a non-tax purpose that would satisfy the business purpose test. This stance led the Tax Court to note in *Rosen* that,

> [A]s to petitioners' claim that the LRFLP was formed to facilitate decedent's gift giving and to preserve the value of her gifts, even if gift giving were an actual reason for the LRFLP's formation, it is not a significant nontax purpose that could characterize the transfer of decedent's assets to the LRFLP as a bona fide sale.[19]

The Ninth Circuit was even more dismissive of gifting as a non-tax purpose for forming an FLP in *Bigelow*: "[G]ift giving is considered a testamentary purpose and cannot be justified as a legitimate, non-tax business justification."[20]

Again, the Tax Court accepted gifting as one of three legitimate, non-tax purposes for forming the entity in *Mirowski*,[21] but *Mirowski* may be an anomalous case for the reasons stated above.

Retained Use or Enjoyment

If the bona fide sale exception to Section 2036 hasn't been triggered, the next hurdle will be whether the decedent retained the use or enjoyment of the transferred property. The IRS isn't required to establish that there was an express agreement for retained use or enjoyment of the transferred property. Rather, an implied agreement inferred from the facts and circumstances is enough to sustain the application of Section 2036(a)(1).

Motivated IRS auditors will cast a wide net when tackling the factual development needed to support an assertion that there was an implied agreement among the partners that the decedent retained the use or enjoyment of the transferred property.

The following red-flag issues will determine whether Section 2036 is applicable to a decedent's transfer of property to an FLP:

- Was the transferor of advanced age and/or in declining health at the time of the formation and funding of the FLP?
- Were all, or nearly all, of the transferor's assets transferred to the FLP, so that there were insufficient assets outside of the partnership to pay recurring living expenses?
- Were any personal-use assets placed in the partnership?
- Was there a lack of genuine pooling of assets by the initial partners?
- Was there a lack of meaningful negotiation between the partners regarding of the terms of the partnership agreement during the planning stage?
- Were there any unreasonable or unexplained delays in the funding of the partnership?
- Were partnership assets ever commingled with the decedent's personal assets?
- Were any non-pro rata partnership distributions made during, or after, the decedent's lifetime?
- Were any partnership distributions made in violation of the terms of the partnership agreement?
- Was there a lack of substantive change in the investment policy after the partnership was created and funded?
- Was there a lack of recorded partnership meetings and/or minutes?
- Were there correspondence, emails, notes, memoranda or illustrations indicating that the formation of the FLP was motivated by efforts to reduce or eliminate estate tax?
- Were direct or indirect distributions made from the partnership to pay estate taxes and administrative expenses?

As the affirmative answers to these questions accumulate, the more evidence there will be of an implied agreement that the decedent retained the use or enjoyment of the transferred property and the harder the IRS will push an assertion of Section 2036(a)(1).

Recommendations

The impact of federal estate taxes can often be

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mitigated for the moderately wealthy by using non-controversial strategies, such as a regular gifting program, irrevocable life insurance trusts and qualified personal residence trusts. For high-net-worth clients who are willing to accept the heightened level of audit scrutiny anticipated under the current $5 million estate tax exemption amount, FLP planning is still a viable strategy for reducing federal estate taxes, but more care than ever is needed in implementing the plan.

The best practice in FLP planning may be to create the entity, fund it and immediately remove all own-

If the decedent doesn't own an interest in the discounted entity, the IRS can't apply Section 2036.

ership interest in the entity from the client's estate. If the decedent doesn't own an interested in the discounted entity, the IRS can't apply Section 2036, which is an estate tax rule, to pull the transferred assets back into the decedent's gross estate at their undiscounted values. For example, a married couple can remove nearly $15 million of discounted partnership interest from their combined estates under the current exemption amount by reducing the fair market value of the partnership by a combined 33 percent discount for lack of marketability and lack of control.

Additional steps that can minimize the audit risk inherent in FLP planning include:

- **Sales to intentionally defective grantor trusts.** As an alternative to gifting an ownership interest in a discounted entity during lifetime, the interest may be sold to an intentionally defective grantor trust in exchange for a promissory note. Again, the key here is that no ownership interest in the discounted entity will be includible in the decedent's gross estate, which precludes the application of Section 2036.[22]

- **Adequate disclosure of lifetime gifts.** Prior to 1997, the IRS could propose adjustments to lifetime transfers as part of an audit of the transferor's estate tax return, even if the lifetime transfer had been reported on a gift tax return filed more than three years prior to the transferor's death. Under the Taxpayer Relief Act of 1997, IRC Section 6501(c)(9) was amended to provide that the three-year statute of limitations on reported gifts doesn't begin unless the gift is "adequately disclosed" on a gift tax return. However, providing adequate disclosure of the gift precludes the IRS from taking a "second look" at the disclosed gifts, either on a subsequent gift tax return, or on the donor's federal estate tax return, after the three-year statute of limitations on the gift tax return has lapsed. Complying with the adequate disclosure requirements found in the final regulations under Section 6501 will protect the three-year statute of limitations on reported lifetime transfers of an interest in an FLP, as well as other hard-to-value assets.

- **Qualified appraisals.** Commissioning a qualified appraiser to value the transferred interest in the discounted entity, whether the interest is transferred during lifetime or at death, is critically important. If there aren't enough "bad facts" to trigger inclusion of the transferred assets under Section 2036, the IRS may still challenge the size of the combined discounts for lack of control and marketability. The appraiser should be accredited with the American Society of Appraisers or have similar credentials, and all valuation reports should be prepared in accordance with the Uniform Standards of Professional Appraisal Practice.[23]

- **Pragmatic dealings with the IRS.** During the course of any estate or gift tax audit, there are at least three reasons to cooperate with the IRS and respond timely to reasonable requests. First, this may help move the audit toward a pragmatic resolution of unresolved issues. Second, Treasury Department Circular No. 230 mandates that attorneys, accountants and enrolled agents must adhere to certain duties and restrictions to practice before the IRS.[24] Third, in the rare gift or estate tax case that leads to a Tax Court trial, dealing

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with the IRS in a cooperative manner shifts the burden of proof to the IRS on all factual matters.[25]

- **Settling an FLP case at the examination level.** Technically, IRS auditors aren't authorized to "settle" cases at the examination level of an IRS audit. The official charge of an auditor is to develop issues, propose adjustments and transfer "unagreed" cases to the Appeals Division. If an "impartial" appeals officer can't settle the case, it will be docketed for review in the Tax Court. In practice, however, more pragmatic estate tax auditors should be open to discussions that might lead to a resolution of all disputed issues at the examination level. In my 12 years as an auditor, there were fewer than 10 cases I couldn't resolve in examination, but I also knew of colleagues who would be unwilling to budge on proposed adjustments and would routinely send cases to the Appeals Division. My goal was to make good use of limited government resources by efficiently closing cases without the involvement of the Appeals Division, let alone the expense and delay of a Tax Court proceeding. As with any negotiated controversy, if both sides believe there's risk if a case goes to trial, a compromise is likely to be in everyone's best interest.

If FLP planning is part of an overall strategy to minimize the impact of federal estate taxes, practitioners and high-net-worth clients should recognize that the IRS will be closely scrutinizing estate and gift tax returns reporting transfers of these entities. Taking some of the steps outlined above may help taxpayers withstand the heightened audit scrutiny that's anticipated.

Endnotes

1. *See* "Tax Stats" at *www.irs.gov/taxstats.*
2. Auditors typically receive estate tax returns nine-to-12 months after the return has been filed, often leaving less than two remaining years on the three-year statute of limitations to assess additional tax under Internal Revenue Code Section 6501.
3. Illustrations quantifying how much federal estate tax can be saved using a family limited partnership (FLP) places the taxpayer's representative in the difficult position of asserting that the FLP was formed for non-tax purposes.
4. Billing records can be particularly problematic for the estate if the records indicate that efforts to form the partnership followed closely upon a diagnosis of a life-threatening illness.
5. IRC Section 7602.
6. *Schauerhamer v. Commissioner,* T.C. Memo. 1997-242.
7. *Stone v. Comm'r,* T.C. Memo. 2003-309.
8. The U.S. Court of Appeals for the Fifth Circuit may have created some confusion on this issue, laboring through a lengthy analysis of the adequate consideration test in *Kimbell v. United States,* 371 F.3d 257 (5th Cir. 2004).
9. The court has occasionally departed from the *Bongard* framework, such as in *Malkin v. Comm'r,* T.C. Memo. 2009-212.
10. *Gregory v. Helvering,* 293 U.S. 465 (1935).
11. Boris I. Bitker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (5th ed. 1987), at par. 14.51.
12. *Rosen v. Comm'r,* T.C. Memo. 2006-115.
13. *Ibid.*
14. *Mirowski v. Comm'r,* T.C. Memo. 2008-74.
15. Obviously, government requests for a deceased taxpayer's medical records will seem like an intrusion into the most delicate taxpayer privacies, but it's often a necessary part of the factual development of a federal estate tax audit. As an anecdote, in one estate tax audit I conducted, I not only obtained complete medical records indicating the taxpayer's declining health leading up to a particular transaction, but also I requested an actual tissue sample from the decedent's archived medical file to be analyzed by a medical expert I had hired for the government. The issue in that case was whether there was a less than 50 percent probability that the taxpayer would have survived more than one year from the date of the transaction in question. Under Treasury Regulations Section 25.7520-3(b)(3), the actuarial factors of IRC Section 7520 may not be used to determine the present value of an annuity, income interest or reversionary interest if an individual who's a measuring life is "terminally ill" at the time of the transaction, so that there's at least a 50 percent probability that the individual will die within one year.
16. *Rosen, supra* note 12.
17. *Bigelow v. Comm'r,* T.C. Memo. 2005-65.
18. *See, e.g., Movitz v. Fiesta Inva., LLC* (*In re Ehmann*), 319 Bankr. 200 (Bankr. D. Ariz. 2005).
19. *Rosen, supra* note 12.
20. *Bigelow v. Comm'r,* No. 503 F.3d 955 (9th Cir. 2007).
21. *Mirowski, supra* note 14.
22. Recently, in *Pierre v. Comm'r,* T.C. Memo. 2010-106, the Tax Court considered an Internal Revenue Service challenge to the sale to an intentionally defective grantor trust strategy, with only a nominal valuation adjustment resulting in the government's favor.
23. *See Kohler v. Comm'r,* T.C. Memo. 2006-152, for an example of how an appraiser's lack of credentials (in this case, the government's appraiser) may influence the outcome of a valuation case.
24. Circular 230 is codified at 31 CFR Part 10.
25. *See Estate of Marjorie Degreeff Litchfield v. Comm'r,* T.C. Memo. 2009-21.

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SECTION OF TAXATION
State Bar of Texas

August 15, 2011

Douglas H. Shulman
Commissioner
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Washington, D.C. 20044

Internal Revenue Service
CC:PA:LPD:PR (Notice 2011-62)
Room 5203
PO Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: Comments on proposed Revenue Procedure, Notice 2011-62

Dear Commissioner Shulman:

On July 19, 2011, the Internal Revenue Service (the "IRS" or "Service") issued Notice 2011-62, a proposed Revenue Procedure that updates existing rules on permissible communications between Appeals and other IRS functions. The IRS requested comments on the proposed Revenue Procedure by August 18, 2011. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments on the proposed procedures.

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.

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

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE 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 IRS for the time and thought that has been put into preparing the proposal, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Mary McNulty

Mary McNulty
Chair, Section of Taxation
The State Bar of Texas

cc: Christopher Wagner
Chief, Appeals
Internal Revenue Service

COMMENTS ON PROPOSED REVENUE PROCEDURE, AS SET FORTH IN NOTICE 2011-62 ISSUED ON JULY 19, 2011

Principal responsibility for drafting these comments was exercised by Joel N. Crouch, Robert D. Probasco, and Stephanie D. Mongiello. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Emily A. Parker reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, the Chair of COGS, also reviewed the comments on behalf of COGS.

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

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Date: August 15, 2011

Section 1001(a) of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "1998 Act") required the Commissioner to develop a plan to ensure the independence of Appeals, including prohibiting *ex parte* communications between Appeals and other IRS employees to the extent that such communications appear to compromise the independence of Appeals. In our experience, many taxpayers question the independence of an Appeals function that is still part of the IRS. We share the IRS' support for an effective Appeals process, which requires not only that Appeals is independent but also that taxpayers perceive Appeals to be truly independent, and we believe that the prohibition of *ex parte* communications contributes significantly to that goal. We commend the IRS for the time and thought that has been put into preparing the proposed Revenue Procedure to promote the independence and perceived independence of Appeals. We also appreciate the opportunity to comment on the proposal and hope that our comments prove to be helpful. We agree with the proposal for the most part and believe that it represents a significant improvement to Revenue Procedure 2000-43. We respectfully suggest, however, the IRS consider certain changes that we believe could further improve the procedures.

Remedies

Effective procedures ultimately depend on not only training and monitoring but also the existence of proper remedies for violations thereof. The IRS issued guidance regarding prohibited *ex parte* communications in Revenue Procedure 2000-43 but did not address remedies for violations of the rules. The proposed Revenue Procedure states that the remedy for curing a violation of the *ex parte* communication rules is within the sole discretion of Appeals and that most breaches may be cured by allowing the taxpayer or representative an opportunity to respond after the violation. We respectfully suggest the IRS consider allowing the taxpayer the option of either 1) having the case reassigned to a new Appeals Officer or 2) responding to the *ex parte* communication. In some instances, neither reassigning the case to a new Appeals Officer nor giving the taxpayer an opportunity to respond will be an adequate remedy. Therefore, we believe that Appeals should consider additional remedies for more serious violations.

Section 2.10(1) of the proposed Revenue Procedure states:

Most breaches of the *ex parte* communication rules may be cured by timely notifying the taxpayer/representative of the situation, sharing the communication or information in question and affording the taxpayer/representative an opportunity to respond. The specific administrative remedy that may be made available in any particular case is within the sole discretion of Appeals.

We commend the IRS for addressing the subject of remedies, but we believe the proposed Revenue Procedure does not go far enough to ensure the perceived independence of IRS Appeals. In the 1998 Act, Congress was concerned with anything that might "appear to compromise the independence of the appeals officers." The appearance of independence is best assessed from the perspective of the taxpayer, not the IRS. We believe that *any* violation of the *ex parte* communication rule potentially will appear to taxpayers as compromising the independence of the Appeals Officer. In some instances, notification and an opportunity to respond may be enough to satisfy the taxpayer, who may not want to incur the inconvenience or expense that might accompany reassignment to a new Appeals Officer. In other cases, however, the taint of the *ex parte* communication may not be mitigated so easily.

We respectfully suggest that, to maintain both the actual independence and the appearance of independence of the Appeals Officer, the proposed Revenue Procedure give the taxpayer the following options: 1) an opportunity to respond to the *ex parte* communication, as currently proposed by the IRS, or 2) having the matter assigned to a new Appeals Officer who has not been tainted by the *ex parte* communication. These alternative remedies would allow the taxpayer to weigh the perceived damage arising from the violation of the rules against the effectiveness and the cost and inconvenience of different remedies. We believe that this choice is best made by the taxpayer, as the prejudiced party, rather than the IRS. We further believe that any negative impact associated with allowing taxpayers this option is very low, due to the potential inconvenience and additional expense the taxpayer may incur. Most taxpayers likely will not request a new Appeals Officer, unless they perceive the violations of the rules to be very serious. In a situation in which Appeals determines that neither alternative adequately addresses the seriousness of the harm to the taxpayer from the *ex parte* communication, we agree that Appeals, after consulting with the affected taxpayer, should be permitted to determine the specific administrative remedy that may be made available.

Communications With Counsel on Docketed Cases and With the Department of Justice

Section 2.06(2)(a) of the proposed Revenue Procedure states that the *ex parte* communication rules do not apply to communications between Appeals and Counsel in connection with cases docketed in the United States Tax Court, except while the case is within Appeals' jurisdiction. Section 2.08(2) of the proposed Revenue Procedure states that the *ex parte* communication rules do not apply to communications with the Department of Justice ("DOJ"). We respectfully suggest that the IRS consider applying the *ex parte* communication rules to both situations, with an exception for communications of a ministerial, administrative, or procedural nature.

We understand that attorneys in the Office of Chief Counsel are expected to exercise independent judgment in rendering legal advice and to apply the law with integrity and fairness to all. However, the goal of the 1998 Act was not merely the independence of Appeals but also the perceived independence of Appeals. Once a case is docketed in the United States Tax Court, Counsel is acting in an advocacy role. Accordingly, *ex parte* communications may cast doubt on Appeals' independence. While the case is in Counsel's jurisdiction, we question whether Counsel would need to communicate with Appeals beyond the scope of the exception we suggest. If communications beyond the scope of that exception take place without taxpayer participation, taxpayers will be concerned about possible prejudice if the case were subsequently transferred back to Appeals' jurisdiction or if other, related cases were subsequently handled by Appeals. Allowing the taxpayer an opportunity to participate in such communications would alleviate these concerns and support the perception of Appeals' independence. We also respectfully suggest that the IRS review Revenue Procedure 87-24 and revise it as appropriate based on the principles of the 1998 Act and the proposed Revenue Procedure.

Communications with employees of DOJ, including the U.S. Attorneys' offices, are not subject to the *ex parte* communication rules because the 1998 Act applied only to communications between Appeals and other IRS employees. We understand and appreciate that, while the IRS can regulate Appeals employees, it cannot easily impose its rules on outside functions. However, as with Counsel attorneys in a docketed case, DOJ attorneys are acting in an advocacy role. *Ex parte* communications will cast doubt on Appeals' independence with respect to that case and other, related cases. Accordingly, we suggest that the IRS work with DOJ to establish procedures comparable to those suggested above for communications between Appeals and Counsel in docketed cases.

Miscellaneous

We also noted a few minor matters that the IRS might wish to consider when finalizing the proposed Revenue Procedure:

- Section 2.01(3)(d) of the proposed Revenue Procedure allows Appeals to proceed with an *ex parte* discussion or meeting with the originating function to avoid unreasonable delay, subject to documenting the reason for proceeding without the taxpayer or representative. We agree that Appeals should not be forced to delay a discussion or meeting for an unreasonable period of time and recognized that what constitutes an unreasonable period of time is best determined by the facts and circumstances rather than by a bright-line rule. We anticipate that in most cases Appeals will notify the taxpayer or its representative in advance that a discussion or meeting will proceed *ex parte* and provide a final opportunity to participate. However, the proposed Revenue Procedure does not require this advance notice. We respectfully suggest that the IRS consider adding such a requirement.

- Section 2.06(1) prohibits *ex parte* communications "regarding an issue in a case pending before them with a field attorney if the field attorney personally provided legal advice regarding the same issue in the same case to the originating function or personally served as an advocate for the originating function regarding the same issue in the same case." We appreciate the value to Appeals of obtaining legal advice from Counsel, while maintaining the ultimate responsibility for independently evaluating a case. However, we respectfully suggest that the IRS consider broadening the scope of the prohibition of *ex parte* communications with field attorneys. We believe that taxpayers would understandably question the impartiality and objectivity of a field attorney who had personally provided legal advice to or served as an advocate for the originating function with respect to: (a) the same issue in other cases; (b) other issues in the same case; or (c) different issues and different cases for the same taxpayer. Therefore, we respectfully suggest that *ex parte* communications also be prohibited in these situations.

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SECTION OF TAXATION
State Bar of Texas

September __, 2011

Douglas H. Shulman
Commissioner
Room 3000 IR
1111 Constitution Avenue, NW
Washington, D.C. 20044

Internal Revenue Service
CC:PA:LPD:PR (Notice 2011-62)
Room 5203
PO Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: Comments on Notice 2011-1

Dear Commissioner Shulman:

The Internal Revenue Service (the "IRS" or "Service") issued Notice 2011-1 in which it requested comments relating to the application of section 10101(d) of the Patient Protection and Affordable Care Act, P.L. 111-148, nondiscrimination standards to insured group health plans. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments.

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.

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

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE 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 appreciate being extended the opportunity to submit these comments.

Respectfully submitted,

Mary McNulty
Chair, Section of Taxation
The State Bar of Texas

COMMENTS ON NOTICE 2011-1

Principal responsibility for drafting these comments was exercised by Susan A. Wetzel and Henry Talavera. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Felecia Finston reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, the Chair of COGS, also reviewed the comments on behalf of COGS.

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

Contact Persons:

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Date: September __, 2011

As our comments address fundamental issues associated with the application of the nondiscrimination requirements under section 105(h) of the Code[1] to fully-insured plans in general, this comment is intended to be a broad, conceptual response to the request for comments made in Notice 2011-1.

We express our gratitude to the Department of Treasury, the Department of Labor and the Department of Health and Human Services (the "***Departments***") for the relief provided by Notice 2011-1. As employers strive to comply with the many new requirements under the Patient Protection and Affordable Care Act, P.L. 111-148 ("***PPACA***"), this relief is very helpful to employers.

As you know, section 105(h) of the Code generally provides that a self-funded medical plan cannot discriminate in favor of highly compensated individuals either with respect to (i) eligibility to participate, or (ii) benefits provided under the plan. Pursuant to section 105(h)(8) of the Code, the nondiscrimination requirements apply on a controlled group basis, meaning that all employees of employers in the same controlled group are treated as though they are employed by a single employer.

Section 10101(d) of PPACA added section 2716 to the Public Health Service Act ("PHS Act"), which provides that a group health plan (other than a self-insured plan) must meet the requirements set forth in section 105(h)(2) of the Code, and that "rules similar to the rules contained in paragraphs (3) [nondiscriminatory eligibility classification], (4) [nondiscriminatory benefits], and (8) [certain controlled groups] of section 105(h) of such Code shall apply." In addition, section 2716 of the PHS Act applies the definition of "highly compensated individual" contained in section 105(h)(5) of the Code to PPACA's requirements.

Prior to delving into the specific application of certain provisions of section 105(h) of the Code to fully-insured health plans, it is important to note that even sponsors of self-funded health plans are uncertain of how the requirements of section 105(h) of the Code apply to their plans. In practice, the methods of conducting Code section 105(h) nondiscrimination testing are varied and uncertain, as many third party administrators do not understand how to interpret the testing requirements, let alone run the testing. Regardless of how the Code section 105(h) requirements are applied to fully-insured plans, it is imperative that guidance be issued regarding how all group health plans should conduct the nondiscrimination testing to aid employers in their compliance efforts. We respectfully suggest that this guidance include, among other things, clarification regarding whether the same aggregation and disaggregation rules that apply to qualified retirement plans under section 410(b) can be applied by analogy to the testing under section 105(h) of the Code. In addition, since the discrimination testing rules regarding self-funded medical plans typically work in tandem with those governing cafeteria plans and dependent care flexible spending accounts, it would be helpful if a uniform definition of highly compensated employee applied to all such arrangements.

[1] All references to the "Code" shall mean the Internal Revenue Code of 1986, as amended, unless otherwise specifically noted.

A. Design Issues Associated with the Application of Section 105(h) of the Code to Fully-Insured Health Plans

Due to the requirement that self-funded group health plans must comply with the nondiscrimination requirements of section 105(h) of the Code, many employers in industries with low wage workforces moved to fully-insured health plans as a means of providing some level of health care coverage to their employees.

In industries such as food service, movie theaters, sales and retail, where employees are generally paid by the hour, and in the case of the food service industry and sales, where employees are paid primarily by tips or commissions, many employees simply cannot afford insurance or do not have sufficient wages in their weekly paychecks from their employers to cover the premiums required for the insurance.

Many employers in these industries sponsor mini-med programs for hourly employees with premium levels that are low enough that the majority of the hourly employees can afford the coverage, and maintain a more generous fully-insured program for non-hourly employees, usually at the corporate or management level. While the benefits offered under the mini-med programs are often significantly less generous than the plans offered to non-hourly employees, the costs are also significantly lower, which enables the hourly employees to have coverage. If only the higher cost, more generous plan were offered, these individuals may in many circumstance not be able to afford any coverage at all.

Section 105(h) of the Code tests who is "benefiting" under the plan being tested. While there is very little guidance regarding whether a person is "benefiting" under a group health plan if they are merely eligible and not covered, many practitioners have interpreted this requirement as imposing a utilization test based upon who has actually elected coverage under the plan. If this interpretation is applied to fully-insured plans, many plans will fail this test even if employers expand eligibility for both the mini-med programs and the corporate plans to all employees. There will inevitably be a failure in the testing because many of the hourly employees would never elect the corporate program without significant subsidies. Since employers cannot force employees to elect coverage, short of paying 100% of the premium (which many employers cannot afford to do), in our view the PPACA should test whether coverage is made available to all employees on a nondiscriminatory basis – *i.e.*, (i) premiums for nonhighly compensated individuals are the same as or less than those charged to highly compensated individuals; and (ii) the waiting periods for eligibility for nonhighly compensated individuals are the same as or less than the waiting periods for highly compensated individuals.

Application of the Code section 105(h) testing requirements in this manner would be consistent with the testing requirements under Code section 401(k) and Code section 401(m) that apply to qualified cash or deferred arrangements with employer matching contributions. Specifically, section 401(a)(3) of the Code provides that, in order for a plan to be a qualified plan under section 401(a) of the Code, it must satisfy the requirements of section 410(b) of the Code. Section 410(b) of the Code generally provides, in relevant part, that a plan must meet one of the following requirements:

(A) The plan *benefits* at least 70 percent of employees who are not highly compensated employees; [or]

(B) The plan *benefits* —

(i) a percentage of employees who are not highly compensated employees benefiting under the plan which is at least 70 percent of

(ii) the percentage of highly compensated employees benefiting under the plan.

Section 410(b) of the Code [emphasis added]. Treas. Reg. §1.410(b)-3(a)(2)(i) provides that "an employee is treated as benefiting under a section 401(k) plan for a plan year if and only if the employee is an eligible employee under the plan as defined in §1.401(k)-6 for the plan year. Similarly, an employee is treated as benefiting under a section 401(m) plan for a plan year if and only if the employee is an eligible employee as defined in §1.401(m)-5 for the plan year."

This eligibility rule clearly does not require that the employee actually elect to participate, but rather only that he or she be eligible to participate. Since Code section 401(k)/401(m) plans provide contributions only for those who elect to participate in the plans, the IRS adopted a pragmatic testing rule that treats an employee as "benefiting" if he or she is eligible. This approach does not penalize plans or employers for an eligible employee's choice not to participate.

Our suggestion to apply to group health plans the same section 410(b) testing rules that apply to Code section 401(k)/401(m) plans relates only to eligibility to participate in the health plan and would not impact whether benefits or contributions under the health plan would be discriminatory. Once a health plan covers a non-discriminatory group of employees, we would suggest that there be a safe harbor for a plan under which the same benefits are available for all employees at the same or lower employee premium as paid by a highly compensated individual for such coverage option. For purposes of determining compliance with section 105(h) of the Code, employee pre-tax contributions should either be disregarded to the extent made under a cafeteria plan intended to satisfy section 125 of the Code, or alternatively, treated the same as any other employer contribution made on behalf of health plan participants.

The requirements of section 105(h) of the Code are strikingly similar to the requirements set forth in section 410(b) of the Code, in that section 105(h) of the Code also requires that the plan *benefits* "70 percent or more of all employees . . ." Further, both self-insured and fully-insured medical plans are strikingly similar to Code section 401(k)/401(m) plans, where participation by the employee in the employer's plan is voluntary and the employee only receives a financial benefit if he or she elects to participate in the plan. Applying to fully insured group health plans subject to PPACA the same definition of "benefiting" under section 410(b) of the Code as applies to Code section 401(k)/401(m) plans would result in a consistency in how similar benefit plan discrimination testing terms are used and defined within the Code.

Further, due to the similarity between sections 105(h) and 410(b) of the Code, rules similar to those provided under section 410(b)(6)(C) of the Code [Special Rules for Certain Dispositions or Acquisitions] also should be incorporated into the requirements of section 105(h) of the Code to give employers sufficient time following a corporate transaction to determine how to satisfy the nondiscrimination requirements. Without this relief, employers could immediately violate the nondiscrimination rules by simply acquiring an entity that has different benefit plans.

Moreover, if an employer maintains more than one type of program or coverage, we respectfully request that, in crafting discrimination testing rules for fully-insured plans, the Departments consider either excluding from consideration for testing purposes employees who are eligible for mini-med plans or modifying the test to allow employers to aggregate the mini-med and corporate programs when conducting the testing. Excluding from consideration employees who are eligible for mini-med programs would be consistent with the provisions of Treas. Reg. §1.410(b)-6(g)(3) which allow exclusion from consideration employees of tax-exempt entities if they are also eligible to make contributions under a Code section 403(b) plan. If this exclusion feature is not implemented, we respectfully suggest that aggregation of the mini-med programs with the corporate programs be permitted, regardless of whether these programs are "substantially similar" or completely different, so long as all employees within the same geographic region are eligible for both programs.

PPACA merely requires that rules be adopted that are "similar" to the requirements of section 105(h) of the Code and does not require rules that exactly mirror these requirements. If aggregation is not permitted, many employers with fully-insured plans may consider completely eliminating all their health plans in order to avoid testing failures, since covering everyone under the plan between now and 2014 would require employers to subsidize significant portions of the premiums. As a result of the ailing economy and high cost of health care premiums for fully-insured plans, it may be less expensive for employers to simply eliminate coverage and, in 2014, pay the penalty for not offering coverage. Allowing aggregation would avoid this result, while allowing the hourly employees (arguably, the ones the law was designed to protect) to keep the coverage that they have today.

Accordingly, we respectfully request that the Departments consider implementing the following suggestions:

1. The nondiscrimination testing applied under PPACA should test eligibility and not actual coverage under the plan similar to the manner in which the definition of "benefiting" under section 410(b) of the Code is applied to Code section 401(k)/401(m) plans. This approach would recognize that employers cannot force employees to elect coverage.[2]

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[2] As long as eligibility for coverage is offered on a nondiscriminatory basis (the premium amounts charged are the same for all classes or are only higher for the highly compensated individuals, and waiting periods for nonhighly compensated individuals are the same or shorter than those for highly-compensated individuals) employers can continue to offer coverage to their workforces without being unduly burdened with increasing costs. The implementation of a utilization test could result in the terminations of certain insured employer group medical programs.

2. Transition relief for corporate transactions similar to that contained in section 410(b)(6)(C) of the Code should be included in the guidance.

3. Employers with more than one benefit program or plan should be allowed to aggregate these programs for purposes of testing whether the programs, as a whole, are discriminatory, provided that (i) all employees within the same geographic region are eligible for all programs, and (ii) mini-med programs offered to employees below a certain income level are treated as coverage that is equivalent to any other health coverage provided to any group of employees. For example, if regular health coverage costs an employee more than 10% of gross income, that employer should be able to offer only a mini-med plan to its low-paid employees without having to offer other more expensive regular coverage to those employees. Alternatively, employees eligible for mini-med programs should be excluded from consideration, and mini-med programs should be excluded from the testing requirements, under section 105(h) of the Code.[3]

B. Application of Section 105(h) Test to Partners and S Corporation Shareholders

Section 105(g) of the Code provides that, for purposes of section 105 of the Code, "the term 'employee' does not include an individual who is an employee within the meaning of section 401(c)(1)(relating to self-employed individuals)." Specifically, section 401(c)(1) of the Code provides that the term employee does not apply to any individual who has self-employment income for a taxable year. Thus, the term employee generally excludes partners of partnerships and S corporation shareholders who have flow-through income.

Due to the flow-through nature of the income of partners and S corporation shareholders, their exclusion from the nondiscrimination requirements of section 105(h) of the Code makes sense. These individuals pay premiums on an after-tax basis and receive a corresponding deduction on their individual tax returns. These same individuals could, in lieu of receiving coverage under the entity's group health plan, elect instead to purchase individual policies and receive the same deductions on their individual tax returns for the cost of coverage.

Large partnerships and S corporations with self-funded plans can exclude their partners and shareholders from the testing requirements and thus decrease their highly compensated employee pool. If the exclusion in section 105(g) of the Code is not applied to fully-insured plans, these entities will have an unusual advantage over small partnerships and S corporations with fully-insured plans. Moreover, inclusion of partners in small partnerships and S corporation shareholders in the fully-insured plan testing will cause many small partnerships and S corporations to fail their testing. In that case, these smaller businesses may simply elect to terminate plan coverage, contrary to the goal of the PPACA.

Accordingly, we respectfully suggest that the Departments consider applying rules similar to those set forth in section 105(g) of the Code in implementing the nondiscrimination testing requirements of PPACA.

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3 This approach will encourage employers to offer coverage for all of their employees, while at the same time giving employers a reasonable alternative for satisfying section 105(h) of the Code.

C. Overall Compliance Issues Under Section 105(h)

Section 2716 of the PHS Act does not apply to grandfathered plans. In general, the grandfathering of certain plans or agreements when a new law is enacted gives employers time to consider how the new requirements will apply to these pre-existing plans. Thus, employers may plan for any new costs or changes in design that are required by the new law.

Unfortunately, in the case of PPACA, the grandfathering provisions give little relief to employers with fully insured group health plans. In our experience, few, if any, health insurers have helped employers secure grandfathered health policies. For employers in the retail, restaurant and leasing or staffing industries ("***Retail Industry***"), this problem has been particularly acute. Compliance with section 105(h) of the Code is impractical for those Retail Industry employers, as those employers have historically covered relatively few employees under fully insured products, while at the same time offering "mini-med" or no health plans to the bulk of its employees. The lack of a viable alternative has created a problem for the Retail Industry and other employers. Retail Industry (and other) employers are unable to offer health insurance to all of their employees, because insurers require employers to commit to pay at a minimum of 50% of such employees' insurance costs. In our experience, in the Retail Industry, where cost margins are low, insurance has proven to be cost-prohibitive.

Accordingly, in addition to the foregoing comments regarding the rules under section 105(h) of the Code and their applicability to fully insured health insurance policies, we believe that other comments are appropriate regarding the interim final regulations issued under the Interim Final Rules for Group Health Plans and Health Insurance Coverage Relating to Status as a Grandfathered Health Plan under PPACA, 75 Fed. Reg. 34538 (June 17, 2010), along with the corresponding amendment published in 75 Fed. Reg. 70114 (November 17, 2010) (collectively "***Grandfathered Plan Regulations***").

It is critical for the Retail Industry and other employers to either:

(i) retain grandfathered status to avoid complying with section 105(h) of the Code, or

(ii) find an option that permits employers to cover their employees other than on an after-tax basis.

In our experience few, if any, insurers are capable of offering grandfathered health insurance policies. The Departments provided some relief in the amended Grandfathered Plan Regulations by permitting employers to switch insurers; however, that relief has proved fleeting. In practice, insurers are not offering policies that will match all benefits, copayments, and deductibles under prior insurance policies.

For example, we are aware that one insurance company that has renewed its prior insurance policies indicated it no longer was offering a grandfathered insurance policy as an alternative, simply because the insurer had established a copayment for certain specialty drugs (e.g., $100) when such drugs were not covered previously under such insurance policy. Prior to

January 1, 2011, the insurer had offered coverage for certain specialty drugs after satisfying a high dollar deductible (e.g., $5,000), and then the coverage offered for such drugs was subject to coinsurance (e.g., the employer paid 80% versus 20% for the employee). In the Grandfathered Plan Regulations, the government appears to assume that employers have the ability (and insurance companies were willing) to offer insurance policies that might be grandfathered under PPACA. However, in our experience, many employers (particularly smaller employers) have no ability to dictate what benefits are contained in an insurance policy. An insurer may offer several options, but most employers do not have the ability to secure customized insurance policies.

Therefore, we respectfully request that the Departments consider granting the following relief:

1. We respectfully suggest that the Departments consider permitting all employers with existing insurance policies to self-insure any copayments, deductibles, or coinsurance that may be necessary to retain grandfathered status and providing that any such self-funded coverage can be offered on a pre-tax basis without regard to the testing under section 105(h) of the Code. Without this relief, many employers will not be able to reasonably and practically take advantage of any of the relief offered under the Grandfathered Plan Regulations. If relief is not provided, we believe that employers will have only the following few alternatives, which we believe Congress did not intend by passage of PPACA:

(a) provide coverage only on after-tax basis to a limited number of employees;

(b) reorganize its workforce so that such employer hires few, if any, any full-time employees, or, in the right circumstances, fewer employees of any kind; or

(c) drop coverage entirely for its workforce.

We would not expect this result to be what Congress intended by PPACA. If the government permits this relief and amends the Grandfathered Plan Regulations, employers will be providing coverage as required by the changes in law to keep its employees whole. Further, employers will not be entirely reliant on the insurance industry to duplicate benefits exactly within an insurance policy. That task has, in our experience, proven impossible.

2. We respectfully suggest that the Departments consider permitting any relief to be retroactive back to the first plan year beginning on or after March 23, 2010. Although the government amended the Grandfathered Plan Regulations to permit employers to switch insurers after November 15, 2010, employers have not been able to switch insurers as a practical matter. Many employers had plan years beginning after September 23, 2010 and before November 15, 2010. Other employers had insufficient time to implement changes with insurers as the amended Grandfathered Plan Regulations were issued too late in the year for employers to effectively find alternative insurers, if any, which could offer policies that comply with the Grandfathered Plan Regulations.

In addition, in our experience, insurance companies generally have been inflexible in addressing issues under section 105(h) of the Code with employers. We would ask the government to consider permitting employers to correct any gaps retroactively in the changes, given the uncertainty in applying PPACA and the government's evolving views of how PPACA should be implemented.

3. We respectfully suggest that the Departments consider working with insurance companies to offer insurance policies under which the employer is not committed to make any contribution (e.g., permitting 100% funding of insurance policies through employee contributions) and urging the insurers to offer plans that comply with the Grandfathered Plan Regulations. While insurers already have the ability to offer individual policies or policies that permit no employer contributions, the premiums for such policies are generally much higher than group policies due to underwriting concerns. Policies paid for exclusively by employees, whether on a pre-tax or after-tax basis, are generally cost prohibitive for the average consumer.

We hope these comments are helpful to the Departments.

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CONSEQUENCES OF CARRIED INTEREST REFORM FOR THE PRIVATE INVESTMENT INDUSTRY

By: Stas Getmanenko[1]

[1] Stas Getmanenko, SMU Dedman School of Law, LL.M. (taxation Class of 2011

CONSEQUENCES OF CARRIED INTEREST REFORM FOR THE PRIVATE INVESTMENT INDUSTRY

PART I: INTRODUCTION

A great majority of present-day private investment funds are structured as *limited partnerships*.[2] This characterization typically applies to hedge funds, private equity funds, venture capital funds, real estate investment funds, and other similar entities. In the most common scenario, a limited investment partnership includes two types of participants: the general partner (the management company) and the limited partners (the investors). Usually, the limited partners provide the overwhelming share of the capital, and the general partner provides a token amount of capital and investment services.[3]

For its services, the management company (the general partner) usually charges two types of fees: a management fee and a performance fee. A typical management fee ranges between 1 and 2 percent of assets under management, whereas the performance fee can reach upward of 20 percent or more of the partnership‘s profits. As a result, historically, the performance fee has become a powerful incentive for successful fund managers.[4]

The general partner receives the performance fee through a disproportionate allocation of the partnership‘s profits, a compensation scheme commonly referred to as ―carried interest." Because a partnership does not incur any entity level tax, all of the partnership‘s profits are ―passed through" to its partners, including the general partner‘s performance fee. The pass-through gain also retains the taxable characteristics determined at the partnership level.

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[2] *See generally* TIMOTHY SPANGLER, THE LAW OF PRIVATE INVESTMENT FUNDS (2008) (documenting this trend).
[3] For greater detail concerning typical structure of alternative investment vehicles see *id.*
[4] In 2010, the highest-paid twenty-five hedge fund managers earned $22.07 billion, more than $3 billion more than the group collectively earned in 2009. *See Paulson Earns Almost $5B in 2010, To 25 Hedgies Taken in $22B,* FINalternatives, Apr. 1, 2011, http://www.finalternatives.com/node/16161. The trend is clearly accelerating: Another commentator reports that, for example, in 2007, the fifty highest paid hedge fund managers collected $29 billion in carried interests. *See* Sanford M. Jacoby, *Finance and Labor: Perspectives on Risk, Inequality, and Democracy*, 30 COMP. LAB. L. & POL‘Y J. 17.

In the case of investment partnerships, the gain is sometimes a capital gain because of the nature of the assets held by these partnerships.[5] Consequently, the bulk of individual managers' compensation can often be classified as a capital gain, taxed at lower capital-gain rates.

Quite predictably, this favorable tax treatment of what, at least at first glance, appears to be compensation for investment services stirs dissatisfaction among many,[6] and Congress has threatened to reform the present treatment of carried interests on several occasions.[7] So far, none of the congressional attempts have come to fruition. Nevertheless, many commentators and industry insiders agree that eventual congressional action is inevitable rather than probable.[8] In dollar terms, the stakes are high for the fund managers and for the government.[9] The policy considerations also exert pressure on the lawmakers to bring greater correlation to the tax rates of the country's wage earners and investment fund managers. Ever-increasing budget deficits, undoubtedly, stack the odds further in favor of reform.[10]

Assuming then, hypothetically, that the Congress does act, what alternative compensation structures will emerge in the private investment industry? This paper explores several options as well as provides a digest of many of the relevant issues surrounding taxation of carried interest.

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[5] Not all funds will derive long-term capital gains. Most hedge funds generally trade too often to generate long-term capital gains consistently. Private equity funds, on the other hand, will almost always have long-term capital gains as the bulk of their income.

[6] *See, e.g.,* Darryll K. Jones, *Sophistry, Situational Ethics, and the Taxation of the Carried Interest*, 29 NW. J. OF INT'L L. & BUS. 675 (2009) (Jones describes his article as ―strident expression of indignation about what a majority of tax scholars and, indeed, legislators consider a glaring yet persistent inequity in the tax code.").

[7] *See infra* Part IV.

[8] *See, e.g.,* Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 LOYALA UNIVERSITY CHICAGO LAW JOURNAL 197, 228 (2008) (―For carried interest reform to fail, it must be defeated every time it is proposed; for it to succeed, it must succeed only once. . . . Carried interest reform seems inevitable. Unwise, but inevitable.").

[9] Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of taxing Profits Interests as Ordinary Income*, 50 WILLIAM AND MARY LAW REVIEW 115 (2008).

[10] President's State of the Union Address (President Obama's promise not to reduce budget deficit on the backs of country's most vulnerable citizens), available at http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address.

* * *

Before undertaking a detailed examination of potential ―industry responses,” it is first necessary to understand the existing framework of taxation of private investment funds and the mechanics of the proposed change. Readers who are well-versed in partnership taxation or (as one commentator puts in) are partnership taxation ―jocks”[11] will likely wish to skip forward.

PART II: TAX CONSEQUENCES UPON THE RECEIPT OF CARRIED INTERESTS

The present structure of private investment funds is driven, at large, by the realities of partnership taxation.[12] The flexibility afforded to the partnerships in allocating partnership profits,[13] together with the absence of entity-level tax, make possible a ―tax-friendly” compensation arrangement that compares most favorably with wage employment.[14] Carried interest is at the heart of this arrangement.

There exist several possible fund structures. The make-up of investors and the fund‘s investment strategy will largely determine the specifics.[15] The following discussion assumes the ―plain vanilla” domestic structure, where the investors will be U.S. taxable individuals and the fund will be structured as a domestic partnership. The management team will also be comprised of U.S. individuals, who will receive part of their compensation through ―carried interest.”

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[11] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 16 (2008)

[12] *Private Equity Funds*, Tax Mgmt. Portfolios, Tax Mgmt. Inc. (BNA) No. 735, at A-13 (2004) (―Virtually every U.S. private equity fund, with the exception of certain parallel entities, is structured as a pass-through entity for tax purposes.”).

[13] *See* SPANGLER, *supra* note 2.

[14] *See infra* Parts III A, B.

[15] For greater detail on fund structures, see David S. Miller and Jean Marie Bertrand, *The U.S. Federal Income Tax Treatment of Hedge Funds, Their Investors and Their Managers*, pp 1-8, *available at* http://ssrn.com/abstract=1758748.

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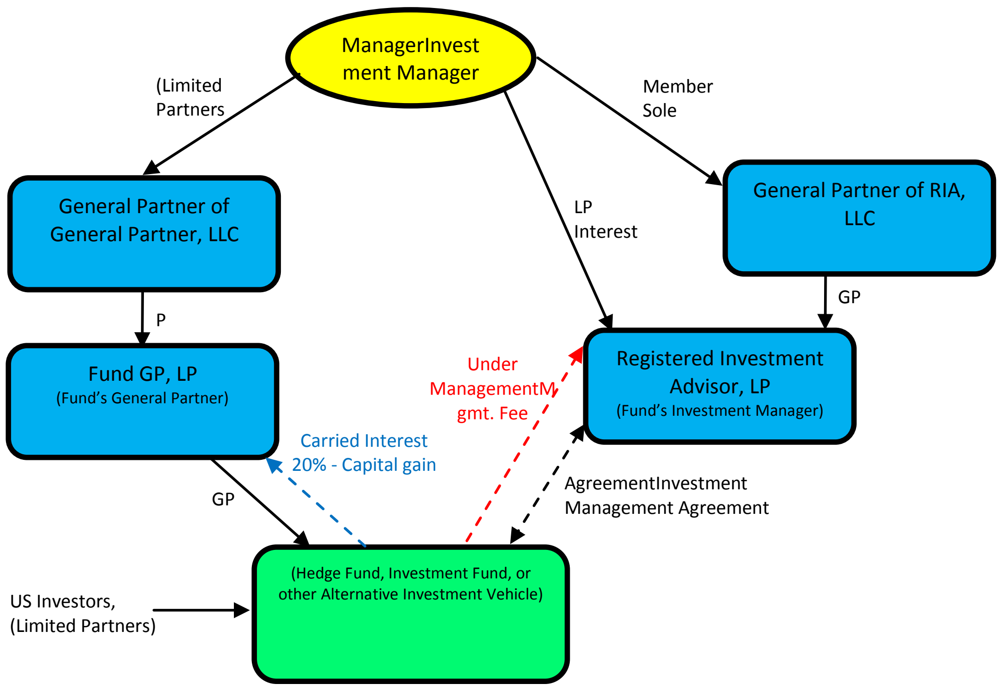
Chart 1: *Plain Vanilla Domestic Hedge Fund Structure*



A. The Typical Arrangement

Suppose Manager and Investor form a hedge fund or a private equity fund.[16] The fund is structured as a limited partnership where Investor is the limited partner, and the general partner is a one-member LLC wholly owned and controlled by Manager.[17] The LLC has not ―checked the box" and therefore is treated as a partnership for federal tax purposes. At the outset, Investor and Manager agree that Investor will invest $95 million and Manager will invest $5 million in exchange for partnership's capital interests. Consistent with the state law and the intent of the parties, Manager, as the general partner, will actively manage the fund. Manager subsequently

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[16] The traditional distinction between hedge funds investing in liquid assets and private equity funds investing in illiquid assets has been slowly eroding because hedge funds increasingly often include in their investments illiquid and nonlisted assets, thus ―blurring the lines between the previously well-defined structures." *See A Hedge Fund Perspective*, GREG N. GREGORIOU AND FRANCOIS-SERGE LHABITANT IN GREG N. GREGORIOU AND FRANCOIS-SERGE LHABITANT, STOCK MARKET LIQUIDITY: IMPLICATIONS FOR MARKET MICROSTRUCTURE AND ASSET PRICING 407 (2008).

For the purposes of this paper, this distinction is of little relevance because the author is concerned primarily with the tax consequences resulting from ―carried interest," a compensation scheme common to both private equity funds and hedge funds.

[17] For a more detailed discussion of a typical private investment fund (hedge fund, private equity fund, real estate investment fund, and others), see generally DAVID STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY (2010).

invests the partnership's funds into gold bars, betting that the precious metal prices will rise over the next decade (the agreed duration of this "alternative investment vehicle").[18]

Investor and Manager agree that despite their disproportionate capital contribution to the partnership, the partnership's profits will be split as follows: 20% to Manager and 80% to Investor. Investor will also pay Manager an annual Management Fee equal to 2% of the Fund's assets as valued at the end of each quarter.[19] This disproportionate allocation of profits is agreed to be fair by the parties because Manager will invest time and labor into maintaining and managing the Fund's day-to-day operations. Additionally, Investor believes that Manager will properly "hedge" against unacceptable investment risk and provide a level of return on investment that will justify the disproportionate allocation of profits. Investor is unable or unwilling to accomplish these objectives without Manager. The appropriate language memorializes this arrangement in the Limited Partnership Agreement.

B. Profits and/or Carried Interest

There has been some conceptual inconsistency when it comes to describing the disproportionate share of profits that investment fund managers receive. The Treasury generally describes them as "profits (carried) interest,"[20] thus lumping the concepts of carried interest and profits interest together. However, several commentators have pointed out the conceptual shortcoming of equating profits interest with carried interest.[21] A pure *profits interest* would be the interest that a manager would receive solely in exchange for future services. A carried

[18] Colloquially, an alternative investment vehicle is usually anything other than run-of-the-mill mutual fund, stock, bond, or other security available to an average investor.
[19] Following the 2008 financial crisis, the management fees have come down and now range between 1% and 2%.
[20] *See, e.g.,* U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2012 REVENUE PROPOSALS 61 (Feb. 2011).
[21] *See e.g.,* Paul Carman, *Taxation of Carried Interests*, 87 TAXES 111 (2009) ("A "carried interest," for the purposes of this article, is a right to a disproportionate allocation of profits when a manager has paid something for the manager's interest. A "profits interest" is an interest in respect of which the manager has paid nothing and would get nothing if the entity were liquidated immediately after the interest was issued.").

interest, on the other hand, is a disproportionate allocation of future profits to the manager‘s capital interest. That is, the manager contributed some capital to the partnership and received a special allocation of future income. The allocation may very well represent the effort the manager would exert in managing the fund, a perfectly fair and permissible result under the present framework of partnership tax.

C. Capital and Profits Interest Defined

In a typical partnership a partner may receive a *capital interest* in the partnership and a *profits interest* in future income. These interests are distinct.[22] A capital interest gives its holder a right to a share of the proceeds from the sale of partnership assets in a complete liquidation of the partnership.[23] A profits interest, on the other hand, is a ―partnership interest other than a capital interest.”[24] In our case, it is a right to receive a disproportionate share of partnership‘s future profits. More specifically, as a general rule, in the event of liquidation, a partner with a capital interest would receive money equal to the partner‘s capital account. The profits interest, on the other hand, would be worthless.[25]

D. Non-recognition of the Receipt of Capital Interest

Within the general rule of Section 721, the partners‘ contribution of property in exchange for a partnership‘s *capital interest is tax free*: No gain or loss is ―recognized to a partnership or any of it partners on a contribution of property to the partnership in exchange for in interest in the partnership.”[26] The non-recognition in this instance is based on the rationale that transfer of

[22] Hereafter, this paper‘s focus is on tax consequences to Manager, therefore, for the most part, it ignores the consequences to Investor.
[23] *See* Rev. Proc. 93-27, 1993-2 C.B. 343.
[24] Descriptive, isn‘t it? *See id.*
[25] The profits interest is worthless in the sense that its value upon liquidation is zero. In reality, an investment fund‘s profits interest often becomes worth millions over the life of the fund.
[26] However, § 721(b) provides a narrow exception in the event when a partnership would be treated as an ―investment company” if a partnership were incorporated. ―Investment company” in this context is defined under

property in exchange for a partnership interest is considered a mere change of form in the partners' investment.[27] The Tax Code's intent not to impede the formation of business enterprises is frequently offered as another justification for non-recognition.[28]

E. Non-recognition of the Receipt of Profits Interest

Using our previous example (and assuming briefly[29] that we could bifurcate carried interest into a capital interest and a profits interest), Manager received a 15% profits interest and a 5% capital interest. The capital interest was received tax-free in return for contribution of services. Today, the receipt of a disproportionate *profits interest in exchange for services* is also a *tax-free* event.[30] Much of the criticism surrounding the present tax treatment of private investment funds arises in the context of non-taxability of carried interests upon their issuance and the subsequent taxation of managers' profits at capital gain rates.

Assuming that bifurcation is absolutely correct and 15% of future profits is indeed received for the performance of services, *the profits interest remains untaxed due to the difficulty of valuing* the amount of future income represented by the profits interest.[31] In most cases, a

351(e)(1) and Reg. § 1.351-1(c) and includes a company that aims to achieve tax-free diversification of its founders' interests.

Although tax-free diversification of interests is frowned upon by the Code in this instance (the Code attempts to impose a realization event), it is sometimes possible through certain financial products, such as private placement annuities.

[27] STEPHEN A. LIND, ET AL., FUNDAMENTAL OF PARTNERSHIP TAXATION 30 (8th ed. 2008).

[28] *See id*.; *see also* I.R.C. § 351.

[29] This assumption is very simplistic because it ignores the realities of permissible special allocations.

[30] Some scholars argue that non-taxability of profits interest is merely a negative implication from Rev. Proc. 93-27 and Reg. 1-721-1(b)(1). In other words, the Treasury has explicitly stated that the issuance of *a capital interest* in exchange for services is a *taxable event*. This, they argue, is *not* equivalent to saying that the issuance of a *profits interest* is a *non-taxable event*. Indeed, neither Rev. Proc. 93-27, nor Reg. 1-721-1(b)(1) state that the issuance of a profits interest is a non-taxable event. To the contrary, the proposed regulations state that an issuance of a profits interest in exchange for services is a taxable event, taxed at the fair market value of the interest. In a typical scenario, the value of an interest in future profits is entirely speculative and consequently of no present value.

Therefore, ignoring the semantics, the end result is identical whether (1) issuance of a profits interest in exchange for services is non-taxable or (2) the issuance of a profits interest is taxable at the fair market value of the interest, where the fair market value of the interest equals 0. If a profits interest can be reasonably valued, it will likely be taxed under Rev. Proc. 93-27.

[31] *See, e.g, St. John v. United States*, 841 USTC 9158 (C.D.Ill.1983); *Kenroy, Inc. v. Commissioner*, 47 T.C.M. 1749 (1984).

hedge fund or a private equity fund cannot guarantee profitability, let alone predict the rate of future return, if any. The uncertainty on valuation of future profits thus permits the receipt of a profits interest to be untaxed.[32]

F. Distinction from the Receipt of Capital Interest in Exchange for Services

The law's differentiation between capital interests and profits interests permits for a distinct tax treatment of the receipt of these interests by the partners *in exchange for partners' services* provided to or for the benefit of the partnership. Whereas the receipt of a *profits interest results in tax-free treatment*, the receipt of a *capital interest in exchange for services is immediately includible in taxable income*.[33] Accordingly, in our example, if Manager contributed $5 million in cash ***and*** $15 million in future services in exchange for a capital interest, Manager would be forced to include $15 million as ordinary income in Year 1.[34] If following such contribution, the partners agreed that profits would be allocated "straight-up" (that is, in proportion to partners' capital interests), *the economic effect* would be equivalent to

[32] A typical hedge fund or a private equity fund agreement sets forth provisions that disclaim any promise or guarantee of future gains. In certain instances, however, predictability and valuation of future income might be possible, for example, in funds where income would come from a "high quality debt security" or a "high quality net lease." *See* Rev. Proc. 93-27, 1993-2 C.B. 343 (establishing that a receipt of a partnership profits interest in exchange "for services provided to or for the benefit of the partnership" is generally nontaxable, but can be taxable in three situations: (1) if the profits interest relates to a substantially certain and predictable stream of income; (2) if within two years of receipt, the partner disposes of the profits interest; or (3) if the profits interest is a limited partnership interest in a publicly traded partnership within the meaning of Section 7704(b).).

Revenue Procedure 2001-43 clarifies that the result applies if the service partner taken into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 33-35 (Comm. Print 2007).

[33] *See* Treas. Reg. § 1.721-1(b)(1). This Regulation links Subchapter K with Section 83 of the Code by stating that a service partner's receipt of *a capital interest is taxable under Section 83*. Section 721 does not provide for non-recognition in this instance because the partner is not contributing "property." Partner contributing services is deemed as "being compensated" and thus realizes ordinary income under 61(a). In such case, the partner takes "tax-cost" basis in the partnership interest. I.R.C. § 1012.

Whether Section 83 applies to the service partner's receipt of a *profits interest* is subject to a considerable debate, which, nonetheless, "has been rendered moot" by Rev. Proc. 93-27 and Rev. Proc. 2001-43. *See* William R. Welke et al., *Compensating the Service Partner with Partnership Equity: Code §83 and Other Issues*, 79 TAXES 94, 105 (2001).

[34] The result assumes that the partnership interest is "transferable" and "not subject to a substantial risk of forfeiture." I.R.C. § 83(c)(1). In other words, the law wants to make certain that the property interest really results in income to the partner receiving the interest and timing for taxation is therefore appropriate.

compensating Manager with a carried interest. The tax bill, however, would vary significantly. Thus becomes apparent the value of tax planning.

G. Carried Interest

The conceptual difficulty arises in determining the appropriate treatment of *carried interest* because, in the case of a carried interest, the partnership interest is given in exchange for a *contribution of capital* **and** *services*.[35] This difficulty is exacerbated by the present framework of partnership tax, which permits a partner to perform services for the partnership in her capacity as a partner. In such cases, the character of the partner's distributive share of income is not reclassified even if the share has been enhanced by the partner's performance of services.

Technically, therefore, the receipt of a carried interest does not fall squarely into the safe harbor of Revenue Procedures 93-27 or 2001-43.[36] Nevertheless, it has been a long-accepted practice to rely on this guidance for non-taxability of the receipt of carried interest. I feel important to mention again that the Service generally lumps together the concepts of profits interest and carried interest.

PART III: COMMON CRITICISM OF THE PRESENT TREATMENT OF CARRIED INTERESTS

Examination of the proposed changes (which follows in Part IV) is better understood in light of the widespread criticism aimed at the present tax treatment of carried interest. Additionally, the industry's potential response (which is discussed in Part V) cannot be analyzed without keeping in mind the potential congressional intent, which, in all likelihood, will seek to end the present status quo. Accordingly, this section summarizes, in pertinent manner, some of the most frequent jabs at the present treatment of carried interest and offers one defense.

A. Character of Carry

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[35] *See* Carman, *supra* note 20, at 111.
[36] *See* Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUMBIA JOURNAL OF TAX LAW 1, 10 (2010); *id* at 114.

The pass-through nature of partnerships requires the determination of the character of the partners' distributive share to be made at the partnership level. Today, based on the nature and strategy of the investment fund, the carried interest structure allows fund managers, in certain instances, to characterize carried-interest gains as long-term capital gains and/or qualified dividend.[37] In literature, the most frequent criticism of this arrangement is raised by the conceptual question: Is carried interest a form of compensation for services, or is it more similar to an interest in capital?[38] The critics generally argue that carried-interest gains are compensation for investment services and therefore should be taxed at ordinary income rates. The private investment industry, backed by a fairly subdued academic minority,[39] responds that the present treatment of carried interest is appropriate.

Contrary to the assertion of some critics that carried interest income is clearly compensation for services, the issue is not quite as axiomatic as it is often made out to be.[40] However, for practical purposes, the Service's application of Revenue Procedure 93-27 in the context of carried interest seems to indicate that (as far as the Service is concerned) fund managers receive disproportionate profits interest in *return for services*. The scope of this

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[37] Since qualified dividends are presently taxed at applicable capital gain rates, I will, for simplicity, omit qualified dividends from further discussion and simply focus on capital gains.
[38] *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 45 (Comm. Print 2007).
[39] *See, e.g.,* David A. Weisbach, *The Taxation of Carried Interest in Private Equity*, 94 VIRGINIA LAW REVIEW 715, 763 (2008) ("The considerations discussed [in Weisbach's article] indicate that the treatment of carried interests should not be changed. Under current law, private equity sponsors are treated the same way they would be treated if they engaged in the activity directly rather than through a partnership. There are sound reasons, many deeply embedded in partnership tax law, for retaining this approach. Moreover, changes would likely be very complex and easily avoidable, imposing costs on the economy while raising little revenue. Distributional concerns are important, but they are not centrally related to the taxation of carried interests. Instead, they arise because of the capital gains preference and, if they are going to be addressed, should be dealt with directly."); *see also* Fleischer, *supra* note 10, at 5 ("Distributive justice, of course, is also a concern."); House Hearing, supra note 1 (Statement of Victor Fleischer), at 7 ("A few professors have been retained by the private equity industry to argue for the status quo; there may be a handful of others who independently support the status quo, but they are few and far between.") .
[40] *See Jones*, *supra* note 5, at 685 ("Generically, the grant of a carried interest is the promise to pay an uncertain amount in exchange for services. Even proponents admit this much.").

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Revenue Procedure is unambiguously clear – “to [provide] guidance on the treatment of the receipt of a partnership profits interest *for services provided* to or for the benefit of the partnership.”[41] Moreover, the Treasury stated on several occasions, most recently in the 2012 Revenue Proposal, that it deems income received from “profits (carried) interests” as income from the performance of services.[42]

1. Historical Perspective on Subchapter K

When in 1954, a Congressional study was lamenting the inadequacy and confusion of statutory provisions relating to partnership tax law, it noted the following: “[The] confusion is particularly unfortunate in view of the great number of business enterprises and ventures carried on in the partnership form. It should also be noted that the partnership form of organization is much more commonly employed by small businesses and in farming operations than the corporate form.”[43] As a result, the study continued, the principle objectives of Subchapter K would be “simplicity, flexibility, and equity as between the partners.”[44]

Hardly the original drafters of Subchapter K envisioned that present-day alternative investment vehicles would utilize the partnership form to control assets valued by the trillions and do so virtually exclusively for tax purposes.[45] As it now stands, the antiquated framework of Subchapter K applies rather awkwardly to modern finance.

2. Historical Perspective on Capital Gains Treatment

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[41] Rev. Proc. 93-27, 1993-2 C.B. 343 (emphasis added).
[42] *See* STAFF OF JOINT COMM. ON TAX‘N, DESCRIPTION OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT‘S FISCAL YEAR 2011 PROPOSAL 385 (Aug. 2010) (JCS-2-10).
[43] H.R. REP. NO. 1337, 83d Cong., 2d Sess. 65 (1954); S. REP. NO. 1622, 83d Cong., 2d sess. 89 (1954).
[44] *Id.*
[45] *See, e.g.,* Curtis J. Burger, *W(h)ither Partnership Taxation*, 47 TAX L. REV. 105, 110 (1991) (“Partnerships of [1954] era were rather simple ventures: the neighborhood hardware store or lumber yard, the law firm or brokerage house, the band of theatrical angels or the oil and gas syndicate. These typified the general and limited partnerships that were familiar to the drafters of subchapter K.”).

Following the passage of the Sixteenth Amendment,[46] Congress, for the most part,[47] consistently awarded some manner of preference to individuals‘ capital gains rates.[48] As a result, labor income has normally been taxed at higher rates.[49] The general justification for the preferential treatment of capital gains is based on the idea that a lower tax rate will attract *capital investments*, fund entrepreneurial activity, and mitigate, to some extent, inflationary (as opposed to economic) appreciation of capital assets.[50] Another incarnation of the same argument is the prevention of the so-called ―lock-in” effect. In other words, a potential tax liability deters taxpayers from selling capital assets, thus stagnating the economy. In *Burnet v. Harmel,*[51] the Supreme Court stated that the policy for the lower capital gains rate is ―to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.”[52]

Over the years, the preferential treatment of capital gains has received a fair amount of criticism, and many have questioned the rationale of lower capital gain rates altogether.[53] In many instances, the support has been advanced retroactively, following the actual introduction of the preference in 1921.

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[46] U.S. CONST. amend. XVI (granting Congress the power to ―lay and collect taxes on incomes, from whatever source derived”).

[47] From 1913 to 1921, capital gains were taxed at ordinary income rates; The Tax Reform Act of 1986 repealed most of the preferences, raising the maximum rate to 28% and 33% in some instances. Beginning with 1997, The Taxpayer Relief Act of 1997 brought back many of the preferences for capital gains.

[48] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, PRESENT LAW AND HISTORICAL OVERVIEW OF THE FEDERAL TAX SYSTEM 57-62, (2010) Committee Print JCX-51-10, (providing the complete list of historical capital gain and ordinary income rates); *see also* Charles J. Cooper et al., *The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains*, 12 VIRGINIA TAX REVIEW 631, 637 (1993).

[49] I.R.C. §§1, 61.

[50] *See generally* David Carris, *Capital Gains Taxation: A Full Circle?* 12 THURGOOD MARSHALL LAW REVIEW 43 (1989) (examining historical treatment of capital gains and the reasons behind the treatment).

The capital gain which results purely from inflation is still taxed even though the gain does not represent any true economic gain. For a discussion on indexation of capital gains for a reflection of true economic, and not inflationary, gain *see generally* Charles J. Cooper et al., *The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains*, 12 VA. TAX REV. 631 (1993).

[51] 287 U.S. 103 (1932).

[52] *Id* at 106 (citing H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921)).

[53] *See, e.g.,* Noel B. Cunningham et al., *The Case of a Capital Gains Preference*, 48 TAX L. REV. 319 (1993).

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The Code provides no express definition of a capital asset, but it is generally understood to be investment property.[54] In any event, it is absolutely clear that labor is not a capital asset. Consequently, when an individual is compensated for labor or services, that individual realizes ordinary income and not a capital gain.[55] However, the line between labor and capital is not always clearly drawn because of our tax system‘s disposition to encourage entrepreneurship. On this frontier lay some of the more difficult cases.[56]

3. Carried Interest: Capital Gain or Ordinary Income?

<u>What is a Capital Asset?</u>

Section 1221 presumes that all assets are capital unless they are excluded by two broad categories of exemptions: assets that are used in a trade or business, such as inventory; and assets that are created through personal efforts of the taxpayer. The text of Section 1221 lists the specific exclusions.

For example, Section 1221 excludes copyrights, literary, musical, or artistic compositions if taxpayer‘s *personal efforts* created such property. Examination of legislative history reveals that congressional intent in exclusion of these assets was to prevent “amateurs” from selling their “book[s] or other artistic work” after holding them for the statutory period and receiving “long-term capital gain treatment on the product of [their] personal effort.”[57] Building on this exclusion through reasonable extrapolation we could then conclude that one distinction between

[54] *See id*.
[55] I.R.C. § 61(a).
[56] For a summary of arguments for and against capital gains, see Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957).
[57] *See* S. REP. NO. 2375, 81st Cong., 2d Sess., at 3097, 3140. *See also Ferrer*, 304 F.2d 125, footnote 5.

capital and non-capital asset is difficult to define but nonetheless clear: Income that results from one‘s labor ought to be treated as ordinary income and not a capital gain.[58]

But this extrapolation falls apart in Section 1235. There, Congress states ―in most contradictory fashion [that] . . . inventions in the hands of the ‗individual whose *efforts* created such property‘ *are to be given capital gain treatment*."[59] In this case, Congress is referring to the treatment of patents rather than copyrights. Conceptual analysis reveals little difference in the creative process of an artist and an architect: Both work and use their skills to create an asset. Yet, upon the disposition of their ultimate creations, the architect‘s gain from the sale of her patent is capital gain, but the artist‘s gain from the sale of his painting is ordinary income. Quite a disparate result.

Legislative history indicates that the inconsistency is largely due to ―ad hoc reactions to political and economic events."[60] Such inconsistencies substantially complicate identification of the *general intent* for awarding preferential treatment to capital gains, and confuse the already blurry definition. If this point is taken to the extreme, then determination of the character of the gain must be evaluated on a case-by-case basis, subject to a detailed examination of congressional intent. Clearly, this approach is not reasonable or practicable, and, in most cases – so long as one does not attempt too strenuously to connect *theoretical justification* of capital gains treatment with the *actual characterization* of an asset – the characterization law is reasonably clear and well-settled.

The Difficulty of Characterization of Carried Interest

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[58] Albeit this is not the only distinction, another one being distinction between business income and capital gain. *See* I.R.C. 1221; *see also* Madelyn Shohen Cantor, *Tax Policy: Copyrights and Patents*, 31 VILLANOVA LAW REVIEW 931, 934 (1986).
[59] Cantor, *supra* note 57 (emphasis added).
[60] *Id.* at 989.

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The law, however, is not clear or well-settled in those instances where capital assets mix with services, such as for example in carried interest arrangements. The determination of the appropriate theoretical character of a carried interest gain is complicated by several factors, including a lack of clear definition of a capital asset. The critics' assumption that carried interest compensation is axiomatically compensation for services does not reflect the complexity of the issue.

The Joint Committee on Taxation acknowledged this much in a widely cited committee print published in 2007.[61] For example, the Committee provides several appropriate ways to frame the issue of characterization:

> [I]t could be said that an investment management business with respect to an investment fund requires the manager to contribute some capital, and the carried interest arrangement is merely a financing by the other investors of the managers' capital investment in the fund. Consequently it would be conceptually appropriate for the manager's income to have the character of capital gain. . . .
>
> On the other hand, it can be argued that such a carried interest arrangement primarily involves the performance of services by individuals whose professional skill generates capital income for investors in the fund.[62]

Consider also an earlier judicial view of the matter: "[A] partner devoting his time and energies to the business of the firm is in fact working for himself and can not be considered an employee of the firm. . . It follows, therefore, that he can not be paid a salary by the firm out of earnings."[63] This view is still pervasive today, even though Section 707(a)(1) clearly establishes that a partner may transact with a partnership in a capacity other than a partner.

Parallels between Carried Interest and Self-created Assets

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[61] *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 33-35 (Comm. Print 2007) [hereinafter J. Comm., Carried Interest].
[62] J. Comm., Carried Interest, at 46.
[63] Tilton v. Commissioner, 8 B.T.A. 914, 917 (1927).

Conceptual criticism of carried interest is generally based on the premise that carried interest is disguised compensation for investment services, which is treated far more favorably than it deserves. There is, however, another way to look at this issue, and that is through comparing taxation of carried interest to taxation of self-created assets.

Taxation of self-created assets is an area where many theoretical issues related to taxation of carried interest come together. Particularly, the issues of timing and character can become more lucid when compared with taxation of self-created assets. I assume in this instance that this comparison is conceptually appropriate. For example, imagine an entrepreneur who starts a business by funding it with loan proceeds. During the next five years the entrepreneur grows the business. He has modest annual earnings on which he pays tax at ordinary rates. However, the majority of the return on his labor comes from the sale of the business, the proceeds of which are treated as a capital gain. In this case, the entrepreneur effectively deferred tax on the self-created asset because he paid no tax on unrealized imputed income; [64] and the character of income, once realized, was a favorable capital gain.[65]

Professor David Weisbach argues that a fund manager can also be viewed as an entrepreneur raising capital to make an investment.[66] He compares a fund manager to an investor who buys stock through a margin account[67] (investor who borrows money from her broker to finance the trade). Investor uses someone else‘s money and their own ―effort and ideas about stock valuations to make money."[68]

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[64] Imputed income has been defined as ―a flow of satisfactions from durable goods owned and used by the taxpayer, or from goods and services arising out of the personal exertions of the taxpayer on his own behalf." Marsh, *The Taxation of Imputed Income*, 58 POL. SCI. Q. 514 (1943).
[65] This result is not without its critics. *See, e.g.,* Noël B. Cunningham & Deborah H. Schenk, *How To Tax the House that Jack Built*, 43 TAX L. REV. 447 (1988).
[66] *See* Weisbach, *supra* note 38, at 717.
[67] *See id.*
[68] *Id.*

The tax-planning strategy where one's labor is invested into a business and the return on labor is not taxed until the ultimate disposition of one's interest in the business is often referred to as sweat equity.[69] Generally, sweat equity is taxed preferentially compared to other labor income. This treatment is rather peculiar because the Code generally frowns upon conversion of labor income into capital gains: Consider, for example, the previously mentioned definition of a capital asset where certain assets created by one's *personal efforts* were not considered capital.[70]

Nonetheless, sweat equity has long been recognized as a real tax subsidy of entrepreneurial activity. To argue that this subsidy is unfairly used by fund managers when it remains available in all other businesses is inconsistent.

On the other hand, Professor Victor Fleischer argues that the comparison of carried interest and self-created assets, at least in the area of income deferral, is not entirely appropriate.[71] He makes the point that administrability concerns, such as accurate measurement of income and access to liquidity, do not apply to fund managers in the manner they apply to entrepreneurs.[72] Therefore, the ―privilege not to be taxed on wealth in the form of self-created assets"[73] may not be the best policy when it comes to fund managers.[74]

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[69] *See, e.g.,* James R. Walker, *Sweat Equity Planning Update: "Still Sweating to the Oldies,"* COLORADO LAWYER, June 2004, *available on westlaw*: 33-JUN COLAW 97.

[70] *See also* Howard E. Abrams, *Taxation of Carried Interests: The Reform That Did Not Happen*, 40 LOYALA UNIVERSITY CHICAGO LAW JOURNAL 197, 198 (2008), citing Rev. Rul. 2004-10, 2004-2 C.B. 960 (―It is too late in the day to argue that the naked sale of one's labor generates capital gain.").

[71] *See Fleischer, supra* note 10, at 36-37.

[72] *See id.*

[73] *See* Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69, 79 (1992) (―Some defend the statutory line [that permits partners to defer income from a profits interest] on the ground that it preserves for partners a privilege they enjoy as individuals. This is the privilege not to be taxed on wealth in the form of self-created assets.").

[74] Professor Fleisher states the following:

> Sweat equity is more lightly taxed than other forms of labor income. The entrepreneurial-risk subsidy that results can be justified by administrative concerns and, perhaps, by the widely shared view that entrepreneurship generates positive social externalities. As I discussed in the previous Part, however, the subsidy for entrepreneurship does not stem solely from the capital gains preference. Rather, it also comes from the choice we make to defer tax on the imputed income that accompanies working for oneself--the ability to invest with pretax dollars and not pay tax

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Suppose, for example, the following scenario: Manager, acting as a sole proprietor, invests $1 million of cash into gold bars. One year later, Manager sells the gold for $2 million and realizes a gain of 100%. The sale proceeds in excess of Manager's basis are treated as a capital gain.[75] Now, to achieve scale, Manager, as entrepreneur, invites Investor to join Manager's fund. In order to buy into his successful fund, Manager charges Investor a fee equal to 20% of the Fund's future profits, but only if the Fund is profitable. Investor gladly agrees because in the absence of Manager, Investor was only able to achieve a 5% return on their money.

Some scholars argue that partners should not be penalized for pooling their labor and capital. Indeed, in this example, there is some difficulty in justifying that the benefit of favorable tax treatment available to Manager prior to his partnering with Investor should be taken away by virtue of conducting business in a partnership form.

Mix of Capital and Services

The difficulty of determining the theoretical character of carried interest is further complicated because fund managers usually contribute both services and capital. In a sterile environment, the line between services and capital would be clearly drawn, and the tax system would impose *capital gain rates* on that portion of income which is attributable to *capital* and *ordinary income rates* on the portion attributable to the *performance of services*. The difficulty here is parsing between the two and assigning a reasonable rate of return to capital. For

> until one's investment is sold. Doing away with the capital gains preference for sweat equity, therefore, would not extinguish the entrepreneurial risk subsidy.

Fleisher, *supra* note 10, at 44.

[75] *See* I.R.C. §§ 1001, 1222.

example, Professor Mark Gergen suggests that when partners contribute capital and labor, the rate of return on labor can be partially masked and difficult to determine.[76]

Consider an easy scenario again using our earlier example of gold bars. In this hypothetical, a $100 million fund of gold bars doubled in price over a 10-year period. Manager received a total of $20 million of $100 million gain as carried interest. We now have to determine which portion of the $20 million is return on capital and which portion is compensation for services. Here, it seems, we could confidently assign a 100% rate of return to capital (the capital doubled in price). If that's the case, then Manager would appropriately receive $5 million as a capital gain resulting from doubling of Manager's capital contribution of $5 million; and the remaining $15 million would be characterized as income from investment services.

However, not all ventures include scenarios where returns could be clearly apportioned between capital and labor. Some funds invest in assets or companies that may be small and risky. In those cases, the distinction between labor and capital income can be hazy.[77] Additionally, present partnership rules permit uneven allocation of partnership profits so long as the allocations have substantial economic effect. In other words, even in those instances where a rate of return on capital can be ascertained with certainty, partners may have valid business reasons to allocate profits *not* in accordance with partners' capital contributions.

Attempting to Separate Returns on Labor and Capital

[76] *See* Gergen, *supra* note 72, at 107 (This solution [of allocating all partnership items in accordance with relative balances in partners' capital accounts] is not perfect. One defect is that if both partners contribute capital and labor, returns on labor are masked. The extreme case is where partners contribute equal capital and labor. In this case, all returns would be treated as returns on capital. If all contribute capital and labor, but in unequal portions, returns on labor would be partially masked. There is no good way to deal with these cases. Returns could be apportioned between labor and capital if a reasonable rate of return could be set for capital. Most ventures, however, where all partners contribute labor and capital are small and risky. In these situations, it is difficult to assign a fair rate of return on capital.") (citation omitted).
[77] *See id.*

There have been a number of suggestions on ways to separate returns on labor and returns on capital. In the context of carried interest and the proposed reform, the partnership bar advanced what one commentator describes as ―a truly ingenious and wonderfully complex solution that purports to disentangle the separate components of a service provider‘s return: a service provider would be taxed on constantly shifting mix of ordinary income from labor and capital from labor converted into earned capital."[78] Unfortunately, she then goes on to point out, ―the existing capital account system is wholly inadequate" to handle this task accurately.[79]

Other commentators have suggested that all investment returns can be separated into three components: risk-free return, risk premium, and a supernormal return.[80] The character of the supernormal portion of the return, they suggest, should be taxed on par with a return to skill or a windfall.[81]

Summary

Characterization of carried interest as compensation for investment services is not axiomatic. Rather, a carried interest represents a blended return on capital and services. Presently, the entire amount of gain flowing from carried interest is treated as return on capital. The proponents of this treatment compare this result to the treatment of sweat equity and thus suggest that it is appropriate. On the other hand, the critics argue that the comparison to sweat equity is misguided because the main advantage of carried interest is in exploitation of differences in tax rate of the manager and the investors.[82] Yet some suggest that even if

[78] *See* Burke, *supra* note 35, at 33.
[79] *Id.*
[80] *See* David Elkins & Christopher Hanna, *Taxation of Supernormal Returns*, 62 TAX LAWYER 93, 115 (2009).
[81] *See id.* (―With regard to supernormal returns, we believe it should be viewed as a return on the taxpayer‘s skill or labor, or in some cases, simply a windfall. It should not be viewed as an element of the return on capital.").
[82] *See* Chris Sanchirico, *Taxing Carried Interest: The Problematic Analogy to "Sweat Equity*," 117 TAX NOTES 239, 244 (2007) (―The tax advantage of carried interest is primarily an exploitation of tax rate differences across taxpayers. The supposedly ubiquitous tax advantage of sweat equity is described as if it were available to a single

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comparison to sweat equity is appropriate, present taxation of sweat equity is problematic as a matter of policy.[83]

B. Concerns over Fairness

The problems of characterization, and particularly the present treatment of carried interest as capital gains, also give rise to concerns over fairness.

Fairness is one of the central concerns of any tax system.[84] Although fairness is difficult to define without some measure of subjectivity and personal ethical judgment,[85] carried interest compensation has received virtually universal criticism as being ―unfair.‖ Even if existence of carried interest is proper under the present law, issues surrounding its fairness will likely persist. Professor Howard Abrams contextualized the issues as follows: ―Hedge fund and private equity managers make too much money, and it pours salt in the wounds when their tax rate is lower than everyone else's.‖[86]

1. Disproportionate Tax Burden

Tax fairness is generally underpinned by the concepts of horizontal and vertical equity.[87] Horizontal equity requires that persons in similar positions carry similar tax burdens. Vertical equity, on the other hand, raises the issue of progressivity and proportionality of tax rates. A progressive rate is conceptually opposite to a proportional rate. In a progressive rate system, tax liability (as a percentage of income) rises with income; in a proportional system, the tax liability (as a percentage of income) remains constant.[88]

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taxpayer, and is, in fact, largely illusory. Consequently, the tax advantage of carried interest gains no real validity by attempts to associate it with sweat equity.").

[83] *See* Victor Fleisher, *Taxing Founders' Stock*, *available at* http://ssrn.com/abstract=1718749.

[84] *See* JOEL SLEMROD ET AL., TAXING OURSELVES 59-60 (4th ed. 2008).

[85] *See generally* Victor Thuronyi, *The Concept of Income*, 46 TAX LAW REVIEW 45 (1990).

[86] Abrams, *supra* note 69, at 198.

[87] *See* SLEMROD, *supra* note 83, at 58-60.

[88] *Id.* at 60.

For example, the American tax system adopts the progressive approach.[89] That is, the greater one's income, the higher *percentage* of tax one will pay. In a proportional system, the tax rate remains constant for all taxpayers regardless of their income. If we accept then, without departure into the underlying reasons,[90] the premise that progressive rates are fair[91] as implemented by the American tax system, the present tax treatment of carried interest does *not* fit neatly within that system.

Successful fund managers are usually top-bracket taxpayers. In dollar terms, the carried interest received by fund managers is often measured by the millions, and in some instances, even by the billions of dollars.[92] The managers are able to reduce their effective tax rate through favorable tax rates on capital gains and preferred dividends.

Thus, horizontal equity is violated because a hedge fund manager may be in the same pre-tax economic position as a wage-earner, but the manager's effective tax rate will be lower due to the character of the manager's income. Vertical equity is violated because the manager's effective tax rate is below that of a lower-income wage earner.

2. Payroll and Self-employment Taxes

Another corollary of classifying carried interest as capitals gains is the exclusion of managers' income from payroll taxes. Employment taxes were authorized by Federal Insurance

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[89] *See, e.g.,* I.R.C. § 1(a), (i).

[90] A debate exists on the fairness of the progressive system of taxation. A departure into this debate would require ―taking several steps back" to evaluate the most basic definitions of fairness and justice. Indeed, such departure would be required if we were to reevaluate the fairness of progressive American taxation. In fact, it is my opinion that it would only be proper to reevaluate these principles through a ―veil of ignorance" (entirely and objectively disinterested state) as described by John Rawls in *A Theory of Justice*, (Cambridge, Mass.: The Belknap Press of Harvard University Press, 1971), pp. 11-103. Such departure is outside the scope of this paper.

[91] *See, e.g.,* Fleischer, *supra* note 10, at 43 (―Most tax scholars agree that we ought to tax labor income progressively so that the average tax rate rises with income."). *See also* Joseph Bankman et. al., *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 1966-67 (1987) (stating that tax literature generally suggests that a fair tax system would implement progressive rates).

[92] *See* Jacoby *supra* note 3.

Contributions Act[93] and originally included two components: (1) the old age, survivors, and disability insurance (―Social Security tax"); and (2) the Medicare hospital insurance (―Medicare tax"). Employment taxes are calculated on employees' wages. Self-employed individuals pay an equivalent tax under Self-Employment Contribution Act.[94]

Usually, the self-employment tax rate is 15.3%.[95] The Social Security portion of the tax (12.4%) is only applied against the first $106,800 of one's earnings.[96] The Medicare tax (2.9%) does not have a comparable ceiling. The payroll/self-employment taxes are a major source of revenue for the federal budget. In 2009, payroll taxes amounted to 42.3% of total federal revenues.[97] The share of the individual income tax for the same year was 43.5%.

Fund managers are generally subject to self-employment taxes on income derived from self-employment, e.g., managing the investment fund. However, managers are usually able to avoid a very substantial portion of the self-employment tax. First, the managers' distributive share of partnership's income that includes interest, dividends, and capital gains is not subject to self-employment tax.[98]

Second, the managers rely on the limited partnership exception contained in Section 1402(a)(13) to minimize self-employment taxes on the 2% of the management fee. The structure is as follows:

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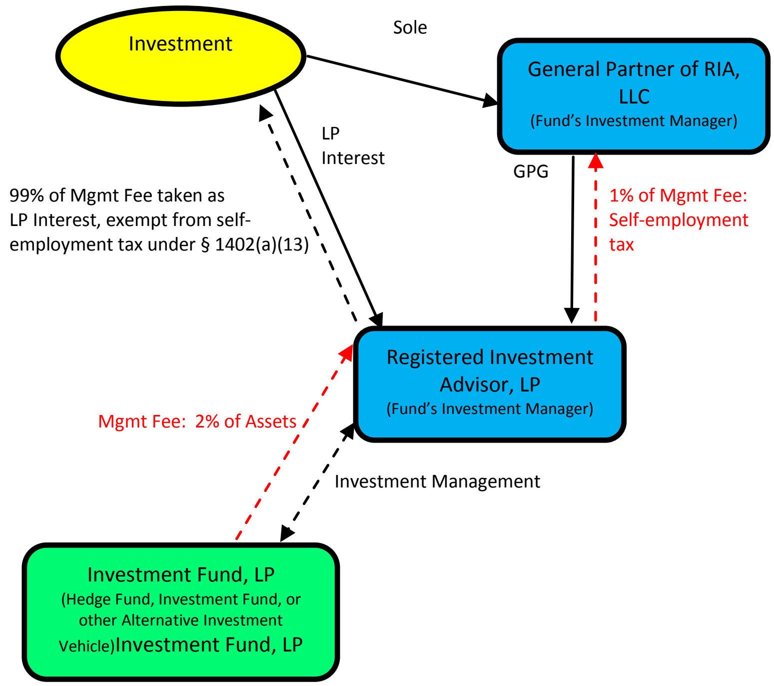
[93] I.R.C. §§ 3101 - 3128.
[94] I.R.C. §§ 1401 - 1403.
[95] It is reduced to 13.3% in 2011.
[96] Old age, survivors, and disability insurance tax is applied only against the wage base, $106,800, in 2010. The hospital insurance tax does not have a maximum wage limit.
[97] The tax proceeds are then distributed into three separate trust funds: Old Age, Survivor Fund; Disability Insurance Fund; Hospital Insurance Fund.
[98] *See* I.R.C. § 1402(a)(2), (3), (13).



Recently, a somewhat similar, but distinguishable structure has been disallowed by the Tax Court in *Renkemeyer v. Commissioner*.[99]

3. Conversion of Management Fee into Capital Gain

In addition to avoiding a substantial portion of self-employment taxes on what may otherwise be compensation for management services, managers can also forego some or all of the management fee in return for a greater portion of carried interest.

4. Inconsistency with Treatment of Executive Compensation

[99] *Renkemeyer v. Commissioner*, 136 T.C. 7 (February 9, 2011).

―In *Renkemeyer*, the individuals were partners in a limited liability partnership. Unlike a limited partnership which requires at least one general partner with unlimited liability, in a limited liability partnership there is no general partner and none of the partners have unlimited liability. The Tax Court in *Renkemeyer* effectively held that none of the individual partners were ―limited partners" within the meaning of section 1402(a)(13) because they actively participated in the partnership's business of providing legal services. The position often taken by the individual investment professionals in a hedge fund is technically distinguishable from the facts in *Renekmeyer*. The investment professionals are 99% limited partners in a limited partnership that has a general partner and it would be the general partner that actively participates. However, the Tax Court in *Renekmeyer* was clearly influenced by the fact that the partners' distributive share of income did not arise as a return on the partners' investment but arose from the legal services they performed and was inclined to look through to the substance of the arrangement. Were the IRS to challenge the position taken by hedge fund investment professionals, surely it would cite to the Renkemeyer case to contend that the income earned by the investment professionals was really compensation for their investment management services." Miller, *supra* note 14, at note 302.

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Section 83 provides the general rule that property received in connection with the performance of services is included in gross income and is treated as ordinary income.[100] Inasmuch as carried interest is compensation for the performance of services, the tax treatment of carried interest is inconsistent with the general framework of Section 83. As a result, the executives of the largest U.S. companies are an unlikely group with a complaint against the fairness of the present treatment of carried interest. Recently, it has become quite common to scrutinize executive pay at many public companies. This trend accelerated following 2008 because a great number of companies receiving government funds continued to compensate their executives lavishly.[101] The Obama administration even appointed a ―pay czar" to oversee and vet executive compensation at the companies receiving government aid.[102]

Some argue, however, that the government and the pay czar are missing the *real* compensation problem in the private investment industry. Indeed, the pay of the executives at the country‘s top companies may be large, but it pales in comparison to compensation of many of the funds‘ managers.[103] In addition, corporate executive usually pay tax at higher effective tax rates than fund managers.

The difference in tax rate is underscored by the character of the received income. On the one hand, fund managers reduce their tax rate by receiving capital gains and preferred dividends, as well as by avoiding the Medicare and Social Security taxes, whereas the executives are not able to minimize their tax rate in this manner. An unintended consequence of this disparity is

[100] *See* I.R.C. § 83; Joint Committee, Carried Interest, at 8.
[101] *See generally* Stas Getmanenko, *Executive Compensation: The Law and Incentives*, 11 WAKE FOREST JN. OF BUS. L. & INTEL.PROP. 81 (2010) (describing recent executive compensation trends in detail).
[102] *See* Deborah Solomon, *White House Set to Appoint a Pay Czar*, WALL ST. J., June 5, 2009, at A2.
[103] *See id.*

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what some industry experts have described as a “brain-drain” from public financial firms to private investment funds.[104]

The area of the greatest overlap in the treatment of executives and fund managers is that of Incentive Stock Options (“ISOs”).[105] And even there, the overlap is minimal.

An incentive stock option is an option that is granted to an “individual for any reason connected with his employment by a corporation.”[106] Section 422 describes these options in greater detail and imposes several limitations. The ISOs are generally considered among the most favorable types of executive compensation because an individual is not taxed on the exercise of the option but rather on the eventual disposition of the asset (usually stock). And then, if the holding period is satisfied, any gain from the sale of ISO stock is treated as a long-term capital gain.

In economic terms, the treatment of ISOs is very similar to carried interest: non-taxable on receipt and favorably characterized on disposition. One important difference however is in the amount of tax subsidy an executive receives in comparison with the fund manager. The favorable treatment of ISOs is limited to $100,000 of stock in a year.[107] Carried interest, on the other hand, is not subject to any comparable limitation.

5. Conversion of Ordinary Income into Capital Gain and Deferral

Ever since the Revenue Act of 1921, with the exception of years 1987 to 1990, the preferential treatment of capital gains has given taxpayers a powerful incentive to convert

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[104] Stephen M. Salley, *Fixing Executive Compensation*, 70 OHIO ST. L.J. 757, 766 (2009); Mark Maremont and Joann S. Lublin, *Limits on Pay Left Unclear in New Law*, WALL ST. J., Feb. 18, 2009, at A4.
[105] *See* Fleischer, *supra* note 10, at 25; Adam Lawton (note), *Taxing Private Equity Carried Interest Using an Incentive Stock Option Analogy*, note, 121 HARV. L. REV. 846 (2008).
[106] I.R.C. § 422(b).
[107] *See* I.R.C. § 422(d).

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ordinary income into capital gains.[108] This conversion is generally frowned upon by the Code, and various provisions attempt to prevent gamesmanship.[109] I have discussed above some of the theoretical shortcomings in classifying carried interest as a capital gain or a qualified dividend. Assuming those shortcomings are true, this is one area where the Code, arguably, fails to prevent capital gains gamesmanship.

Additionally, fund managers, and more broadly, service partners who receive profits interests are able to defer income from the performance of services into the future.[110] For instance, a manager of a private equity fund may labor for a number of years before the portfolio companies are liquidated, by the manager's income will be lumped together and taxed at a later time.

PART IV: POTENTIAL LEGISLATION

To date, there have been several proposals calling for a reform of the present treatment of carried interest. Naturally, each of the proposals has its own peculiarities, but, as a general matter, all are designed to take away the benefit that comes from classifying managers' compensation as long-term capital gains or qualified dividends, and to reclassify all or portion of the compensation as ordinary income as well as to impose a self-employment tax on any reclassified amounts. So far, none of the proposals have succeeded; however, the regularity with which carried interest are mentioned likely foreshadows a change at some time in the future.

A. Legislative Proposals

1. 2007 Proposals

[108] *See* STAFF OF JOINT COMMITTEE ON TAXATION, PRESENT LAW AND HISTORICAL OVERVIEW OF THE FEDERAL TAX SYSTEM 57 (Joint Comm. Print 1955).
[109] *See* BITTKER & LOKKEN: FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶46.1 (Thomson Reuters/WG&L, 2d/3d ed. 1993-2003, updated February 2011 and visited on Mar 16, 2011).
[110] *See* Gergen, *supra* note 72, at 74.

In 2007, there were two bills dealing with carried interest that originated in the House of Representatives. On June 22nd, H.R. 2834 was introduced[111] by Congressman Sander M. Levin (D-Michigan), and on October 30th, H.R. 3996 was introduced[112] by Congressman Charles B. Rangel (D-New York), Chairman of the House Committee on Ways and Means. Although H.R. 3996 eventually passed Congress and was signed into law, at that point, it remained without any of the pertinent provisions relating to carried interest. Representative Rangel also introduced a comprehensive tax reform bill (H.R. 3970) on October 25th. That bill proposed an inclusion of Section 710 in the Internal Revenue Code.[113] The proposed Section 710 would reform the treatment of carried interest.

In a nut shell, the bills proposed to tax as ordinary and subject to self-employment tax that portion of a manager‘s share of partnership income that is attributable to the manager‘s performance of services.

More specifically, the bills introduced the concept of ―investment services partnership interest,"[114] (―ISPI") which was defined as any interest in a partnership which is held by any person if such person provides (directly or indirectly), in the active conduct of a trade or business, a substantial quantity of any of the following services to the partnership:

- advising as to the value of any specified asset;
- advising as the advisability of investing in, purchasing, or selling any specified asset;
- managing, acquiring, or disposing of any specified asset;
- arranging financing with respect to acquiring specified assets;
- any activity in support of these services.[115]

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[111] H.R. 2834, 110th Cong. (2007)

[112] H.R. 3996, 110th Cong. (2007) (eventually becoming Public Law No: 110-166, but without the pertinent carried interest provisions).

[113] Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 710 (2007).

[114] H.R. 3970 § 710(c).

[115] *Id.*

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Any net income with respect to ISPI, would be treated as ordinary income, subject to self-employment tax.[116] Similarly, any gain on the disposition of an investment services partnership interest would also be treated as ordinary income and not a capital gain.[117]

An *exception* is made for *capital interests*.[118] Capital interest is defined as that portion of the ISPI that is acquired through contribution of ―invested capital,” whether money or other property. A ―reasonable allocation” of income with respect to manager‘s ―invested capital” will not be reclassified as ordinary income, where applicable.[119]

An allocation will *not* be treated as reasonable if such allocation would result in the partnership allocating a greater portion of income to invested capital than any other partner who is not providing services would have been allocated with respect to the same amount of invested capital.[120]

Additionally, proposed Section 710 would subject income allocated to ISPI to Social Security and Medicare taxes under Section 1402(a).[121]

2. 2008 Proposal

On June 17, 2008, Representative Rangel again introduced a proposal that would alter the present treatment of carried interest.[122] This proposal was substantially similar to the proposed 2007 legislation; however, it differed in one important respect.

The 2008 bill proposed that loan proceeds to service partners from other partners could *not* be used to capitalize the service partners‘ share of partnership capital. In other words, this

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[116] H.R. 3970 § 710(a).
[117] H.R. 3970 § 710(b).
[118] H.R. 3970 §710(c)(2).
[119] *Id.*
[120] *Id.*
[121] H.R. 3970 § 710(a)(a)(A).
[122] H.R. 6275 § 201, 110th Cong. (2008).

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provision foresaw fund managers borrowing money from fund investors in order to acquire a capital interest in the partnership and thus avoid ISPI.

The provision was drafted as follows: “an investment services partnership interest shall not be treated as acquired on account of a contribution of invested capital to the extent that such capital is attributable to the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any partner or the partnership.” This provision is of substantial importance and is discussed in greater detail *infra*.

3. 2009 Proposal

On April 2, 2009, Representative Levin re-introduced legislation intended to reform the treatment of carried interests.[123] This proposal built on the previous two. There was, however, one noteworthy addition.

The 2009 bill proposed to amend Section 83 to make possible an 83(b) election with respect to a partnership interest transferred in connection with performance of services. The valuation of the interest will be “equal to the amount of the distribution which the partner would receive if the partnership sold (at the time of the transfer) all of its assets at fair market value and distributed the proceeds of such sale (reduced by the liabilities of the partnership) to its partners in liquidation of the partnership.”[124]

In concert to the amendment to Section 83, the bill also permitted any capital interest acquired by the service provider under the revised Section 83 to be classified as a “qualified capital interest” under the proposed Section 710. Any distributive share of income properly arising from qualified capital interest (interest from contribution of money or property, or from

[123] H.R. 1935, 111th Cong. (2009).
[124] *Id.* §1.

previously taxed income arising from 83(b) election) would not be reclassified under the proposed Section 710.

In essence, a *qualified capital interest* would be capital interest resulting from the contribution of previously taxed money, property, or services. Capital interest that is attributable to proceeds of a loan or other similar advance made or guaranteed by another partner in the partnership would be considered a *disqualified capital interest*.

The allocation restrictions would then be as follows: In the case of a qualified capital interest, all items of income, gain, loss, and deduction which are allocated to such qualified capital interest shall ***not*** be reclassified if

> (i) allocations of items are made by the partnership to such qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide any services described in paragraph (1) and who are not related to the partner holding the qualified capital interest, ***and***
> (ii) the allocations made to such other interests are significant compared to the allocations made to such qualified capital interest.[125]

4. 2010 Proposals

Carried interest resurfaced again in 2010 as part of the proposed *American Jobs and Closing Tax Loopholes Act of 2010*.[126] The 2010 edition included a good amount of new detail. For instance, a special rule for dividends was introduced. It stated: ―Any dividend taken into account in determining net income or net loss for purposes of [classifying managers' net income as ordinary] shall not be treated as qualified dividend income for purposes of section 1(h)."[127] The provision thus made clear that the preferential dividend rate also would not be available to

[125] *Id.*
[126] H.R. 4213.EAH, 111th Cong. (2010).
[127] *Id.* § 411.

managers so long as the dividend flowed through to the manager in connection with a profits interest.

There was also a number of novel amendments, including an amendment introduced by Senate Finance Committee Chair Max Baucus, that would tax carried interest allocations at a –blended rate.”[128] That is, an –applicable percentage”, e.g., 75% of the net income from ISPI, would be taxed as compensation income at ordinary rates and be subject to self-employment tax, and the remaining 25% attributable to ISPI would be taxed as under the present law – any gain would retain its taxable character. Any income attributable to a qualified capital interest (capital interest acquired with after-tax money or property), as with the previous proposals, would not be recharacterized.

Several different ratios for applicable percentage were proposed. The House bill provided that prior to January 1, 2013, the percentages would be 50%/50%, and for the years beginning January 1, 2013, 75% of ISPI income would be recharacterized. The Senate amendment also proposed 50%/50% until 2013, but reduced the rate following 2013 to 65%.[129]

B. Obama Administration Revenue Proposals

The Obama administration in revenue proposals for fiscal years 2010, 2011, and 2012 also proposed that treatment of carried interest should be changed. The proposals were very much along the lines of the legislative proposals discussed above.

As reasons for change, the revenue proposals cited, as a foregone conclusion, that income allocable to profits interest is received in connection with the performance of services. As a result, the proposals suggest, income attributable to a carried interest should be taxed (1) as ordinary income and (2) be subject to self-employment taxes.

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[128] –Blended rate” is a phrase used in Miller, *supra* note 14.
[129] Senate Amendment 4301 to H.R. 4213, 111th Cong. (2010).

The administration described the present system as including ―an unfair and inefficient tax preference," which permitted some of the ―highest-income Americans" to benefit from the preferential treatment.[130]

C. Criticism of the Proposed Section 710

Although the desire to reform taxation of carried interest is widespread virtually everywhere but within the private investment industry, the proposed Section 710 has not received universal support. Professor Howard Abrams has become one vocal critic of the proposed provisions. He wrote: ―Will proposed section 710 become law? I don't think so: it has too many technical flaws and too few conceptual underpinnings."[131] Professor Abrams' criticism is focused on two areas: First, he argues, it is inappropriate to tax carried interest as compensation for income without regard to partnership's underlying activities. Second, the technical provisions of Section 710 are flawed because their reach went far beyond hedge funds and private equity funds.[132] Similar criticism has also been voiced by others.[133]

D. Outlook for Reform

In October of 2010, there was a great deal of uncertainty on many of the tax provisions that were to become effective starting January of 2011. The Bush tax cuts were expiring, and no decision was yet made. Inability to know the law as it would be two months from then was frustrating to many tax practitioners, and especially to those practicing estate planning. At this time, I was fortunate to attend several events where Thomas A. Barthold, Chief of Staff of the

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[130] General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, Department of the Treasury (February 2011), at 61.
[131] Howard Abrams, *Carried Interests: The Past is Prologue, Emory University School of Law Research Paper No. 08-32*, *available at* http://ssrn.com/abstract=1085582.
[132] *Id*. at 214-227.
[133] Bradford D. Whitehurst, UPDATE ON CARRIED INTEREST LEGISLATION (VCEXPERTS, Newsletter of Bingham McCutchen LLP), 2010.

Joint Committee on Taxation, was presenting. One estate planning practitioner asked Barthold whether he had any ―gut feeling" on the estate tax in 2011. ―No," was Barthold‘s simple reply.

Indeed, predicting legislature is an ungrateful task, and, nobody can foresee the future. All the same, carried interest reform—unmentioned before 2008—has become a regular point of tax conversation. The House, on several occasions, passed bills that would have changed the present treatment, but the reform then stalled in Senate. Perhaps, the ―blended" approach from the previous legislative session may be the compromise that ushers in change. Or it might not. Certainly, the increasing budget deficits stack the odds further in favor of reform. The lobby behind carried interest does have deep pockets, but it does not necessarily have a broad constituent base, which makes the reform politically palatable. In any event, it is not inconceivable that a reform does occur. But will it be effective? How will the industry respond to change? The following section attempts to answer this question.

PART V: POTENTIAL RESPONSES TO CARRIED INTEREST REFORM

The previous Part revealed two main points of emphasis for the proposed reform. First, it would tax carried interest as ordinary income. Second, it would make carried interest subject to self-employment tax. The result could certainly increase the effective tax rate paid by fund managers. The increase could be rather substantial, both in percentage and dollar terms. The incentive to avoid the increase would also be high.

Whether the new tax would have behavior modifying consequences on the industry remains to be seen. Additionally, it is unclear who would ultimately bear the tax burden. In any event, the response would doubtfully be universal, at least in the short run. For some investment vehicles, such as, for example, hedge funds that derive little long-term capital gains due to trading strategies, the change may amount to an imposition of self-employment tax, which managers are often able to avoid through the limited partnership exemption of Section 1402(a)(13). On the other hand, private equity funds would be more severely affected because the bulk of their income is, in fact, characterized as a long-term capital gain. If the present fund structure persists after the reform, the effective tax rate for private equity managers will likely jump by more than 20 percentage points.

Perhaps, there are even greater changes on the horizon. Certainly doubtful, but revisions of the present system of capital gains taxation may be in store as they were in 1986. They may take away or limit the significant preference long-term capital gains and qualified dividends receive in today‘s regime. If that is the case, Section 710 may be reduced to an imposition of self-employment tax.

In any event, in this Part, I attempt[134] to foresee some of the consequences arising from the adoption of Section 710, as it is presently drafted, for the industry as a whole. I also review some of the alternative compensation arrangements that may emerge in response.

A. Consequences for the Industry as a Whole

The appetite for alternative investment structures has been growing steadily over time and was not put out by the 2008 financial crisis.[135] By most conservative estimates, the hedge fund and private equity industries control between 4 and 5 trillion dollars globally.[136]

Recently, money has continued to flow into the alternative investment space.[137] For instance, hedge funds experienced an inflow of capital in every month of 2010 but one.[138] Much of the new capital is coming from institutional investors, such as university endowments and pension funds,

[134] My attempt comes with a broad disclaimer, which I borrow from experienced practitioners: ―Organizing a private equity fund to accommodate the differing interests of different types of fund investors and the different types of investments that may be made by the fund requires the fund's tax advisor to have an understanding of virtually every part of the Internal Revenue Code.” *See* James H. Lokey & Donald E. Rocap, *Selected Tax Issues in Structuring Private Equity Funds*, PRACTICING LAW INSTITUTE (2008), *available on Westlaw* as 841 PLI/Tax 741.
[135] *See* DAVID. F. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT: AN UNCONVENTIONAL APPROACH TO INSTITUTIONAL INVESTMENT 128-31 (2000).
[136] *See infra* notes 138-141.
[137] Sveya Herbst-Bayliss, *Hedge Funds Kept Taking in Money at End-2010*, REUTERS, http://www.reuters.com/article/2011/01/11/uk-hedgefunds-flows-idUSLNE70A01L20110111 (Jan 11, 2011) (estimating November 2010 inflows at $10.4 billion and hedge fund industry as a whole at $1.3 trillion; June was the only month in 2010 with outflows.).
[138] *Id.*

which recently experienced significant funding deficits.[139] The trend of institutional financing appears only to be accelerating at the beginning of 2011.[140]

One study estimates that the bulk of the hedge fund money is now made up from institutional investors who increasingly view hedge funds and private equity funds as run-of-the-mill investments.[141] This trend is important and is discussed below. With the inflow of money, the total fees also continue to climb. In 2001, the combined income of the top 25 hedge fund managers was less than $5 billion. In 2011, the same group earned more than $22.07 billion.[142]

Despite the mammoth amounts of money earned by fund managers, funds‘ clients are still the ones with all the trump cards. It is precisely clients‘ money that enable fund managers to make their returns. For this reason, I doubt that fund mangers will be successful in shifting the burden of the proposed tax onto the clients. Any proposed structural response would have to favor clients‘ interest first and managers‘ interest second.

To suppose that an increase in tax on fund managers will fundamentally alter the flow of money into the private investment industry is probably unrealistic. There will always be plenty of people who wish to manage large sums of money even if that means they have to pay a higher tax on their income. Hedge funds and private equity funds will continue to exist as long as they are able to generate wealth. Nevertheless, the structure and the composition of certain funds may change: To suppose that fund managers do not attempt to avoid the new tax is equally unrealistic. All the same, presently, there are no other tax-efficient alternatives to carried interest that exist without some type of limitations. The previously discussed Incentive Stock Options present the closest comparison, but

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[139] *See Pensions Pour $18 billion into Hedge Funds*, FINALTERNATIVES, http://www.finalternatives.com/node/16169 (April 4, 2011); *Pensions to Increase Direct Allocation to Hedge Funds in 2011*, FINALTERNATIVES, http://www.finalternatives.com/node/16145 (April 1, 2011).

[140] *See id*.

[141] This study estimates that institutional investors make up 61% of hedge fund capital Capital. *See Survey: Institutional Investors Account for Bulk of Hedge Fund Capital*, FINALTERNATIVES, http://www.finalternatives.com/node/15512 (February 10, 2011).

[142] *See Paulson Earns Almost $5B in 2010, To 25 Hedgies Taken in $22B,* FINALTERNATIVES, http://www.finalternatives.com/node/16161 (Apr. 1, 2011).

it is limited to $100,000 a year. Therefore, if a reform is successful—that is, if the Treasury succeeds in raising any money—the returns somewhere in the industry will be trimmed.

B. Potential Structural Responses

A few years ago, Professor Victor Fleischer in his well-read piece ―Two and Twenty: Taxing Partnership Profits in Private Equity Funds"[143] made the following accurate observation: ―To be sure, it is difficult to predict whether and how some fund managers might choose to restructure their affairs in response to a change in the tax law."[144] This observation certainly remains true today. Nevertheless, several hypotheses have been advanced previously in the literature.[145] I compile a digest of them below and advance some other ones.

1. Loans to Finance Managers' Capital Interest

Loans from limited partners to managers would have been quite an easy solution to the original reform proposal.[146] Indeed, instead of making a special allocation, the fund would distribute income in proportion to the partners' capital interests so as to fit within the ―straight-up" exception of the proposed Section 710. In this case, the general partner instead of contributing a nominal or a small amount would contribute 20 percent of the fund's initial capital, thus entitling him to 20 percent of partnership profits. The manager's capital share, however, would be financed by the limited partners through a nonrecourse loan secured by the manager's interest in the partnership. The manager would receive a fee from the partnership equal to the amount of the interest and use that fee

[143] 83 N.Y.U. L. REV 1 (2008).
[144] *Id.* at 38.
[145] I rely primarily on the following: Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83. N.Y.U. L. REV. 1 (2008); Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of taxing Profits Interests as Ordinary Income*, 50 WILLIAM AND MARY LAW REVIEW 115 (2008); David A. Weisbach, *The Taxation of Carried Interest in Private Equity*, 94 VIRGINIA LAW REVIEW 715 (2008); Howard Abrams, *Taxation of Carried Interest*, 116 TAX NOTES 183 (2007); Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUMBIA JOURNAL OF TAX LAW 1 (2010).
[146] The loan alternative was derived from Victor Fleischer's alternative suggestions for reform of carried interest. *See* Fleischer, *supra* note 144, at 52 (Fleischer proposed to tax managers at ordinary rates on imputed value of interest. He referred to this method as the cost-of-capital method). It was also discussed by Howard Abrams in *Taxation of Carried Interest*, 116 TAX NOTES 183, 186 (2007)

to pay the interest on the loan. On the partnership side, the fee expense would be deductible[147] and would offset the interest income received by the limited partners thereby, in economic terms, making this structure equivalent to the present one.

This approach is not without its problems for several reasons. First, the proposed Section 710 prohibits such loans from limited partners and parties related to them. It remains to be seen if some independent source of financing will become available to the managers. Second, there would be some uncertainty as to whether limited partners would be willing to engage in such transactions.[148] Third—the reason previously unexplored—is a potential for implication of manager's fiduciary obligations under the framework of present securities laws. Assuming, however, that the proposed Section 710 is adopted with the loan prohibition (and if it is adopted, it is more than likely that it would contain such a prohibition), this analysis would be entirely unnecessary.

2. *Conversion of Limited Partners into Creditors*

Another potential structure[149] would include forsaking the traditional limited partnership in favor of some other single-member entity that would be comprised solely of the manager. To finance its operations, this entity would borrow money from the investors (creditors). Loans could be secured by portfolio companies or securities which are later acquired. The entity would then proceed with the investment activity and upon liquidation would return the borrowed funds to its creditors and also pay them interest equal to 80 percent of the entity's profits. In the event of a private equity fund, the manager could, for example, form an LLC and pay himself a reasonable salary during the years of operations (compare to a management fee). The remainder of the manager's income would

[147] However, the deduction may be worthless to many, if not most, fund investors, e.g., U.S. tax-exempt entities that invest through foreign blocker corporations. *See infra*.
[148] *See, e.g.,* Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of taxing Profits Interests as Ordinary Income*, 50 WILLIAM AND MARY LAW REVIEW 115, 150-51 (2008) (―The reason that the transaction is problematic is that the loan is not at a market interest rate.")
[149] This structure was originally proposed by David Weisbach, *supra* note 144, at 760-62, and discussed by Michael Knoll, *supra* note 144, at 152-53.

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come from the sale of the portfolio companies and would be characterized as a capital gain. Manager would thus benefit from the entrepreneurial subsidy (sweat equity) previously discussed.

The obvious drawback of this structure is the unfavorable treatment of interest income to those creditors who pay tax. Instead of a long-term capital gain distributed to investors, creditors would receive ordinary interest income. However, untaxed investors would remain substantially unaffected.[150] Because corporate taxpayers do not receive capital gains preference, they would remain similarly indifferent. Additional detail is provided below.

Tax-exempt Entities, Unrelated Business Taxable Income, and Foreign Blocker Corporations

It is necessary, at this time, to depart, at least briefly, from the simplistic “plain vanilla” fund structure assumed throughout this paper to discuss several of the issues pertinent to U.S. tax-exempt and foreign investors. U.S. tax-exempt entities, such as pension funds and universities, are not taxed on income earned from tax-exempt activities.[151] However, they are taxed on “unrelated business taxable income” (“UBTI”).[152] UBTI can arise in one of two ways. First, the tax-exempt entity engages in business activities that are not related to its tax-exempt status.[153] Second, the tax-exempt entity uses leverage to receive gain from a debt-financed investment.[154] When non-profits invest into hedge funds directly, such investment generally give rise to UBTI under both of these scenarios.

To avoid UBTI, U.S. tax-exempt entities typically set up a foreign “blocker” corporation, which then becomes a limited partner in a foreign “feeder” fund, which then invests in a “master” fund.[155] The master fund can be organized either onshore or offshore, but, in any case, will usually be a partnership for U.S. tax purposes.

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[150] *See infra* for discussion on Unrelated Business Taxable Income.
[151] *See* I.R.C. § 501.
[152] *See* I.R.C. §§ 511(a)(1); Treas. Reg. 1.511-1. *See also* I.R.C. §§ 512, 513.
[153] *See* I.R.C. §§ 512(a); 513(a).
[154] *See* I.R.C. § 514(c).
[155] This is only one possible scenario. There are many other fund structure alternatives. *See* Miller, *supra* note 14, at 2-8.

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Because the blocker corporation becomes a limited partner in a tiered pass-through structure, it will often receive U.S. source income from underlying fund investments. Assuming the blocker corporation does not engage in a U.S. trade or business, it will generally be subject to a 30% US withholding tax on its U.S. source income, unless an exception applies.[156] In fact, in many instances various exceptions do apply to reduce the 30% withholding rate. These exceptions include –portfolio interest,"[157] capital gains not attributable to U.S. real estate,[158] as well as reductions for various types of income under any applicable tax treaty.[159] Therefore, a foreign blocker corporation will usually pay a lower effective tax rate than a U.S. tax exempt entity if it were to invest directly into a hedge fund. In the event of direct investment a U.S. tax-exempt entity would generate UBTI, and as a result, would be taxed on it at the usual corporate rate.[160] By utilizing the foreign blocker, any income from a foreign blocker corporation is instead considered a dividend or Subpart F income to the U.S. tax-exempt.[161]

However, the blocker corporation may not always be necessary in certain instances because some types of income are treated as sufficiently passive, and not as UBTI. This passive income usually includes interest.[162]

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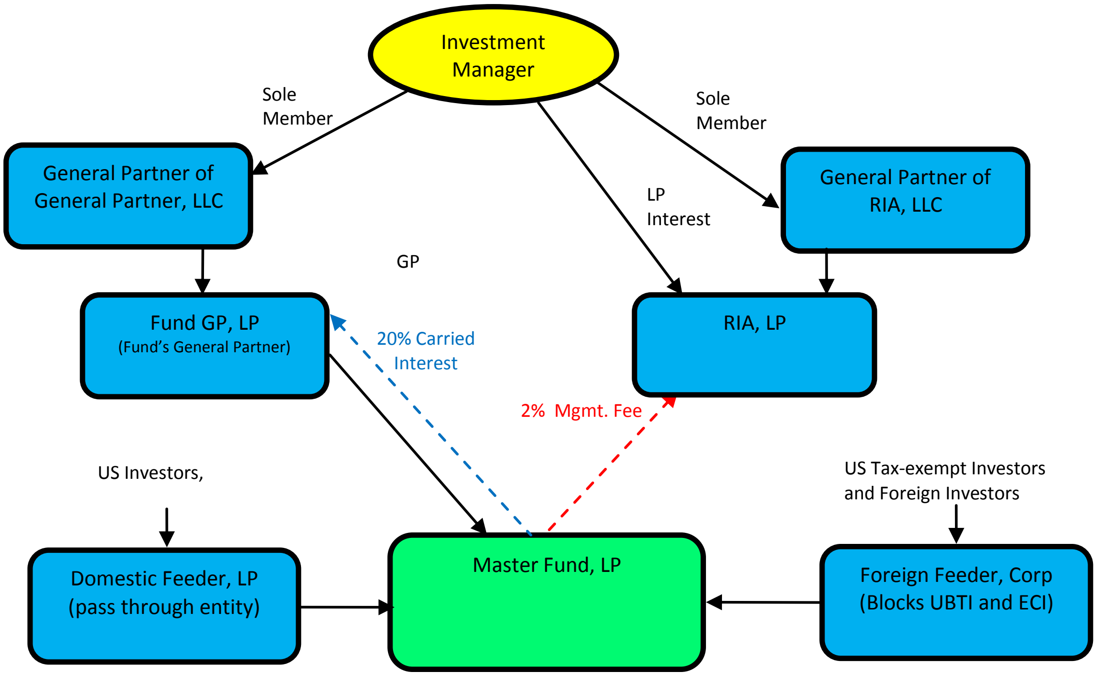
[156] *See* I.R.C. § 881.
[157] *See* I.R.C. §§ 871(h), 881(c).
[158] *See* I.R.C. § 865.
[159] Although, Cayman Islands, the home to many hedge funds, does not have a tax treaty with United States.
[160] *See* I.R.C. § 511(a)(1); Treas. Reg. 1.511-1.
[161] *See* Miller, *supra* note 14, at footnote 77.
[162] *See* I.R.C. § 512(b); Treas. Reg. 1.512-1.

Chart 3: *Master-feeder Fund*



Now, consider one alternative hedge fund structure employing the principles described above: A U.S. nonprofit could simply loan the money to an investment firm, secure it with the future investments with an option to demand repayment at any time (so as to assure liquidity), and classify any of the received income as ―passive investment income" under Section 512(b). It is worth noting that a carried interest reform does not have to take place in order for some U.S. tax-exempt entity to attempt this structure.[163]

The important question is whether the designation of ―creditor" will be respected. One commentator points out that in corporate jurisprudence there is a ―long, confused, and, at times, contentions history of attempting to separate debt from equity."[164] It will remain to be seen whether this structure will invoke similar scrutiny.

Foreign Investors, U.S. Blocker Corporations

[163] As an aside, because many U.S. tax exempts usually have a worthy social policy behind their tax-exempt status (retirement security, education, etc.), there have been some legislative proposals that would relax UBTI rules. Until then, however, U.S. tax-exempt investors will have to be mindful of UBTI rules.
[164] *See* Knoll, *supra* note 144, at 153.

Usually, foreign investors also invest through a blocker corporation so as to avoid U.S. source income that is “effectively connected” (“ECI”) with a U.S. trade or business.[165] The effective tax rate on repatriated ECI can at times reach 54.5%, not including state and local taxes. For this reason, foreign investors will usually invest through a foreign blocker corporation (feeder fund) that becomes a limited partner in the master fund. The master fund then serves as the primary investment vehicle. The blocker corporation thus does not engage in any business activities within the U.S. that could give rise to ECI. Usually, the foreign investors will invest alongside U.S. tax-exempt entities in the foreign blocker corporation as illustrated in the previous chart.

3. Transferring Carried Interest Deductions to Portfolio Firms

This structure was originally proposed by Professor Michael Knoll and applies exclusively to private equity funds.[166] It also, hinges on several assumptions and a great deal of business foresight. Professor Knoll proposes this solution in light of the indifference by institutional and foreign investors to ordinary deductions. In essence, the deduction for paying the manager‘s carry would be transferred from limited partners to the portfolio companies. That is, the portfolio companies would “hire” the fund manager for sums economically equivalent to carried interest. Managers would provide services, and the portfolio companies would deduct the service payments. The upside would be the indefinite deferral on the “recapture” of this deduction made possible by subsequent tax-free corporate acquisitions. The tax-benefit therefore would be enjoyed by the fund‘s portfolio.

The difficult part would be estimating which companies could afford such operational payments and could benefit from a corresponding deduction. Also, the manager‘s share would likely have to be financed prior to exit, and the portfolio companies would need to have sufficient taxable income to benefit from the deduction.

4. Equity Kickers/Options

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165 *See* I.R.C. §§ 871(b)(1), 882(a)(1).
166 *See* Knoll, *supra* note 144 at 153.

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In this structure, the fund would grant the manager an option to buy additional partnership interest in the fund at some predetermined price, for example, at the initial launch valuation. In this scenario, the manager would receive the benefit of the fund‘s appreciation without having to contribute (and risk) substantial sums of money upfront.[167] The manager could exercise this option at some later time (for example prior to liquidation), borrowing money short-term if necessary and repaying it upon receiving a distribution from the fund. The kicker, once exercised is treated as investment income, not as labor income, and therefore receives favorable tax treatment of long-term capital gains.[168]

An alternative to an ―equity kicker" would be an option on a percentage of net increase in value. Professor Karen Burke gives the following example:

> If [the manager] had an option on 20% of the net increase in the value of [the fund] ($5 million)," [the manager] would recognize $1 million of ordinary income upon exercise of the option; the tax would be deferred from grant until exercise of the option; all of the partnership‘s capital gain would be taxed to LP, and P would be treated as paying over compensation of $1 million to [the manager] on exercise of the option, with a corresponding deduction (or capitalized expense).[169]

This scenario would be economically equivalent to a profits interest.[170]

5. The Benefit of Ordinary Deduction from Payment of Carried Interest

Consider the general distinction between a hedge fund and a private equity fund. Hedge funds typically invest in liquid assets such as various types of market securities. Private equity funds, on the other hand, invest in illiquid assets such as stock of private companies. Although this distinction has become somewhat blurred over the years, it is still, for the most part, true. A typical hedge fund will engage in relatively frequent trading and therefore will rarely have long-term capital

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[167] *See* Burke, *supra* note 144, at 9 (―In economic terms, GP‘s profits interest is indistinguishable from an option, i.e., the ability to benefit from an increase in appreciation without risking capital.") (citation omitted).
[168] *See* Fleischer, *supra* note 144, at 11 (―In colloquial terms, if a service partner receives a cash salary and an at-the-money or out-of-the money equity ―kicker," the kicker is treated as investment income, not labor income.").
[169] *Burke, supra* note 144, at 8-9, citing Treas. Reg. §§ 1.83-7(a) (as amended in 2004), 1.83-6(a) (as amended in 2003).
[170] *See id*; Knoll, *supra* note 144, at 133.

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gains to distribute. But a private equity fund will almost always hold its portfolio companies well over a year and thus qualify for favorable capital gains treatment upon disposition. Consequently, unlike investors in a private equity fund, hedge fund investors usually stand to receive very little long-term capital gains treatment.

Section 710 proposes to reclassify that portion of carried interest which is attributable to ISPI as ordinary income. This point requires additional emphasis: Section 710 would override “the long-standing character flow-through rule under § 702 and treat disproportionate allocations to GP as ordinary income (loss).”[171] Put another way, “the net effect is to increase the tax rate on GP‘s implicit salary from 15% to 35%, *without* altering the tax consequences to LP.”[172] In this manner, Section 710 “finesses” the issue of worthless ordinary deductions that would exist if managers were instead paid a salary.[173]

In the event that a salary was paid, it would create a corresponding deduction to the investors. Professor Knoll proposes that this deduction against investors ordinary income may provide a way for the private investment industry to still “blunt the impact” of the reform.[174]

In this scenario, each limited partner would receive an ordinary deduction for their portion of the manager‘s “compensation.”[175] Although manager‘s will be forced to pay a higher percentage of tax on their income, the limited partners could reduce their effective tax rate by deducting the payment of the carry against their ordinary income.

Professor Knoll suggests that for the right investor, an investment fund that generates long-term capital gains, could become a very tax-advantageous investment if the investor can benefit from an ordinary deduction. For instance, Knoll uses the following numbers to illustrate this assertion: If

[171] Burke, *supra* note 144, at 20.
[172] *Id.*
[173] *See* Mark P. Gergen, *A Pragmatic Case for Taxing an Equity Fund Manager’s Profits Share As Compensation*, 87 Taxes 139, 140 (2009) (“Code Sec. 710 tries to finesse this issue.”).
[174] *See* Knoll, *supra* note 144, at 157.
[175] *See* I.R.C. § 162(a)(1).

carried interest were taxed at a 35% rate (ignoring the self-employment tax) the manager would have to charge a 26.5% carry (salary) instead of the usual 20% to remain economically equivalent.[176] Presumably, the investors would be willing to pay the extra carry because they can use the deduction to offset ordinary income.[177] However, for this scenario to provide any joint tax benefit it would require a very particular type of fund and a very particular type of investor.

First, it would require an investor who can benefit from an ordinary deduction, such as, for example, an individual, and not a domestic corporation. Since many institutional and foreign investors invest through passive foreign blocker corporations so as to avoid net basis taxation this deduction would be worthless to them. Second, the individual investor would most likely be subject to deductions limitations of Section 212[178] unless the fund is a ―trader” fund,[179] in which case it would qualify for Section 162 deductions. Since private equity funds (the funds that generate the bulk of industry‘s capital gains) will almost never be a ―trader,” its investors will usually end up with a worthless deduction.

6. Tweaking the Investment Strategy

I discussed previously the general trend of institutional investors (primarily U.S. tax-exempt entities) becoming very comfortable with allocating increasingly significant amounts of their portfolios to hedge funds. Institutional investors prefer liquidity, and for this reason gravitate toward hedge funds more so than towards private equity funds. Moreover, U.S. tax-exempt entities are generally indifferent to long-term capital gains because they invest through foreign blocker corporations, which are not taxed on U.S. source capital gains. In addition, hedge funds often do not generate long-term capital gains because they do not satisfy the holding period. The use of leverage

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[176] *See* 144, *supra* note 169, at 158.
[177] *See id.*
[178] Section 212 deductions are treated as ―miscellaneous itemized deductions” and thus must first exceed 2% of the individual‘s adjusted gross income to be deductible. *See* I.R.C. § 67(a), 641(b). There are potentially six other limitations on 212 deductions. *See* Miller, *supra* note 14, at 45-48.
[179] ―Trader” rather than investor (as in a ―trade or business” within the meaning of Section 162). Whether a fund is a trader is factual determination. For additional detail, see Miller, *supra* note 14, at 48.

also reduces the benefit of qualified dividends by treating them as “payments in lieu of a dividend,” which do not qualify for a preferential tax rate.[180]

In this light, Section 710 could amount to little more than an imposition of a self-employment tax on hedge fund managers‘ carry. But because the social security portion of the tax is capped, the increase in the managers‘ effective tax rate could be rather insignificant (in some instances it could be below 5%).[181] Additionally, fund managers could likely avoid self-employment tax in the manner previously discussed.[182]

In any event, the increase in managers‘ tax bill could be adjusted by higher fees, and higher fees would be justified by tweaking the investment strategy in a manner that would minimize investor‘s effective tax burden. Whereas today pooling of various types of investors creates the efficiency of scale and leverage, segregating the investors in different investment pools in accordance with the investor‘s tax status could increase tax efficiency. For instance, a foreign fund could take advantage of a tax-treaty so as to minimize the effective tax rate for a specific type of foreign investors. The fund could then justify an increase in fees by tax savings.

7. 83(b) Election and Catch-up Capital

In this scenario, the manager would receive 20% of the fund‘s capital interest in return for future services. The capital interest would be a qualified capital interest within the meaning of Section 710. There are several obvious drawbacks to this election. First, the manager will be forced to pay a very substantial tax bill at launch. Second, the manager would be running a substantial risk of economic loss in the event of the fund‘s failure. Alternatively, the manager may want to make “catch-up” capital contributions during the life of the fund so as not to trigger the initial tax bill. Catch-up contributions could be similar in structure to equity kickers discussed previously.

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[180] *See* IRS Notice 2003-67; H.R. Rep. No. 108-94, 108th Cong., 1st Sess. 31 n.36 (2003).
[181] For example, 2.9% would come from Medicare tax, some relatively minor increase would come from the Social Security tax, and some other relatively small amount could come from reclassifying the carry.
[182] *See supra* Part III.B.2. For instance, fund managers could simply reduce the carry and increase the management fee and then use 1402(a)(13) exemption.

The upside of the election would be freezing of ordinary income at purchase price and avoiding self-employment taxes on ISPI. If the manager could obtain a non-recourse loan from the investors for the tax bill, the investors would continue to carry the entire economic risk of loss.

8. The General Avoidance Strategy

In this Section, I attempted to foresee the industry‘s response to the potential reform. I conclude that the impact of the proposed Section 710 would not apply with the same force to all private investment funds and managers. Some will be affected substantially more than others. Private equity funds and real estate funds would likely shoulder most of the impact because their income largely consists of long-term capital gains. But even here the detriment would mean that fund managers are forced to pay a percentage of tax that the rest of the country has been paying all along. The argument that the investment activity would be penalized is likely a bit exaggerated, and the industry will continue to raise money as long as it is able to outperform other investment alternatives. Even if managers are successful in shifting some of the tax burden on the investors, they will experience significant pressure to reduce fees. For example, the recent move by many of the country‘s pension funds to forego the fund-of-funds investment structure identifies a clear pattern in this direction.[183]

As with any other avoidance strategy, fund managers will have two main avenues available to them. First, they could look for an escape hatch within the proposed legal framework. Or, alternatively, they could attempt to restructure in a manner that would make the proposed Section 710 inapplicable altogether. Undoubtedly, if Section 710 is ever passed it will first undergo some substantive revisions as it has in every draft advanced so far. In addition, the Treasury would likely issue additional guidance. The Secretary would likely aim to implement congressional intent, which,

[183] *Study: Pensions To Increase Direct Allocations To Hedge Funds In 2011*, FINALTERNATIVES, *available at* http://www.finalternatives.com/node/16145, (Apr 1 2009).

by all indications, would be to treat managers' share of income as ordinary and to subject it to self-employment taxes.

In a conversation on this subject with Professor Calvin Johnson of the University of Texas School of Law, I inquired whether he had any ideas on “tax-friendly” alternatives to carried interest. He said: “It's hard to predict the direction that a group of very smart and determined people would take when there is that much money at stake.”[184] He then analogized to similar situations in the past, where “loopholes” that were closed only led to the discovery of the new ones.[185] “All the sudden, a sentence in a revenue ruling becomes the most significant thing that leads everyone on a new path.”[186] Until then, we will remain guessing.

C. Tax Avoidance and the Economic Substance Doctrine

The Health Care and Education Reconciliation Act of 2010 added a Section 7701(o) to the Code. The provision is a codification of judicially-created economic substance doctrine. In essence, the codification of the doctrine and the adoption of associated strict liability penalty signals to the taxpayers a new era of tax enforcement.[187] The economic substance doctrine purports to prevent taxpayers from “subverting the purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.”[188]

Although the hurdle of economic substance doctrine has not always been set very high, and “[t]here is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes,”[189] any industry restructuring would certainly appear to be very tax-motivated. Inasmuch as economic substance of the transactions conflicts with the

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[184] Interview with Calvin H. Johnson, Andrews & Kurth Centennial Professor at University of Texas School of Law, in Dallas, Texas (Jan 21, 2011).
[185] *Id.*
[186] *Id.*
[187] *See* Bret Wells, *Economic Substance Doctrine: How Codification Changed Decided Cases*, 10 FLORIDA TAX REVIEW 411, 412 (2010) (“The codification of the economic substance doctrine begins an important new chapter for tax jurisprudence.”).
[188] *Id.*
[189] Yosha v. Commissioner, 861 F.2d 494, 497-98 (7th Cir. 1988) (Judge Posner writing for majority).

present legal framework, the government will have greater latitude to argue against its own previously issued positions.[190]

PART VI: CONCLUSION

If viewed through the lens of current partnership law, carried interest is nothing more than a special allocation that reflects, in part, services performed by the partner in his capacity as a partner and, in part, a return on the partner‘s capital contribution. This structure is available to every partnership and is not reserved exclusively for investment funds. Sure, over the years there have been plenty of calls to reform the treatment of partnership allocations, but the criticism did not originate with the private investment industry.[191] Instead, it flows from some of the sticky issues surrounding the compensation of the service partners in the context of deferral and conversion of income. The proposed legislation singles out private investment partnerships. And although my normative case in favor of the present treatment of carried interest is weak, it grows mainly from my opposition to the reform as it is presently drafted.

The proposed legislation has been said to have some technical shortcomings. It singles out private investment partnerships in response to ―astronomical"[192] returns generated by the fund managers. The theoretical underpinnings of the proposed change are questionable at best and, quite frankly, do not promote equity, simplicity, or efficiency. I agree wholeheartedly with several of the commentators who suggested that the thrust of the reform is misplaced.[193] The root of the problem is not the brazen hedge fund managers who make ridiculous amounts of

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[190] *See* Wells, *supra* note 186, at 452.
[191] *See* Gergen, *supra* note 72; William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3, 76 (1991) (partnership distribution rules ―are seriously defective, in ways that permit serious tax abuse.").
[192] Abrams, *supra* note 144.
[193] *See generally id*; *see also* Weisbach, *supra* note 144.

money and pay little tax. They are merely operating within a system they did not create. In fact, it would be strange if they did not take advantage of it.

A legislative reform that implements highly technical rules to appease political whim does not add conceptual clarity to the Code. Making one area of the law fair in some ways and unfair in others should not be justified by relatively modest amounts of revenue the reform is expected to raise[194] and by the satisfaction that would come from sticking it to the fund managers. Such approach distracts from the root problems. These problems include largely unjustified preference for capital gains and the so-called “heir investors.”

For instance, one commentator points out that a revocation of capital gains preference would “be far less avoidable than technical changes to the partnership tax rules: a technical change to the partnership tax rules leaves the capital gains preference generally available and relies on the ability of the government to distinguish labor income from capital income.”[195]

Another commentator suggests that “[a]rguably, the most telling and urgent juxtaposition is not the fund manager versus her secretary, but the fund manager *and* her secretary versus the wealthy heir investor whom they both service.”[196]

Perhaps, the legislators and the academy might be better off by focusing on these root issues instead.

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[194] *See* Knoll, *supra* note 144.
[195] Weisbach, *supra* note 144, at 763.
[196] *See* Sanchirico, *supra* note 82, at 1153.

Compare to: “[i]t offends our values as a nation when an investment manager making $50 million can pay a lower tax rate on her earned income than a teacher making $50,000 pays on her income.” Kevin Drawbaugh, *Hillary Clinton Slams Private Equity Tax Rate*, REUTERS.COM, Jul. 13, 2007.

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TRANSFER-PRICING WITH SOFTWARE ALLOWS FOR EFFECTIVE CIRCUMVENTION OF SUBPART F INCOME: GOOGLE'S "SANDWICH" COSTS TAXPAYERS MILLIONS

By: John Sokatch[1]

I. Introduction

A. PREFACE

"And remember . . . don't be evil, and if you see something that you think isn't right—speak up!"—Unofficial Slogan from Code of Conduct for Google, Inc.[2]

Every day millions of web users peer into the vast beyond of their proximate familiarities through the use of various internet search engines. These gatekeepers of information allow a remote user in Dallas, Texas to view news from the Middle East, sports scores from the United Kingdom, and stock market information from China. One such gatekeeper and world-renowned search engine servicer, Google, continues to make international headlines[3] by providing, often to the detriment of governments, access to free-flowing information at the click of a button.[4]

[1] John C. Sokatch - Southern Methodist University Dedman School of Law Candidate for Juris Doctor, May 2012 International Law Review - Write-On Editor/Assistant Managing Editor Board of Advocates - Vice-Chair of Public Relations

[2] *See* Google.com, Code of Conduct, http://investor.google.com/corporate/code-of-conduct.html#VII (last visited Feb. 28, 2011) ("The Google Code of Conduct is one of the ways we put "Don't be evil" into practice. It's built around the recognition that everything we do in connection with our work at Google will be, and should be, measured against the highest possible standards of ethical business conduct. We set the bar that high for practical as well as aspirational reasons: Our commitment to the highest standards helps us hire great people, who then build great products, which in turn attract loyal users.").

[3] *See* Julianne Pepitone, *Google Search Working Again in China*, CNNMONEY, July 30, 2010, http://money.cnn.com/2010/07/29/technology/google_china/index.htm.

[4] *See* Google, Corporate Information, http://www.google.com/intl/en/corporate/ (last visited Feb. 28, 2011) ("Google's mission is to organize the world's information and make it universally accessible and useful.").

Although Google is a U.S.-based company whose worldwide operations are subject to local and federal U.S. taxation laws,[5] its cross-border transactions have significantly minimized its tax bill to Uncle Sam.[6]

Consider the following: Consumer A (a non-U.S. citizen) and Corporation Y (incorporated outside the jurisdiction of the United States) contract to do business, whereby A purchases widgets from Y for a certain value. Under general U.S. tax principles, Y‘s recognized income would be subject to tax in the jurisdiction in which the transaction occurred or the place of Y‘s incorporation.[7] As such, this transaction would generally not qualify as a taxable event subject to U.S. taxation rates.[8] Nonetheless, U.S. lawmakers have enacted a long-arm statute that broadly characterizes this situation as a taxable event in the case where Corporation Y is a wholly owned subsidiary of a domestic U.S. company with shareholders residing within the United States.[9] To avoid this result, multi-national corporations take advantage of legal tax havens in the form of off-shore entities that enable them to defer taxes on their income earned from foreign-based entities.[10] Congressional attempts to curb such behavior have largely proven

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[5] *See* I.R.C. § 61(a) (2011); Google, About Us, http://www.google.com/intl/en/contact/ (last visited Feb. 28, 2011).

[6] Jesse Drucker, *Google 2.4% Rate Shows how $60 Billion Lost to Tax Loopholes*, BLOOMBERG, Oct. 21, 2010, http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html.

[7] *See* I.R.C. § 61(a). (short form statute)

[8] *See* I.R.C. § 954(d)(1)(A) (2011); Treas. Reg. § 1.954-3(a)(2) (as amended in 2002) (―Foreign base company sales income does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in subparagraph (1) of this paragraph if the property is manufactured, produced, constructed, grown, or extracted in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or acts on behalf of a related person) is created or organized.").

[9] *See* I.R.C. §§ 951, 952(a)(2), 954(a)(2) (2011).

[10] *See* Craig M. Boise, *Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty*, 14 GEO. MASON L. REV. 667, 667-68 (2007):

to be fruitless,[11] as the number of corporations implementing similar tax maneuvers appears to be increasing every year.[12]

B. The Issue

The Internal Revenue Code dictates that U.S. corporations pay the standard corporate tax of 35% on profits earned domestically and abroad, one of the highest corporate tax rates in the world.[13] In October 2010, however, Bloomberg.com reported that Google reduced its overseas tax rate to 2.4%, resulting in a $60 billion loss to the U.S. government and harsh criticism from politicians for Google‘s injurious, although technically legal, use of international tax loopholes.[14] Google accomplished this feat by utilizing an income-shifting method known to tax lawyers as the ―Double Irish" and the ―Dutch Sandwich," which, as some commentators noted, ―[t]he sandwich leaves no tax behind to taste."[15] Despite the criticisms, several other U.S. technology-based companies, such as Microsoft, Inc. and the social networking giant Facebook, have begun to utilize similar methods to avoid tax payments to the U.S. government.[16]

> Most U.S. multinationals avoid current U.S. taxation of their foreign business income by accumulating such income in controlled foreign subsidiaries: in essence, their offshore piggybanks. The ability to suspend the taxation of foreign business income in this manner is commonly referred to as ‗deferral,‘ and it has become an important strategic objective for managers of U.S.-based multinationals.

[11] *See, e.g.*, I.R.C. § 965 (2010).

[12] *See generally* Boise, *supra* note 9.

[13] *See* I.R.C. § 11(b)(1)(D) (―The amount of the tax imposed by subsection (a) shall be the sum of . . . 35 percent of so much of the taxable income as exceeds $10,000,000."); *see also id.* §§ 951, 952, 954.

[14] Drucker, *supra* note 5.

[15] *Id.*

[16] *Id.* (―‗Google‘s practices are very similar to those at countless other global companies operating across a wide range of industries.'").

Access to these strategies is widely available. For example, KPMG, one of the top four U.S. accounting firms, conducted a survey in 2010 on corporate and indirect rates of countries from various places around the world, which brought to light the incentives behind why companies elect to establish related businesses on international soil, rather than maintain full operations within U.S. borders.[17] This survey is one of many informal sources available to corporate directors, who will review information provided by KPMG and other similar resources to make business decisions in the best interest of the shareholders.[18] As a result, if lawmakers continue to ignore this issue, we will see more companies creating offshore subsidiaries to reallocate profits and escape paying domestic taxes.

Part I of this paper compares international corporate taxation rates to U.S. rates to provide a comprehensive understanding of why companies like Google would elect to utilize transfer pricing and shift profits from U.S. soil. Part II explains the ―Double Irish" and ―Dutch Sandwich" tax maneuvers and how Google implements these strategies to legally lower their effective corporate tax rates to minimal levels. Part III examines various legal measures that the U.S. government has enacted to counter-balance such practices and bring profits back within U.S. borders. It also examines the possible solutions to the problem with commentary on why amendments to the current taxation regime are necessary.

While the extent to which the global economy is affected by avoidance maneuvers implemented by Google and other similarly situated companies remains unclear, such maneuvers may eventually become commonplace practices for average-size businesses. Moreover, while some commentators claim that Google is ignoring its corporate slogan, ―Don't be evil," by the

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[17] KPMG, KPMG'S CORPORATE AND INDIRECT TAX SURVEY 2010 3 (2010), *available at* http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/Corp-and-Indirect-Tax-Oct12-2010.pdf.

[18] *See id.*

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creation of such a scheme,[19] these tax maneuvers may signify a more disturbing and potentially detrimental future for international bodies choosing to ignore such on-goings while the rest of the world embraces the ever-changing landscape and globalization of international business transactions.

II. Background

A. HISTORY AND HISTORICAL DATA ON CORPORATE TAX RATES IN THE UNITED STATES

Corporate law in the United States pre-dates the imposition of the federal income tax. Chief Justice John Marshall famously pronounced a corporation‘s essence in American jurisprudence in *Trustees of Dartmouth College v. Woodward*:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression may be allowed, individuality; properties, by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property, without the perplexing intricacies, the hazardous and endless necessity, of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men, in succession, with these qualities and capacities, that corporations were invented, and are in use.[20]

The idea that a corporation is separate from the individual has since continued thematically with the enactment of subsequent laws regarding liability of corporations.[21] Following the

[19] *See, e.g.*, Drucker, *supra* note 5 (―Google is ‗flying a banner of doing no evil, and then they‘re perpetrating evil under our noses.’”).

[20] Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518, 636 (1819).

[21] Citizens United v. Fed. Election Comm‘n, 130 S. Ct. 876, 899 (2010) (holding that government may not, under the First Amendment, suppress political speech on the basis of the speaker‘s corporate identity).

advent of the federal income tax in 1861, only individuals were taxed on a percentage of their incomes.[22] It was not until the Revenue Act of 1894 that the U.S. government established the principle of treating corporations as taxable entities separate from their owners.[23] The Act was later overturned in *Pollock v. Farmers' Loan & Trust Co.*,[24] where the Supreme Court held 5-4 that the income taxes on interest, dividends, and rents imposed by the Act were unconstitutional because they violated the constitutional provision that direct taxes be apportioned.[25] In 1913, the Sixteenth Amendment reversed the decision in *Pollock* by granting Congress the express power to lay and collect taxes on incomes for individuals and corporations.[26]

The first federal corporate income tax brackets were set at rate of 1% for all income exceeding $5,000.[27] From 1913-1915, Congress eliminated the tax brackets and instead imposed the 1% rate on all taxable income.[28] Corporate tax rates steadily increased for the next few years until the advent of World War II, when economic conditions forced Congress to dramatically increase the rates on the upper corporate income earners to pay for war debts.[29] In 1939, corporations

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[22] U.S. Dep't of Treasury, Chronology of Events 1800-1899, http://www.treasury.gov/about/history/Pages/1800-1899.aspx (last visited Feb. 22, 2011) (―August 5, 1861-The U.S. government levied the first income tax to help pay for the Civil War. All incomes over $800 were taxed three percent until the year 1872, when the tax was repealed.").

[23] Jack Taylor, *Corporation Income Tax Brackets and Rates, 1909-2002*, IRS.GOV, at 284, http://www.irs.gov/pub/irs-soi/02corate.pdf.

[24] Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 429 (1895).

[25] *Id.* at 586.

[26] U.S. CONST. amend. XVI (―The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.").

[27] *See* Taylor, *supra* note 22, at 287.

[28] *Id.*

[29] *See id.*

making over $25,000 per taxable year were subjected to a tax rate of 19%.[30] This rate increased to 24% in 1940 and rose as high as 40% during war times.[31] Corporate tax rates thereafter rose as high as 52.8% in 1969 before finally settling on the present day rate of 35% for the highest corporate earners.[32]

With U.S. corporate tax revenues totaling $191.4 billion, or 9% of total tax revenues for 2010,[33] it is no surprise that corporations are hiring tax attorneys to find ways to circumvent payments to the U.S. government and satisfy their shareholders. Some congressmen are currently attempting to curb this behavior as they work to close these loopholes amid the looming threat of ever-increasing debts.[34] The eventual outcome of these tensions remains unclear; but what remains certain is that corporations will continue to use all means necessary, including outsourcing business overseas, to lower their effective tax despite legislative attempts to the contrary.

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30 *Id.*

31 *Id.* at 287-88.

32 *Id.* at 288; *see also* I.R.C. § 11(b) (2011).

33 Jeanne Sahadi, *Corporate Tax Reform: Talk Grows Louder*, CNNMONEY, Jan. 15, 2011, http://money.cnn.com/2011/01/14/news/economy/corporate_tax_reform/index.htm?hpt=T2.

34 *See, e.g.*, *id.* (―Many business leaders and tax experts say the corporate tax code discourages foreign investment in the United States and hinders the ability of U.S. companies to compete internationally.‖); *see also* Drucker, *supra* note 5 (―U.S. policy makers, meanwhile, have taken halting steps to address concerns about transfer pricing. In 2009, the Treasury Department proposed levying taxes on certain payments between U.S. companies' foreign subsidiaries.‖).

B. SURVEY OF WORLD CORPORATE TAX RATES

With the second-highest gross domestic product (GDP) in the world in 2009, behind the European Union,[35] the United States imposes one of the highest marginal tax rates (35%) in the world on its top corporate income earners.[36] When this rate is coupled with the power of states and local governments to impose additional corporate taxes ranging from 1% to 12% (7.5% on average), U.S. corporations pay well above the world average of 24.99% of their annual income to the federal government.[37] As a result, companies like Google have chosen to establish subsidiaries in other countries with significantly more favorable corporate tax rates to increase profits and offset any of the costs in the process.[38]

Japan, which in 2010 imposed the world's highest corporate tax rate of 40.69%, has recently experienced the effects of that decision.[39] Because of recent economic woes and corporations moving business outside of Japan's borders, Japanese lawmakers chose to cut the corporate tax rate by around 5% to bring the rate more in line with that of the United States.[40] With a national

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[35] *See* The CIA World Factbook, Country Comparison: GDP (Purchasing Power Parity), https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html?countryName=United%20States&countryCode=us&regionCode=na&rank=2#us (last visited Feb. 22, 2011).

[36] I.R.C. § 11 (2011); *see also* Sahadi, *supra* note 32 ("The 35% top corporate tax rate . . . is among the highest in the world.").

[37] *See* Drucker, *supra* note 5 ("Two thousand U.S. companies paid a median effective cash rate of 28.3 percent in federal, state and foreign income taxes in a 2005 study by academics at the University of Michigan and the University of North Carolina.").

[38] *See, e.g.*, *id.*

[39] *See* KPMG, *supra* note 16, at 13.

[40] Hiroko Tabuchi, *Japan Will Cut Corporate Income Tax Rate*, N.Y. TIMES, Dec. 14, 2010, http://www.nytimes.com/2010/12/14/business/global/14yen.html ("Lowering the corporate tax burden by 5 percentage points could increase Japan's gross domestic product by 2.6 percentage points, or 14.4 trillion yen ($172 billion), over the next three years, according to estimates by Japan's Trade Ministry.").

debt nearly twice the size of its $5 trillion economy, Prime Minister Naoto Kan explained that “[b]y daring to go with a 5[%] reduction, [Japan] will spur companies to invest domestically, expand employment and raise wages . . . [t]hat will stimulate the domestic economy, support growth and shake off deflation.”[41] In the three months following the announcement, the Japanese economy grew by a reported 1.1%.[42] Although this is just a preliminary indication of signs that the Japanese economy is improving, several commentators from some of Japan‘s largest corporations have noted that having such a high corporate tax rate “has been one big barrier” to investment in Japanese corporations, and therefore a reduction in the corporate tax rate was “imperative to attract people, products and funds to Japan.”[43]

The United Arab Emirates (“UAE”), a political unit comprised of the seven countries Abu Dhabi, Dubai, Sharjah, Ajman, Umm Al Quwain, Fujairah, and Ras Al Khaimah, boasts the highest tax rate on a specific corporate sector within their boundaries, namely oil companies, which must pay 55% of their operating profits to the local government.[44] But citizens in the UAE are not subject to an individual income tax, nor do any other corporate sectors pay a corporate income tax, which likely offsets any detrimental effects to their economy.[45]

Other notable countries with relatively high corporate tax rates include France at 33.33%, India at 33.99%, Libya at 40%, Pakistan at 35%, South Africa at 34.55%, and Venezuela at 34%.[46]

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[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] The Federation of International Trade Associations, United Arab Emirates, http://www.fita.org/countries/uae.html?ma_rubrique=fiscalite (last visited Feb. 22, 2011).

[45] *See id.*

[46] KPMG, *supra* note 16, at 12-14.

While it may come as no surprise that these are also some of the largest economies in the world, companies from these countries have already or soon will likely implement tax avoidance maneuvers similar to that of Google or simply leave the country for one with a lower corporate tax rate. This could result in dire consequences for the long-term growth of these nations.

At the other end of the corporate tax spectrum, several countries, particularly those with smaller, or less developed, economies refrain from imposing taxes on corporations within their national borders. Several of these countries, such as the Bahamas, Bermuda, and the Cayman Islands are located just off the coast of the United States and provide tax incentives for U.S. companies that place subsidiaries at these locales.[47] Bermuda in particular has become a favorite offshore tax haven because it imposes no income tax, no capital gains tax, no withholding tax on dividends or interest, and currently has no double taxation treaties with other countries.[48] Other countries, like Bahrain, Guernsey, the Isle of Man, Jersey, and Montenegro, also have either negligible or non-existent corporate tax rates that attract investment from other countries around the world.[49] The reasons a country elects to have a certain corporate tax rate may differ from country to country because there are so many economic variables that go into a country's decisions to levy a corporate tax. But with the increased globalization of the world's economy and the pressures on corporate directors to maintain high profit margins, there is now a tremendous incentive for companies to send resources to foreign countries with lower tax rates at

[47] *See id.* at 12.

[48] *See* Gov't of Berm., Office of the Tax Comm'r, About Us, http://www.taxbermuda.gov.bm/ (last visited July 10, 2011); *see also* ADAM STARCHILD, TAX HAVENS FOR CORPORATIONS 31-32 (1979).

[49] *See* KPMG, *supra* note 16, at 12-13.

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the expense and to the detriment of their respective home countries, especially when the logistical barriers that may once have prevented them from investing abroad are gone.[50]

C. Direct Foreign Investment as an Indicator and the Case for Ireland

One indicator that corporations are taking advantage of global tax rate differences is direct foreign investment (―DFI”) into a country.[51] DFI is the ―value of all investments . . . in the home country made directly by residents—primarily companies—of other countries” during a given time period.[52] While DFI does not capture all of the economic benefits effectuated by a low corporate tax rate, it does help to explain why certain countries attract more foreign investment than others despite the lack of domestic resources to support such an investment.[53]

The Netherlands and Ireland, both of which are utilized by Google to make their tax avoidance scheme possible, are good examples.[54] They rank seventh and nineteenth, respectively, in the world for DFI[55] but have relatively low world rankings in population (Netherlands—60th; Ireland—119th),[56] members of the labor force (Netherlands—58th; Ireland—119th),[57] and GDP

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[50] *See* Drucker, *supra* note 5.

[51] *See* The CIA World Factbook, Country Comparison: Stock of Direct Foreign Investment—At Home, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2198rank.html (last visited Feb. 22, 2011).

[52] *Id.*

[53] *See id.*

[54] *See* Drucker, *supra* note 5.

[55] *See* The CIA World Factbook, Country Comparison: Stock of Direct Foreign Investment—At Home, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2198rank.html (last visited Feb. 22, 2011).

[56] *See* The CIA World Factbook, Country Comparison: Population, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2119rank.html (last visited Feb. 22, 2011).

[57] *See* The CIA World Factbook, Country Comparison: Labor Force, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2095rank.html (last visited Feb. 22, 2011).

growth rate (Netherlands—157th; Ireland—199th).[58] These rankings suggest that something other than an invaluable work force, such as more favorable tax situations, contributes to the high influx of foreign investment.

Two attorneys who agree with this hypothesis, Joseph B. Darby III and Kelsey Lemaster, found that Ireland has created an ideal situation for foreign investment, particularly for foreign technology companies like Google.[59] According to Darby and Lemaster, Ireland's ability to attract foreign investment stems from pressure from the European Union to remove discriminatory tax incentives and Ireland's subsequent decision to enact a uniform corporate tax in 1999.[60] As a result, Ireland imposes a meager 12.5% rate on taxable income of corporations, which is one of the lowest corporate tax rates in the world, especially among developed countries.[61] Ireland has also entered into several favorable tax treaties with other countries that have the effect of significantly limiting corporate income taxes on business transactions made between those countries.[62] When coupled with Ireland's well-educated, English-speaking

[58] *See* The CIA World Factbook, Country Comparison: GDP–Real Growth Rate, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2003rank.html (last visited Feb. 22, 2011).

[59] Joseph B. Darby III & Kelsey Lemaster, *Double Irish More than Doubles Tax Savings: Hybrid Structure Reduces Irish, U.S. and Worldwide Taxation*, PRAC. U.S./INT'L TAX STRATEGIES, May 15, 2007, at 2, 11-16, *available at* http://gtlaw.com/portalresource/lookup/wosid/contentpilot-core-2301-5813/pdfCopy.name=/darby07g.pdf (―Ireland is attractive for low corporate tax rates and because it has yet to implement (or enforce aggressively) some of the more familiar ―anti-abuse" mechanisms.").

[60] *See id.*

[61] *See id.*

[62] *See id.*

workforce ―it is easy to see why Ireland has become a preferred foreign base of operations for U.S. software companies and other U.S. technology-driven enterprises."[63]

Ireland simultaneously refuses to enforce aggressively ―anti-abuse" mechanisms related to transfer-pricing regulations.[64] Normally, countries with a high volume of economic activity will heavily regulate transfer-pricing transactions to prevent maneuvers, like the one employed by Google, where companies will shift taxable income to low-tax jurisdictions.[65] For example, the United States has adopted § 482 of the Internal Revenue Code:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.[66]

This provision grants broad authority to the Treasury Secretary to ―adjust" items that are reported by corporations seeking to game, or even abuse, the transfer-pricing regulations.[67] Without the ever-present threat that a corporation's income could be adjusted to reflect properly any abuses of income tax laws and regulations, Ireland attracts more international business at the expense of decreased tax revenues.[68] While the long-term effects of this decision still remain

[63] *See id.*

[64] *See id.*

[65] *See id.*

[66] I.R.C. § 482 (2011).

[67] *See id.*

[68] *See* Darby & Lemaster, *supra* note 58, at 12.

largely unclear, Ireland's recent seeking of bailout funds may, in part, be attributable to such shortsighted fiscal policies.[69]

D. BASIC INTERNATIONAL TAXATION CONCEPTS OF CORPORATIONS

The United States subscribes to a "residence-based" tax system whereby a corporation is subject to income tax if it is "created or organized in the United States or under the law of the United States or of any State," or "effectively connected with the conduct of a trade or business within the United States."[70] As such, U.S. corporations must pay federal income taxes on all sources of income whether earned domestically or worldwide.[71] This is true whether or not the taxes were paid in the foreign country based on the same receipt of income.[72] Accordingly, U.S.-

[69] *See* Joe Brennan & Stephanie Bodoni, *Ireland Seeks Bailout as 'Outsized' Problem Overwhelms Nation*, BLOOMBERG, Nov. 21, 2010, http://www.bloomberg.com/news/2010-11-21/lenihan-says-he-will-recommend-ireland-should-formally-ask-for-eu-bailout.html ("Ireland was one of the poorest countries in Europe when it joined the EU in 1973 along with Britain. Even with European subsidies, unemployment in the mid-1980s averaged 16 percent. In the 1990s, lured by a 12.5 percent corporate tax, companies such as Pfizer Inc. and Microsoft Corp. helped Ireland export its way into becoming the "Celtic Tiger." The jobless rate sank to 3.9 percent by 2001. In the decade through 2006, Ireland grew at an average annual rate of about 7 percent, the fastest among euro-area countries. That expansion, together with easy credit, fanned a real- estate bubble. Home prices almost quadrupled in the decade through 2007. It went disastrously wrong for Ireland following the 2008 demise of Lehman Brothers Holdings Inc., which turned the slowdown in the property market into an implosion that engulfed the economy. The ISEQ stock index has plunged 70 percent from its record in 2007.").

[70] Matthew J. Mauntel, *Stimulating the Stimulus: U.S. Controlled Subsidiaries and I.R.C. § 965*, 33 B.C. INT'L & COMP. L. REV. 107, 109 (2010) (citing I.R.C. § 11 (2011)) ("stating that all corporations are taxed on their income, but that is further limited to domestic corporations by I.R.C. § 882").

[71] Treas. Reg. § 1.1-1(b) (1974) ("[A]ll citizens . . . are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.").

[72] The Tax Code recognizes the existence of two types of corporations—domestic (one organized or created under the laws of the United States, or any of its states) and foreign (one which is not domestic). I.R.C. § 7701(a)(4)-(5) (2011). "The term 'domestic' when applied to a corporation or partnership means created or organized in the United States or under the law of the United

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based corporations must recognize taxable income attributed to their foreign subsidiaries‘ business operations worldwide.[73] Company directors, therefore, often seek ways to alleviate the pressures of the ―double taxation” by implementing strategic tax avoidance measures to satisfy corporate shareholders‘ interests.

One way that corporations avoid this double taxation, which has enjoyed longtime support since early Tax Court decisions, is ―by transferring assets and/or business activities to a foreign corporation, such that neither the corporation nor the U.S. shareholder would be currently taxable in the U.S. on the corporation‘s income.”[74] Corporations can set up and transfer assets to foreign subsidiaries, which are recognized as separate taxable entities and whose income does not automatically flow through the parent corporation.[75] In the event that the foreign subsidiary earns income from sources outside the United States and conjunctively does not conduct a U.S. trade or business, the foreign subsidiary is not subjected to taxation by the United States.[76] But any distributions by a subsidiary in the form of dividend payments[77] or payments for goods or

States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations.” *Id.* § 7701(a)(4). ―The term ‗foreign‘ when applied to a corporation or partnership means a corporation or partnership which is not domestic.” *Id.* § 7701(a)(5).

[73] *See id.* § 11(a) (―A tax is hereby imposed for each taxable year on the taxable income of *every* corporation.”); *id.* § 882(a)(1) (defining as ―taxable income” that income which is ―effectively connected with the conduct of a trade or business within the United States.”)

[74] *See* Darby & Lemaster, *supra* note 58, at 2.

[75] *See* PHILLIP F. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION 5 (1980).

[76] *See id.* at 5-6.

[77] I.R.C. § 316(a) (2011) (the term ―dividend” is defined as ―any distribution made by a corporation to its shareholders—1) out of its earnings and profits accumulated after February 28, 1913, or 2) out of its earnings and profits of the taxable year . . . without regard to the amount of the earnings and profits at the time the distribution was made.”).

services that are repatriated back into U.S. soil are taxable upon receipt by the corporation‘s shareholders.[78]

Due to the stringent nature of Tax Court decisions, corporate tax advisors must strategically plan around these provisions and study world corporate tax rates to incorporate federal tax avoidance measures like the ―Double Irish" and ―Dutch Sandwich." As shown, anyone who studies the Tax Code and applicable case law quickly realizes the ever-present struggle between both individuals and corporations and the IRS for payment and non-payment of taxes, which serves as a viable starting point for this paper‘s analysis of Google‘s tax avoidance mechanisms.

E. Foreign Tax Havens

Since the rise of the corporate fiduciary duty by directors to protect shareholder interests, corporations have sought ways to increase earnings and decrease operational costs—one such operational cost being taxes. Unfortunately for those companies incorporated within U.S. borders, complete avoidance of taxation is tricky because income tax calculations are based on U.S. citizenship.[79] Consequently, the U.S. corporation cannot completely avoid federal taxation without simultaneously relinquishing its U.S. citizenship.[80] Companies not willing to take such extreme action will instead take advantage of the Nineteenth Century principle that corporations,

[78] *See* POSTLEWAITE, *supra* note 74, at 6.

[79] *Id.* at 11.

[80] *See id.* (―For most American businessmen, relinquishing U.S. citizenship is neither necessary nor desirable. The most commonly used method of establishing the tax haven company, therefore, is to incorporate in the tax haven country (or countries, if a tiered structure is desirable), thereby taking advantage of the principle that is observed world-wide—a corporation has the legal status of a separate legal person.")

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under the U.S. Constitution, enjoy separate legal status from their employees.[81] When applied, the separate “legal person” principle entitles a foreign-based corporation “to the same privileges, as any citizen of that country.”[82] Such privileges entitle the corporation to benefit from the tax laws governing that particular country, aside from any multi-national tax treaties senior to those laws.[83] Similar behaviors are observed in companies located solely within U.S. borders—for example, many companies elect to incorporate in the state of Delaware due to more favorable liability protections.[84] While incorporating in another state does not give the corporation more favorable federal income tax treatment, the basic principle remains the same: businesses will constantly seek avenues to lower costs and avoid risk exposure in the form of liabilities, taxes, or any other cost-inducing mechanism.[85]

The foreign tax haven can be recognized in basically any form of business genre found in the United States. Companies in one of the most popular industries—shipping (or aircraft) services—regularly establish tax haven companies by incorporating in low-tax jurisdictions. Due to the transient nature of their business and near-universal demand, shipping corporations, like DHL (originally founded in San Francisco, CA in 1969 and reincorporated in Germany in

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[81] Santa Clara v. S. Pac. R. Co., 118 U.S. 394 (1886) (“One of the points made and discussed at length in the brief of counsel for defendants in error was that ‘Corporations are persons within the meaning of the Fourteenth Amendment to the Constitution of the United States.’”) (comments of court reporter in preamble to opinion).

[82] *See* POSTLEWAITE, *supra* note 74, at 11.

[83] *See id.* at 11-12.

[84] *See id.*

[85] *See id.* at 12.

2001), have either been bought out or established their headquarters overseas because of lower corporate tax rates.[86]

Google, a producer of mainly intangible computer and internet software, utilizes entities formally known as ―patent holding companies" to create tax havens. Although primarily based out of California, Google creates licensing agreements with its international subsidiaries by allowing them to realize profits from the use of Google's software outside U.S. borders.[87] Because the local laws in which the subsidiary is located (in this case, the Netherlands) allows the subsidiary to deduct royalty payments from gross income calculations on distributions made to Google in accordance with the licensing agreement, the Dutch subsidiary avoids Dutch withholding taxes on dividends.[88] Therefore, Google and its Dutch subsidiary set the royalty rate at an optimum level to minimize Dutch tax exposure and maintain operations abroad.[89] Although Google's system is significantly more complicated, as the next section explains the underlying theme remains the same: Google (a publicly traded company since August 2004[90]) ultimately answers to its shareholders, whose stock appreciates in value when Google is able to report high profit margins.

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[86] DHL, Company Portrait, http://www.dhl.com/en/about_us/company_portrait.html (last visited June 27, 2011).

[87] *See generally* Erik Sherman, *How Google Hides its Profits from the Tax Man*, BNET**,** Oct. 21, 2010, http://www.bnet.com/blog/technology-business/how-google-hides-its-profits-from-the-tax-man/6296; *see also* Google, About Us, http://www.google.com/intl/en/contact/ (last visited June 27, 2011).

[88] *See* POSTLEWAITE, *supra* note 75, at 26-27.

[89] *See id.*

[90] Paul R. La Monica, *Google Sets $2.7 Billion IPO*, CNNMONEY, Apr. 30, 2004, http://money.cnn.com/2004/04/29/technology/google/ (―In the filing, Google said that it generated revenues of $961.9 million in 2003 and reported a net profit of $106.5 million. Sales rose 177 percent from a year ago although earnings increased by just 6 percent. Google also revealed that [it] has been profitable since 2001.").

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F. APPLICABLE PROVISIONS TO MAKE THESE SCHEMES POSSIBLE

As corporate tax strategists continue to discover more complex ways to circumvent recognition of taxable income, Congress has attempted to counteract the transfer of assets by enacting “anti-deferral rules” and transfer-pricing rules to prevent or penalize the use of a foreign corporation to avoid taxes on sources of income.[91] Anti-deferral rules seek to curb a domestic corporation‘s ability to defer recognition of income attributed to a foreign subsidiary.[92] One such anti-deferral rule is codified in Section 951 of the Tax Code, which requires U.S. shareholders to currently recognize parts of their income from “controlled foreign corporations” (“CFC’s”).[93]

The Internal Revenue Code provides for the taxation of CFC‘s, which are controlled by U.S.-based parent companies.[94] A CFC is defined as:

> Any foreign corporation if more than fifty percent of (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.[95]

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[91] *See* Darby & Lemaster, *supra* note 58, at 10.

[92] *See id.* at 11.

[93] I.R.C. § 951(a)(1) (2011) (“(1) In general. If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends, (A) the sum of (i) his pro rata share (determined under paragraph (2)) of the corporation‘s subpart F income for such year.”).

[94] *See generally id.* §§ 951-964.

[95] *Id.* § 957(a).

Consequently, a U.S. shareholder must have ownership of the CFC‘s company stock to satisfy the ―control” requirement for purposes of taxation.[96] The U.S. shareholder is then taxed at the applicable tax rate based on the receipt of income from the CFC.[97]

Because U.S. parent corporations generally qualify as ―U.S. shareholders,”[98] if the parent corporation‘s ownership of the subsidiary‘s stock rises to the level of 50% or more, then their parent/subsidiary relationship meets the definition of a CFC and all income will be currently recognizable during the taxable year.[99] While this rule as codified can be used to give corporations generous tax breaks, Tax Court decisions have limited the availability of these breaks by strictly enforcing the requirements of § 957(a). For example, the Tax Court in *Framatome Connectors USA, Inc. v. C.I.R.*[100] held that a U.S. corporation failed the ―control” requirement of § 957(a) where it did not own 50% or *more* of the ―voting power” in stocks of the foreign subsidiary.[101] The Tax Court found it dispositive that the six veto powers and an 80% supermajority permitted the Japanese-based subsidiary to block important company decisions, and, as a result, the U.S. parent company did not exercise ―control” over the requisite voting power for § 957(a) recognition.[102]

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[96] *See id.*

[97] *See id.* § 951(a).

[98] *See id.* § 951(b) (―[T]he term ―United States shareholder” means, with respect to any foreign corporation, a United States person . . . who owns . . . 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.”).

[99] *See id.* § 957(a).

[100] *Framatome Connectors USA, Inc. v. C.I.R.*, 118 T.C. 32, 32 (2002).

[101] *Id.* at 60-61.

[102] *See id.* at 49.

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Shareholders of CFC‘s are taxed according to the rules for ―Subpart F” income.[103] Subpart F income includes: 1) income from the insurance of U.S. risks, 2) foreign base company income, and 3) amounts attributable to international boycott participation or to illegal bribes or kickbacks.[104] Most relevant to this article, ―foreign base company income” includes: 1) foreign personal holding company income, 2) foreign base company sales income, 3) foreign base company services income, and 4) foreign base company oil related income.[105] To prevent corporations from abusing the recognition provisions of § 957(a), Congress, under § 952(a)(2), requires CFC‘s to report ―foreign based income,” defined by § 954(a) to mean, in part, ―the foreign base company sales income for the taxable year.”[106] Accordingly, if a CFC receives income earned abroad, it must report it to the parent company located in the United States, who subsequently must recognize the earnings as taxable income under the Tax Code.[107] For many software-based companies who sell and license software products to foreign-based CFCs, this catch-all income recognition provision generally prevents tax avoidance on the sale of software products to CFCs, because even though they are outside U.S. borders, when the CFCs turn around to sell the products, the U.S. corporation will have to recognize the income from these transactions.[108]

These rules fall short of capturing Google‘s strategy, which utilizes a transfer-pricing model that avoids § 954 recognition through an exception to the Tax Code on transfers of intangible

[103] *See* I.R.C. § 952(a)(1)-(4) (2011).

[104] *See id.*

[105] *Id.* § 954(a).

[106] *Id.* § 954(a)(2).

[107] Darby & Lemaster, *supra* note 58, at 2, 11.

[108] *See id.* at 11.

property. As a service-based internet company that provides advertising and search engine products, Google takes advantage of the exemptions provided by the Tax Code for “foreign base company sales income” from its advertising programs.[109] Generally, when a U.S. corporation transfers a product to one of its foreign-based subsidiaries, § 367(d)(2)(A)(i) necessarily deems the property to be sold “in exchange for payments which are contingent upon the productivity, use, or disposition of such property.”[110] Sections 954(a)(2) and 954(b)(5) generally mandate distributions to domestic shareholders made by CFCs to be taxable events if the following four requirements are met:

1) the purchase or sale must be to or from a related party
2) the transaction must involve personal property
3) the purchase or sale must be for use or destination outside the base company jurisdiction
4) the personal property must not have been manufactured, produced or constructed by the foreign base company.[111]

The term “related parties” is defined to include all entities and individuals that own more than 50% of the CFC‘s stock.[112]

Conversely, and as is the case with Google, the foreign base provision is inapplicable if the personal property is “manufactured, produced, or constructed by the CFC.”[113] The Treasury

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109 I.R.C. § 954(d)(1).

110 I.R.C. § 367(d)(2)(A)(i).

111 POSTLEWAITE, *supra* note 74, at 249-50; *see also* I.R.C. § 954(a)(2), (b)(5), (d)(1)(A-B).

112 POSTLEWAITE, *supra* note 74, at 250; *see also* I.R.C. § 954(d)(3). The term “related parties” also includes corporations controlled by the CFC or by the same persons who control the CFC. POSTLEWAITE, *supra* note 74, at 250.

113 POSTLEWAITE, *supra* note 74, at 250.

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Regulations provide that this exemption is only applicable if the CFC manufactures the property in its totality or conducts a ―substantial transformation of the property.”[114] The Tax Court historically takes a relaxed approach when addressing the issue of ―substantial transformation,” making the determination on a case-by-case analysis by looking at the totality of the surrounding facts and circumstances.[115] On the other hand, if the property purchased by the CFC is not ―substantially transformed,” but instead is utilized as a component part in the end-product (i.e. computer hard drives purchased for the manufacture of assembled computers), then the income generated from the sale becomes taxable income under the Code.[116] The court in *Dave Fischbein* sided with a U.S. corporate taxpayer in its holding because the operations of its subsidiary established in Belgium were ―substantial [enough] in nature . . . to constitute the manufacture of [the] product.”[117] Even though the U.S.-based corporate stock holder was fully capable of developing the end product, the court found it dispositive that the lower labor and overhead costs, tariff and quantity restrictions, and the subsidiary‘s purchase of some of the machine‘s components from unrelated local entities were sufficient to warrant the exclusion of the income generated from the reach of U.S. taxation.[118]

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[114] *Id.*; *see also* Treas. Reg. § 1.954-3(a)(4)(ii) (2009) and examples thereunder.

[115] *See* Dave Fischbein Mfg. Co. v. Comm‘r., 59 T.C. 338, 352, 360 (1972) (income from individual parts of portable bag-closing machines was not includable as Subpart F income because the parts ―were not perfect, that many of them had to be individually tailored and tested in order to have a completed, functioning sewing machine, that the mechanics were trained and experienced and used skill and judgment in performing their tasks, and that they were not performing purely ministerial functions.”).

[116] *See* Treas. Reg. § 1.954-3(a)(4)(ii) (―If personal property purchased by a foreign corporation is substantially transformed by such foreign corporation prior to sale, the property sold by the selling corporation is manufactured, produced, or constructed by such selling corporation.”).

[117] *Dave Fischbein*, 59 T.C. at 357.

[118] *See id.*

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Ordinarily, software companies that develop their product solely within U.S. borders subsequently must recognize the income attributed to these transfers as taxable income because of their “sale” recognition.[119] But § 367(d) recognition does *not* apply to cross-border transfers of intangible property if the intangible property is developed by the CFC outside of the United States.[120] Moreover, if the software is a product of joint development through a “cost-sharing” arrangement, whereby the rights to utilize the intangible property in the United States are retained by the U.S. company (i.e. Google), and the rights to utilize the property outside the United States are vested in the CFC, then the non-U.S. rights are treated as being created in the jurisdictional location of the CFC.[121] It is under these circumstances that software companies, like Google, can avoid § 945 and § 367 recognition through the cost-sharing arrangement of transfer-pricing.

[119] I.R.C. § 367(d)(2)(A) (2011) (“[T]he United States person transferring such property shall be treated as-- (i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and (ii) receiving amounts which reasonably reflect the amounts which would have been received--(I) annually in the form of such payments over the useful life of such property, or (II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition. The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.”).

[120] I.R.C. § 367(d)(1) (2011).

[121] *See* Darby & Lemaster, *supra* note 58, at 11; *see generally* Treas. Reg. § 1.482-7A (2009).

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III. Discussion

A. The Issue of Transfer Pricing

Due to the rise in communications and increased economic globalization, the world has witnessed a relatively new phenomenon—the “Multinational Enterprise” (“MNE”).[122] Because MNEs do not have to adhere to one single, internationally recognized tax code, the use of MNEs creates increasingly complex taxation issues for tax administrations around the world.[123] Consequently, various tax administrations use transfer-pricing guidelines as a means to govern MNE activity as they, like most consumers, search for ways to re-capture those profits otherwise lost to taxation.

Transfer-pricing is the practice of making payments from one business entity to another affiliated business entity for the receipt of goods or services.[124] MNEs may elect to utilize transfer-pricing for marketing or policy reasons, or to avoid the higher taxation rates imposed upon market-based transactions, as in Google‘s case.[125] Because commercial transactions between two related business entities are not subject to the same market forces as those pertaining to non-related entities, members of the Organization for Economic Co-Operation and Development (“OECD”) have agreed to abide by a principle known as the “Arms-Length

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[122] Organisation for Economic Co-Operation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, at P-1, ¶ 1 (1995) (“The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in broad international context.”).

[123] *See id.* at P-1, ¶ 2.

[124] OECD Centre for Tax Policy and Administration, About Transfer Pricing, http://www.oecd.org/about/0,3347,en_2649_33753_1_1_1_1_1,00.html (last visited June 26, 2011).

[125] *See id.*

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Principle” to ensure that the tax base of MNEs is divided fairly.[126] Article Nine of the OECD Model Tax Convention explains:

> [When] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[127]

Abiding by this principle treats transactions between related companies as though they were non-related, ―arms-length” dealings, thereby theoretically subjecting them to equivalent tax treatment.[128] The OECD member countries believe that adoption of this creates broad parity of tax treatment between MNEs and independent enterprises.[129] Accordingly, the principle seeks to eliminate any tax advantages or disadvantages that would create distortions of relative competitive advantages associated with related or non-related status.[130]

As mentioned above, national tax laws like § 482 of the U.S. Tax Code allow tax administrations to enforce the ―Arm‘s Length Principle” by ―apportion[ing] or allocat[ing] gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if [they] determine[ ] that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations,

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[126] *See id.*

[127] *See* OECD, *supra* note 121, at I-3, ¶ 1.6.

[128] *See id.*

[129] *See id.* at ¶ 1.7.

[130] *See id.*

trades, or businesses."[131] Nevertheless, because the tax laws and regulations have failed to adapt to the changing times, Google has found several tax loopholes between various OECD member countries to allow it to reduce their effective tax rate to a meager 2.4%.[132]

B. EXPLANATION OF THE ―DOUBLE IRISH" AND ―DUTCH SANDWICH"

Utilizing a complex scheme of transfer-pricing agreements, conflicting tax codes, and bi-lateral tax agreements, Google has amazed many on-lookers that its system remains legally viable. The company accomplishes this feat through the creation of two subsidiaries in Ireland, one subsidiary in the Netherlands, and one subsidiary in Bermuda.[133] In 2003, Google, a United States corporation, initiated the process when it negotiated and received approval from the IRS for its confidential transfer pricing arrangement with a newly established subsidiary, Google Ireland Holdings (Ire. sub. 1) (―GIH").[134] In accordance with the principles of transfer-pricing mentioned above, Google, as a software developer, could set up the joint development transfer-pricing arrangement with its GIH subsidiary so that Google retained the domestic rights for use of the software and GIH obtained the international rights for use of their software through an amortized buy-in agreement.[135] As such, GIH controlled access to Google's famously popular search engine software, advertising banners, and the Android platform.[136]

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[131] I.R.C. § 482 (2010).

[132] *See* Drucker, *supra* note 5.

[133] *See id.*

[134] *See id.*

[135] *See* Treas. Reg. § 1.482-7A(a) (2009) (―A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.").

[136] Sherman, *supra* note 86.

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By allocating all of their international revenues to Ireland, Google could continue to research and develop products in the United States while simultaneously earning profits abroad and avoiding high U.S. corporate taxation rates.[137] GIH next established its operational ―anchor” off the U.S. coast in the British overseas territory of Bermuda.[138] This Bermudian subsidiary claims to be the ―effective centre of management” for GIH, thereby exempting GIH from Irish taxation.[139] Furthermore, by filing a ―check-the-box election,” the Bermudian subsidiary, as a ―foreign eligible entity,”[140] can elect to be classified as an entity that is disregarded as separate from its parent-company, Google, for U.S. tax purposes.[141] As a result, any exchange of ―royalty” payments between GIH and its Bermudian tax haven transfers tax-free from any tax administration because the U.S. or Irish taxation laws do not recognize the Bermuda subsidiary as a taxable entity for purposes of their tax codes.[142]

Returning to the Irish mainland, GIH, as a licensee of Google‘s software, allows one of its wholly-owned subsidiaries, Google Ireland Limited (―GIL”) to utilize Google‘s software to perform its global marketing operations and receive all international advertising profits.[143] This tax maneuver earns the nickname ―Double Irish” for its employment of two Irish-based

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[137] *See* Drucker, *supra* note 5.

[138] *See id.*

[139] *See id.*

[140] Treas. Reg. § 301.7701-3(b)(2) (2006) (A ―foreign eligible entity” is any foreign entity that (i) engages in a threshold quantum of business activity such that is not properly classified as a trust and (ii) is not explicitly listed in the regulations as a ―per se” corporation.); *see also* Treas. Reg. § 301.7701-3(a), -2(a), -2(b)(8) (2006) for listing of ―per se” corporations.

[141] *See* Darby & Lemaster, *supra* note 58, at 12.

[142] *See* Sherman, *supra* note 86.

[143] *See* Drucker, *supra* note 5.

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subsidiaries for its international operations.[144] In turn, GIL receives all foreign-based income[145] that, subsequently, is subjected to the favorable 12.5% corporate tax rate in Ireland as a beneficiary of the cost-sharing agreement.[146] In 2009, GIL was credited by Google with 88% of its $12.5 billion in non-U.S. sales.[147]

Conversely, Irish tax law allows GIL to write off its royalty payments for use of GIH‘s software rights as trade expenses that, in 2008, permitted GIL to deduct $5.4 billion in royalties, and left GIL paying at a nominal 1% effective tax rate.[148] If GIL immediately tried to return these profits back to GIH, the transfer would create taxable income under Irish law.[149] Instead, GIL and GIH set these royalty payments at an optimal level so that GIL can reduce its taxable income to a nominal amount to be taxed at the Irish 12.5% corporate rate.[150] Therefore, to evade Irish withholding taxes, payments from GIL must take a brief detour in the Netherlands—a maneuver characterized as the ―Dutch Sandwich”—before finding their way back to GIH.[151]

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144 *See id.*

145 *See* I.R.C. § 954(a)(2) (2011) (―The term ‗foreign base company income‘ means . . . (2) the foreign base company sales income for the taxable year.”).

146 *See* Treas. Reg. § 1.482-7A (2011)(―A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.”); *see also* Darby & Lemaster, *supra* note 58, at 12.

147 Drucker, *supra* note 5.

148 Sherman, *supra* note 86.

149 *See id.*

150 Darby & Lemaster, *supra* note 58, at 14.

151 Drucker, *supra* note 5.

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By exploiting a low rate of corporate taxation and generous European Union (“EU”) agreements, GIL is able to make “royalty” payments to another EU member, the Netherlands.[152] Per the “Taxation of Cross-Border Interest and Royalty Payments” agreement by the EU member states in June 2003, corporations in one member state are allowed to make interest and royalty payments to subsidiaries located in other member states, provided that the beneficial owner of the payment is a company or permanent establishment in another member state.[153] GIL, therefore, pays royalties to an employee-less shell corporation in the Netherlands, Google Netherlands Holdings BV (Dut. sub.) (“GNH”), with the sole purpose of receiving these payments from GIL, and immediately redirecting them to the Bermuda holding company.[154] All of the income received by the Bermudian subsidiary, in turn, enjoys the luxury of sandy beaches and Bermuda‘s non-existent corporate taxation rates.[155] The reported income remains on the island until Google decides to repatriate the income through dividend payments, whereby the payment will be subjected to the applicable U.S. dividend rate of taxation.[156] Assuming Google has no plans to repatriate these revenues back into the country any time soon, Google shareholders continue to benefit from skewed annual reportings, while the U.S. government, to date, reports losses upwards of $60 billion.[157]

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[152] *Id.*

[153] European Commission Taxation and Customs Union, Taxation of Cross-Border Interest and Royalty Payments in the European Union, http://ec.europa.eu/taxation_customs/taxation/company_tax/interests_royalties/index_en.htm (last visited June 26, 2011) (“These interest and royalty payments shall be exempt from any taxes in that State provided that the beneficial owner of the payment is a company or permanent establishment in another Member State.”).

[154] *See* Sherman, *supra* note 86.

[155] *See* KPMG, *supra* note 16, at 12.

[156] *See* Darby & Lemaster, *supra* note 58, at 13.

[157] *See* Drucker, *supra* note 5.

While policymakers search for ways to close these gaps that cost the U.S. Treasury millions of dollars each year, Google has benefited greatly from employing this scheme. In 2001, Google reported revenues of nearly $86.5 million, of which only 18% were attributable to international revenues.[158] By 2004, the year of Google's Initial Public Offering, revenues had nearly quadrupled from 2001 reportings to $3.2 billion, and international revenues accounted for 34% of Google's revenues.[159] Six years later, Google's financial statements have been off the charts as the effects of increased market globalization and internet usage have made Google one of the highest revenue-grossing corporations in the world. To date, Google reports 2010 unaudited gross revenues totaling more than $29.3 billion, of which 52% are attributable to international revenues.[160] Even though much of these revenues do not translate into taxable income to the U.S. government, profits lost to foreign taxable entities cost taxpayers millions in lost revenue. While the U.S. government tries to close a national debt in excess of $1.4 trillion, Google and other U.S.-based companies implementing the ―Double Irish" and ―Dutch Sandwich" tax avoidance arrangements have their proverbial cake and eat it too by reaping the benefits of the U.S. economy and more favorable tax laws abroad.[161]

[158] Google, 2003 Financial Tables–Investor Relations, http://investor.google.com/financial/2003/tables.html (last visited June 26, 2011).

[159] Google, 2004 Financial Tables–Investor Relations, http://investor.google.com/financial/2004/tables.html (last visited June 26, 2011).

[160] Google, 2010 Financial Tables–Investor Relations, http://investor.google.com/financial/2010/tables.html (last visited June 26, 2011).

[161] *See generally* Drucker, *supra* note 5.

IV. Possible Solutions to the Problem

A. Application of I.R.C. § 965

In 2005, the IRS reported nearly $804 billion in earnings and profits earned abroad by controlled foreign companies of U.S. corporations.[162] Conversely, only $362 billion of those earnings were subsequently repatriated back into the U.S. economy and taxed at the U.S. corporate income tax rate.[163] That same year, Congress, as part of the American Jobs Creation Act of 2004, enacted § 965 of the Tax Code in an attempt to offer companies a one-time opportunity to repatriate profits earned abroad at greatly reduced tax consequences to the company.[164] The reasoning behind § 965's enactment was the belief that the repatriation of profits would stimulate the economy and create jobs for American workers in the process.[165] Instead, commentators observed the following:

> Economists concluded that the repatriation holiday produced a windfall gain for companies with large amounts of accumulated earnings in low-tax countries. They found that companies used the funds principally for share repurchases. And they found that companies that benefited from the holiday were no more likely to spend on growing their businesses than companies that did not benefit.[166]

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[162] Lee A. Sheppard & Martin A. Sullivan, *Repatriation Aid for the Financial Crisis?*, 53 TAX NOTES INT'L 275, 276 (2009).

[163] *Id.*

[164] Celina Rogers, Risk and Section 965 Repatriation, CFO.com, Oct. 20, 2005, http://www.cfo.com/article.cfm/4486225/c_5541231/?f=archives.

[165] I.R.C. § 965 (2004); H.R. Rep. No. 108-548(l) (2004) ("The Committee observes that the residual U.S. tax imposed on the repatriation of foreign earnings can serve as a disincentive to repatriate these earnings. The Committee believes that a temporary reduction in the U.S. tax on repatriated dividends will stimulate the U.S. domestic economy by triggering the repatriation of foreign earnings that otherwise would have remained abroad. The Committee emphasizes that this is a temporary economic stimulus measure.").

[166] *See* Shephard & Sullivan, *supra* note 161, at 276-77.

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While the U.S. economy never fully realized the potential benefits of § 965 as a means to recapture those foreign profits avoiding high U.S. corporate tax rates, § 965 serves as a reminder that the process may not be an easy one, considering corporations willingness to dole out large sums of cash to protect their bottom line.[167]

In its current form, § 965 allows MNEs from the United States to benefit from an 85% tax break from income earned by foreign subsidiaries given that the payments were repatriated through cash dividends to their U.S. parent company within a one year time frame.[168] Section 965(b)(4) requires the dividend payments to adhere to the Domestic Reinvestment Plan (―DRIP”) requirements, in that they: a) be approved by the taxpayer‘s president, or chief executive officer (or equivalent) along with subsequent approval by the taxpayer‘s board of directors (or its equivalent), and b) be provided for reinvestment in the U.S. economy as a source of ―worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation.”[169]

Not surprisingly, many corporations who took advantage of the tax holiday seemingly ignored the federally-mandated requirements,[170] as the U.S. Treasury reported only $16.5 billion in revenues from its enactment.[171] Some companies even cut jobs domestically after repatriating billions in cash dividends.[172] Section 965 had a second side effect because it incentivized companies to ship intangible assets abroad in hopes that Congress would either extend the

[167] Mauntel, *supra* note 69, at 128.

[168] *Id.*

[169] *See* I.R.C. § 965(b)(4) (2011).

[170] *See* Shephard & Sullivan, *supra* note 161, at 278-79.

[171] *See* Mauntel, *supra* note 69**,** at 113.

[172] *See id.* at 120-21.

applicable period or reintroduce the bill at a subsequent date.[173] Despite lobbying efforts by companies like Oracle Corp., Eli Lilly & Co., and Hewlett-Packard Co. to have Congress grant such relief, Congress has repeatedly declined to re-enact § 965, likely due to the previous abuses and marginal returns of its existence.[174]

One method to accomplish essentially the same goals as those provided by § 965 would be to completely eliminate the DRIP requirements before reenacting a Tax Holiday program like the one provided by § 965. However, taking into account the potential for abuse of another tax holiday and the fact that billions of dollars in corporate profits remain stationed abroad until a time when it becomes profitable to repatriate them back into the United States, it is still a question how the U.S. government, likely with the help of other foreign governments, can close this gaping hole in the Tax Code while avoiding the dire consequence of forcing U.S. corporations to move their headquarters abroad. Moreover, how much does the U.S. government care that these sorts of tax havens continue to exist in the face of historically high federal deficits? Recent political history would suggest not much.

B. IMPLEMENTING A NEW SYSTEM OF FOREIGN TAXATION

A simpler solution, considering its ranking among other developed nations, would be to follow in the footsteps of Japanese lawmakers and lower the tax rate for all U.S. corporations to a level on par with, or lower than, other developed nations. Currently, the U.S. marginal corporate tax rate ranks at the top of industrialized nations.[175] Yet the current state of affairs of its tax system

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[173] *See id.* at 126.

[174] Ryan J. Donmoyer, *Lilly, Oracle Lose Senate Bid for Overseas-Profits Tax Discount*, BLOOMBERG, Feb. 4, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=anUvSkYMAtT8&refer=us.

[175] *See* KPMG, *supra* note 16, at 12.

advocates continual defectors and circumventors who aimlessly sink profits into tax avoidance schemes to gain a larger piece of the consumer-driven economy of the United States. Alternatively, providing incentives in the form of tax breaks or lower rates for U.S. corporations who, in fact, derive profits from CFCs could recapture lost tax revenues while mitigating the unwarranted externality of shipping corporate business abroad. U.S. resistance to such a system has seemingly backfired on the Treasury and IRS, as they both waste millions of taxpayer dollars per year in oversight and monitoring of the tax schemes, only to arrive at the all-too-obvious conclusion that U.S. corporations are setting up these schemes and the government has no real way of stopping it.[176]

Notably, Matthew J. Mauntel offered similar advice in his article *Stimulating the Stimulus: U.S. Controlled Subsidiaries and I.R.C. 965*, where he suggested that the United States look to the recent overhauls in the Canadian approach to CFCs.[177] Currently, Canadian tax regulations provide tax exemptions for foreign-based income derived from certain countries privy to tax-information-sharing agreements with the Canadian government.[178] This system exempts almost 90% of foreign-based corporate income produced by Canadian subsidiaries.[179] Due to the similarities between the U.S. and Canadian tax systems and the free trade agreement between the countries,[180] it would significantly benefit the United States to follow in Canada‘s footsteps before it loses business in a similar fashion to its neighbors to the north.

[176] *See* Drucker, *supra* note 5.

[177] *See* Mauntel, *supra* note 69**,** at 127.

[178] *See id.*; *see also* U.S.-Canada Tax Treaty art. XXIV, § 2(b), Sept. 26, 1980, 1986-2 C.B. 258.

[179] *See* Mauntel, *supra* note 69**,** at 127.

[180] *See generally* North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289.

To date, the United States has tax treaties established with sixty-seven countries around the world.[181] This list includes countries relevant to the ―Double Irish” and ―Dutch Sandwich” maneuvers, like Ireland and the Netherlands.[182] Similarly (and unlikely by coincidence, given Google‘s contemporaneous undertakings), in 2003, the United States and the Bahamas entered into an information-sharing agreement that took effect on Jan. 1, 2004.[183] These types of treaties and agreements are intended to increase the transparency of international tax mechanisms and, in some cases, tax individuals and entities at reduced rates on certain items of income they receive.[184]

Yet by allowing for an exemption for most, if not all, of foreign-earned corporate income, whether from countries sharing treaties or information agreements or on the whole, internationally-based corporations would likely find it economically advantageous to repatriate profits stationed abroad or move businesses into the United States. Moreover, the United States may find the economic stimulus package it has so desperately sought over the past decade, notwithstanding the repeated failures of raising and lowering of the prime rate and ineffective domestic tax credits. As Mauntel is quick to point out, ―the United States and Canada are two of the last industrialized countries to attempt world-wide taxation and Canada is prudently in the process of abandoning it after finding it uncompetitive and unwieldy.”[185]

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[181] IRS, United States Income Tax Treaties–A to Z, http://www.irs.gov/businesses/international/article/0,,id=96739,00.html (last visited Feb. 28, 2011).

[182] *See id.*

[183] Amanda Banks, *Bahamas Commits to Information Sharing Agreement with United States*, TAX-NEWS.COM, Dec. 18, 2003, http://www.tax-news.com/news/Bahamas_Commits_To_Information_Sharing_Agreement_With_United_States____14475.html.

[184] IRS, Tax Treaty Overview, http://www.irs.gov/businesses/small/international/article/0,,id=96434,00.html (last visited Feb. 28, 2011).

[185] *See* Mauntel, *supra* note 69**,** at 127.

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For example, § 954(b)(3)(A) currently provides an exclusion of foreign-based income if the sum of the foreign base company income constitutes less than 5% of the gross income of the entire corporation.[186] The Code further requires that the U.S. parent company report all income from the CFC if the sum of the foreign base company income exceeds 70% of the U.S. corporation‘s gross income for the taxable year.[187] Corporations often attempt to undermine these threshold requirements with careful tax planning so that they can exclude these foreign profits. As previously mentioned, Google‘s reported revenues totaled $29.3 billion in 2010, of which 52% are attributable to international revenues.[188] Under current application, the “de minimus” provision encourages cross-border corporations to elude § 954(b)‘s reach by establishing a scheme whereby foreign profits are apportioned among thousands of smaller shell corporations so that each individual entity never surfaces above the 5% threshold. Instead of utilizing significant taxpayer dollars to police this possibility, why not raise the “de minimus” provision to a “majority” threshold? In other words, a corporation could exclude amounts less than 50% of the parent-corporation‘s gross income, and remove the application of § 954(b)(3)(B), which forces the taxpayer to recognize all foreign profits above the 70% threshold. While, admittedly, any definitive threshold amount would still present opportunities to avoid U.S. taxation, a 50% threshold would serve a two-fold purpose: 1) it would properly reflect that

[186] I.R.C. § 954(b)(3)(A) (2011) (“If the sum of foreign base company income (determined without regard to paragraph (5)) and the gross insurance income for the taxable year is less than the lesser of--(i) 5 percent of gross income, or (ii) $1,000,000, no part of the gross income for the taxable year shall be treated as foreign base company income or insurance income.”).

[187] I.R.C. § 954(b)(3)(B) (“If the sum of the foreign base company income . . . and the gross insurance income for the taxable year exceeds 70 percent of gross income, the entire gross income for the taxable year shall . . . be treated as foreign base company income or insurance income (whichever is appropriate).”).

[188] Google‘s 2010 Financial Tables, *supra* note 159.

percentage of a corporation subject to foreign taxation laws in their proportionate share of total gross income, and 2) it would increase the tax base of cross-border corporations by allowing for a larger exclusion and encouraging more corporations to incorporate within the United States.[189]

Under the current tax regime, the Code allows for the shareholder to exclude those portions of his earnings and profits from his or her taxable income whenever a CFC makes a distribution to the parent company.[190] This system is designed to prevent any ill-effects of ―double taxation" that may occur as a result of the distribution.[191] However, the situation where a U.S. shareholder who owns stock in a foreign-operated corporation that earns income from non-U.S. sources and concurrently must comply with non-U.S. standards is subjected to U.S. taxation seems to completely contravene a system that constantly preaches ―substance over form."[192] Furthermore, this system simultaneously relieves a corporate shareholder of the adverse effects of ―triple-taxation", in which the foreign-based earnings of the corporation are subjected to taxation by the foreign jurisdiction and to ―double-taxation" at the U.S. corporate and shareholder levels.[193]

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[189] I.R.C. § 954(b)(3)(B) (―If the sum of the foreign base company income. . .and the gross insurance income for the taxable year exceeds 70 percent of gross income, the entire gross income for the taxable year shall. . .be treated as foreign base company income or insurance income (whichever is appropriate).").

[190] *See* I.R.C. § 959(b) (―For purposes of section 951(a), the earnings and profits of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a), shall not, when distributed through a chain of ownership described under section 958(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States shareholder (or to any other United States shareholder who acquires from any person any portion of the interest of such United States shareholder in the controlled foreign corporation).").

[191] *See id.*

[192] *Contra* I.R.C. § 482.

[193] *See* I.R.C. § 954(a).

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Although there are no current plans by either the House of Representatives or the Senate to amend the legislation surrounding foreign-based income to ameliorate the effects of Subpart F income recognition, there have been several attempts by various Members of Congress to do so.[194] While it remains to be seen what the future holds for foreign-based income, one can certainly expect that corporations like Google will continue to find various methods to circumvent the harsh inequities derived from U.S. taxation on income clearly attributable to transactions where neither party resides within U.S. borders.

V. Conclusion

The United States and other international taxation bodies will certainly face unfavorable outcomes if they continue to expand the reach of their taxation laws to transactions in which none of the parties directly avail themselves of their domestic protections. While those jurisdictions claim they have a right to apply their taxation laws to such events, they simultaneously risk deterring any future direct foreign investment and alienation of their own domestically-created businesses. As previously mentioned, such ill-effects are already being felt by the United States as corporations like Google continue to establish and operate subsidiaries outside U.S. soil to avoid U.S. taxation. One can reasonably assume that these practices will continue to be implemented. Furthermore, as the United States tries to close the historically high national deficit, it appears to be economic suicide to continue to dissuade businesses from

[194] *See* H.R. 5328, 111th Cong. (2010) (―Repeal of Look-Thru Rule for Royalties Received From Controlled Foreign Corporations. Paragraph (6) of section 954(c) of the Internal Revenue Code of 1986 is amended-(1) by striking ‗rents, and royalties' in subparagraph (A) and inserting ‗and rents', and (2) by striking ‗, rent, or royalty' both places it appears in subparagraph (B) and inserting ‗or rent'."); *see also* S. 45, 112th Cong. (2011).

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BE CAREFUL WHAT YOU WISH FOR: JUDICIAL DEFERENCE TO TREASURY REGULATIONS AFTER *MAYO FOUNDATION FOR MEDICAL EDUCATION & RESEARCH V. UNITED STATES*

BE CAREFUL WHAT YOU WISH FOR: JUDICIAL DEFERENCE TO TREASURY REGULATIONS AFTER *MAYO FOUNDATION FOR MEDICAL EDUCATION& RESEARCH V. UNITED STATES*

By: Bryan Dotson[1]

I. INTRODUCTION

In *Mayo Foundation for Medical Education & Research v. United States*, the U.S. Supreme Court accepted the government's position that judicial deference to Treasury Regulations should be guided by the same principles that apply to review of other agencies' administrative rules.[2] In doing so, the Supreme Court resolved nearly three decades of confusion regarding the appropriate level of deference to accord Treasury Regulations.[3] At that point, the *Rowan-National Muffler* framework that prevailed for nearly thirty years as the standard for substantive judicial review of Treasury Regulations was officially replaced by the generally applicable *Mead-Chevron* standard.[4]

Under the *Rowan-National Muffler* framework, the reviewing court's initial inquiry focuses on the authority that the Treasury utilized to promulgate the rule.[5] If the Treasury utilized a specific grant of authority to promulgate the rule, then any reviewing court will be bound to the statutory interpretation contained within that rule so long as the interpretation is within the delegation of authority.[6] If, however, the Treasury utilized its general grant of authority to prescribe "all needful rules and regulations for the enforcement of [the Internal Revenue Code]," then the reviewing court had to determine whether the rule implemented "the

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[2] Mayo Found. for Med. Educ. and Research v. United States, 131 S.Ct. 704, 716 (2011).
[3] *See id.* at 712.
[4] *Id.* at 714.
[5] United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982).
[6] Rowan Cos. Inc. v. United States, 452 U.S. 247, 253 (1981).

congressional mandate in some reasonable manner."[7] A regulation "carries out the congressional mandate in a proper manner" when it "harmonizes with the plain language of the statute, its origin, and its purpose."[8] Some of the factors a reviewing court will look at to determine the level of force that a general authority rule will have are

> if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent[,] . . .the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.[9]

Under the *Mead-Chevron* framework, the initial determination a court must make is whether the regulation qualifies for *Chevron* deference.[10] An administrative rule interpreting a statutory term "qualifies for *Chevron* deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority."[11] If the rule qualifies for *Chevron* deference, then the agency need only establish that the statutory language that the rule interprets is ambiguous and that the interpretation is a permissible one to bind the reviewing court to that interpretation.[12] If the rule does not qualify for *Chevron* deference then the rule has no binding effect upon the reviewing court beyond the power to persuade.[13] The force of such a rule depends upon "the thoroughness evident in its consideration, the validity of

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[7] I.R.C. § 7805(a) (West 2002); *Rowan*, 452 U.S. at 252 (quoting United States v. Correll, 389 U.S. 299, 307 (1967).
[8] Nat'l Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 477 (1979).
[9] *Id.*
[10] United States v. Mead Corp., 533 U.S. 218, 226-27 (2001).
[11] *Id.*
[12] Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-43 (1984).
[13] *Mead*, 533 U.S. at 234.

its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."[14]

The *Mayo* decision seemingly represents a significant victory for the government. Under the *Mead-Chevron* framework, the Treasury will no longer have to prove that the regulations promulgated pursuant to their general authority carry out the congressional mandate in a proper manner.[15] Where the Treasury will find this new framework troublesome, however, is in establishing that their regulations qualify for *Chevron* deference. Congress has delegated broad interpretative authority over the Internal Revenue Code (I.R.C.) to the Treasury, but the Treasury has failed to meet the procedural requirements of the Administrative Procedure Code (A.P.A.) in exercising that authority.[16] As such, in more than an insubstantial number of cases, the Treasury will still need to earn the reviewing court's deference by establishing a set of factors, which very much resemble the *National Muffler* factors that the *Mayo* opinion seemingly freed them from proving.

This Comment discusses the future of judicial deference to Treasury Regulations under the *Mead-Chevron* framework as commanded by the U.S. Supreme Court. Rather than relieving the Treasury of the burdensome practice of defending the validity of their regulations subject to judicial review, because of the Treasury's past practice of promulgating those regulations, the new framework simply changes the type of regulations that the Treasury will have to defend. Part II will discuss the historical levels of deference that reviewing courts have accorded agency

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[14] Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944).
[15] *See Mead*, 533 U.S. at 226-27.
[16] *See* I.R.C. § 7805(a) (West 2002). *See generally* Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 Notre Dame L. Rev. 1727 (2007) [hereinafter Hickman, *Coloring Outside the Lines*] (finding that the Treasury did not use the Traditional A.P.A. process in 40.9% of the 232 rulemaking projects surveyed from January 1, 2003 to December 31, 2005.).

rules.[17] Part III will discuss the *Mayo* decision.[18] Part IV will briefly describe the analysis of agency interpretations under the *Mead-Chevron* framework.[19] Part V will analyze how the Treasury's Regulations will fare under this new framework.[20] Finally, in Part VI, this Comment will conclude that in many instances the Treasury's victory in *Mayo* is hollow because their past practice of promulgating regulations will preclude them from obtaining the powerful binding deference described in *Chevron.*[21] Instead, the Treasury will still have the burden to convince a reviewing court to accept those interpretations.[22]

II. Historical Overview of Judicial Deference To Agency Statutory Interpretations

1. General Principles

"A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof."[23] When reviewing agency action, a "reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action."[24] Although a seemingly straightforward mandate, the responsibility to "decide all relevant questions of law" becomes complicated if the reviewing court is determining the validity of agency action that interprets a statutory term that the agency administers.[25] On the one hand, *Marbury v. Madison* very clearly established that

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17 *See infra* Part II.
18 *See infra* Part III.
19 *See infra* Part IV.
20 *See infra* Part V.
21 *See infra* Part VI.
22 *See infra* Part VI.
23 5 U.S.C.A. § 702 (West 2007); *see also id.* § 701(b)(2) ("„agency action' includes the whole or a part of an agency rule, order, license, sanction, relief, or the equivalent or denial thereof, or failure to act").
24 *Id.* § 706.
25 *Id.*

"[i]t is emphatically the province and duty of the judicial department to say what the law is."[26] On the other hand, Congress specifically delegated responsibility to administer a particular statutory scheme to subject matter experts within the administrative agency. Over the years, the Supreme Court has struggled to define the appropriate level of deference a reviewing court should give to agency interpretations of statutory terms contained within its enabling statute.

In the early twentieth century, Congress began giving executive and independent agencies authority to adopt legally binding regulations.[27] This expansion of agency regulatory powers led many courts and scholars to question whether these delegations would violate the non-delegation doctrine.[28] Although the Supreme Court nearly always upheld Congressional delegations of rulemaking authority during this period, its rhetoric concerning these rulemaking grants signaled that they were constitutional so long as the grant was narrow and specific.[29] Accordingly, legally binding regulations promulgated pursuant to a specific grant of authority would not violate the non-delegation doctrine and as a result could bind the regulated public and the courts.[30] Regulations promulgated pursuant to an agency's general authority to prescribe "all necessary rules and regulations," however, would constitute an unconstitutional delegation of legislative authority if they were legally binding.[31] As a result, regulations adopted pursuant to an agency's general power could not bind the regulated public or the courts, but were treated as

[26] *Marbury v. Madison*, 5 U.S. 137, 177 (1803).
[27] Kristin E. Hickman, *The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1564 (2006) [hereinafter Hickman, *The Need for Mead*].
[28] *Id.* at 1565.
[29] *Id.* at 1566.
[30] *Id.*
[31] *Id.* at 1567.

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merely exercises of the inherent executive power to interpret the laws in the course of enforcing them.[32]

During this period, specific authority regulations were "controlling on the court unless they are issued improperly or are clearly contrary to the will of Congress."[33] A reviewing court, would, therefore, defer to an interpretation of a statutory term contained in a specific authority regulation so long as it was not "„unreasonably and plainly inconsistent' with the statute they are designed to implement" or "arbitrary, capricious, or clearly contrary to the statute."[34] Therefore, so long as the agency acted within its delegation of authority in promulgating the regulation, the reviewing court was bound by the interpretation contained therein.[35]

Conversely, if the agency sought to define a statutory term under its general authority, it was faced with a much more difficult task.[36] The reviewing court deferred to an interpretation advanced by the agency through a general authority regulation only if it "implement[ed] the congressional mandate in some reasonable manner."[37] To determine whether a particular regulation "carrie[d] out the congressional mandate in a proper manner, [the court would] look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose."[38] To determine the level of force that a regulation would have upon a reviewing court, the relevant inquiries were whether the regulation was:

> a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later

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32 *Id.*
33 John F. Coverdale, *Chevron's Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings after Mead*, 55 ADMIN L. REV. 39, 73-74 (2003) [hereinafter Coverdale, *Chevron's Reduced Domain*].
34 *Id.* at 74.
35 Rowan Companies, Inc. v. United States, 452 U.S. 247, 253 (1981).
36 *See id.* at 252.
37 *Id.* (quoting United States v. Correll, 389 U.S. 299, 307 (1967)).
38 *Id.* at 253 (quoting Nat'l Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979)).

> period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the [agency's] interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.[39]

This led several courts to defer to a regulation only when the regulation represented "that interpretation, which can most fairly be said to be [e]mbedded in the statute, in the sense of being most harmonious with its scheme and with the general purposes that Congress manifested."[40] Thus, not only would an agency promoting the interpretation contained in a general authority regulation have to establish the rule as a valid exercise of that power, but also that the interpretation is one which accords with what Congress intended when it passed the statute.

As non-delegation concerns waned, and as administrative agencies increasingly saw regulations promulgated pursuant to their general rulemaking power as a way to promote their policy objectives, courts began to characterize regulations based upon their function rather than their source of authority.[41] Consistent with this trend, the Supreme Court revolutionized judicial review of agency regulations in *Chevron USA, Inc. v. National Resources Defense Council, Inc.*[42] At issue in *Chevron* was the validity of a general authority E.P.A. regulation interpreting the term "stationary source" in the Clean Air Act.[43] The Clean Air Act required "nonattainment" states to establish a permit program regulating "new or modified major stationary sources" of air pollution.[44] Under the Clean Air Act, a permit may not be issued for one of these new or

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[39] *National Muffler*, 440 U.S. at 477.
[40] Comm'r v. Engle, 464 U.S. 206, 217 (1984) (quoting NLRB v. Lion Oil Co., 352 U.S. 282, 297, (1957) (Frankfurter, J., concurring in part and dissenting in part)).
[41] Hickman, *The Need for Mead*, *supra* note 27 at 1574-75.
[42] *Chevron, U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 866 (1984).
[43] *Id.* at 840.
[44] *Id.*

modified stationary sources unless several stringent conditions are met.[45] The E.P.A definition of "stationary source" contained in the regulation allowed an existing plant that contained several pollution-emitting devices to install or modify one piece of equipment without meeting the permit conditions if the alteration will not increase the total emissions from the plant.[46]

The Supreme Court resolved the issue by stating that when Congress leaves an ambiguity in the statute, and charges an agency with responsibility to administer that statute, then there is "an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation."[47] "Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."[48] Thus, because the Clean Air Act did not command a particular definition of "stationary source," then the agency's decision to adopt a plant-wide definition rather than an equipment specific one represented a legitimate policy choice by those whom Congress charged with carrying out its intent.[49] The result was the Supreme Court's recognition that exercises of implicit (general authority) as well as explicit (specific authority) delegations merit strong deference.[50]

2. Treasury Regulations

Both *Rowan Companies Inc. v. United States* and *National Muffler Dealers Association v. United States* directly addressed the degree of deference a reviewing court should give to Treasury Regulations.[51] Thus, prior to *Chevron*, there was no question as to the standards for reviewing a challenge to the validity of a Treasury Regulation. Those issued pursuant to a

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[45] *Id.*
[46] *Id.*
[47] *Id.* at 843-44.
[48] *Id.* at 844.
[49] *Id.* at 866.
[50] Hickman, *The Need for Mead*, *supra* note 27 at 1578.
[51] Rowan Cos. Inc. v. United States, 452 U.S. 247 (1981); Nat'l Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472 (1979); discussion *infra* Part II.1.

specific delegation of authority were given controlling weight if the regulation was within the statutory grant of power.[52] Those regulations enacted pursuant to the Treasury's general power to develop "all needful rules and regulations," were given a level of deference according to a reviewing court's analysis of the factors outlined in *National Muffler*.[53]

Chevron, however, was not a tax case, so following it there remained a great deal of confusion regarding the appropriate level of deference to give to general authority regulations.[54] The Supreme Court themselves sent several confusing signals on the issue.[55] In the cases that the Supreme Court decided following *Chevron*, the Court cited both *National Muffler* and *Chevron* twice in majority opinions.[56] In addition, *National Muffler* was cited three times in separate concurring or dissenting opinions while *Chevron* was cited only twice.[57] Once, in his dissenting opinion in *Newark Morning Ledger Company v. Commissioner*, Justice Souter cited both *Chevron* and *National Muffler* in the same passage.[58] Following these mixed signals, lower courts struggled to determine the precise relationship between *Chevron* and *National Muffler* when choosing between mandatory deference and multifactor respect with respect to general authority Treasury Regulations.[59]

III. *MAYO FOUNDATION FOR MEDICAL EDUCATION & RESEARCH V. UNITED STATES*

In *Mayo Foundation for Medical Education & Research v. United States*, the Supreme Court finally resolved the confusion regarding the correct framework for judicial review of

52 *Rowan*, 452 U.S. at 253.
53 I.R.C. § 7805(a) (West 2002); *Rowan*, 452 U.S. at 253.
54 *See* Hickman, *The Need for Mead*, *supra* note 27 at 1578-88.
55 *Id* at 1579.
56 *Id.*
57 *Id.*
58 *Id.*
59 *See id.*

Treasury Regulations.[60] At issue in *Mayo* was the validity of a general authority Treasury Regulation that excluded employees that worked forty hours or more from the student exception of the Social Security Act.[61] The Mayo Foundation challenged the validity of this regulation because it would subject the stipends it pays to students enrolled in their medical residency programs to FICA taxes.[62] The District Court invalidated this regulation because it found the statutory terms unambiguous and because, under the factors announced in *National Muffler*, it was not entitled to deference.[63] On appeal, the Eighth Circuit upheld the regulation, but utilized the *National Muffler* factors during its *Chevron* analysis to conclude that it was a reasonable interpretation of the statute.[64]

The Supreme Court directly addressed the confusion regarding *Chevron* and *National Muffler* and stated, "we are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly recognized the importance of maintaining a uniform approach to judicial review of administrative action."[65] Accordingly, "[t]he principles underlying our decision in *Chevron* apply with full force in the tax context."[66] "We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations."[67] Thus, "*Chevron* and *Mead*, rather than *National Muffler* and *Rowan*, provide the appropriate framework for evaluating" Treasury Regulations.[68]

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[60] Mayo Found. for Med. Ed. & Research v. United States, 131 S. Ct. 704 (2011).
[61] *Id.* at 710.
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.* at 713.
[66] *Id.*
[67] *Id.*
[68] *Id.* at 714.

IV. Judicial Deference To Agency Regulations Under *Mead-Chevron* Framework

In *Mayo*, the Supreme Court ended nearly thirty years of confusion regarding the appropriate framework to evaluate the validity of Treasury Regulations. No longer would reviewing courts look to the authority under which the Treasury promulgated the regulation as required under *Rowan*, and then apply either controlling deference or persuasive deference depending upon how the regulation fared under the *National Muffler* factors. Rather, the reviewing court's analysis is guided by the same principles that apply to the review of all other administrative agency action that interprets a statutory term. Under this framework, the reviewing court determines the appropriate level of deference to give to an agency's statutory interpretation by answering two threshold questions: (1) Does the particular regulation in question qualify for *Chevron* deference? and (2) Under the appropriate standard, what is the proper level of deference to give to that interpretation?

1. Chevron Qualification

Administrative implementation of a particular statutory provision qualifies for *Chevron* deference when it appears that (1) Congress delegated authority to the agency generally to make rules carrying the force of law, and (2) the agency interpretation claiming deference was promulgated in the exercise of that authority.[69]

In determining whether Congress delegated authority to the agency to make rules carrying the force of law, "[t]he starting point for this inquiry is, of course, the language of the delegation provision itself."[70] If the enabling statute "gives an agency broad power to enforce all provisions of the statute" then that authority is clear.[71] Next, there then must be an indication

[69] United States v. Mead Corp., 533 U.S. 218, 226-27 (2001).
[70] Gonzales v. Oregon, 546 U.S. 243, 258-59 (2006).
[71] *Id.* at 259.

that Congress intended these acts to carry the force of law.[72] "Delegation of such authority may be shown in a variety of ways, as by an agency's power to engage in adjudication or notice and comment rulemaking, or by some other indication of comparable congressional intent."[73] When Congress "provides for relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement" with the effect of law, then it is fair to assume that Congress intended such actions to have the force of law.[74]

If Congress delegated authority to the agency to make rules carrying the force of law, such actions will not be accorded *Chevron* deference unless the rule was promulgated in accordance with the exercise of that authority.[75] In order to do this, the agency's exercise of authority must be (1) within the statutory grant of authority and (2) in accordance with any procedural requirements that accompany that grant of authority.[76]

2. Deference Levels

If the administrative implementation of a particular statutory provision qualifies for *Chevron* deference, then it receives the powerful mandatory deference described in *Chevron*.[77] If the administrative interpretation does not qualify for *Chevron*, then it may still merit some deference "given the specialized experience and broader investigations and information available to the agency, and given the value of uniformity in its administrative and judicial understandings of what a national law requires."[78]

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[72] *Mead*, 533 U.S. at 227.
[73] *Id.*
[74] *Id.* at 230.
[75] *Id.* at 227.
[76] *See* Gonzales v. Oregon, 546 U.S. 243, 259-60 (2006).
[77] *Mead*, 533 U.S. at 226-27.
[78] *Id.* at 234 (quoting Skidmore v. Swift & Co*,* 323 U.S. 134, 139-40).

Under *Chevron,* the reviewing court must defer to an agency's interpretation if the agency can establish two requirements.[79] First, the statutory language at issue must be ambiguous.[80] If a court ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect.[81] In determining Congressional intent, the reviewing court has all the traditional tools of statutory construction.[82] Two common tactics that reviewing courts have used to determine the range of possible meanings a term has are dictionaries and prior judicial interpretations.[83] If a prior court decision holds that a particular statutory construction follows from the unambiguous terms of the statute, then there is no room for agency discretion and that construction will trump an agency's interpretation.[84]

If the reviewing court determines that Congress did not have an intention on the precise question at issue, then the next requirement the agency interpretation must satisfy is that it must be a permissible construction of the statute.[85] The court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding.[86] An agency's choice of one of several plausible constructions of ambiguous statutory language is a policy decision, and that agency policy decision must be upheld if it is "reasonable."[87]

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[79] Chevron U.S.A., Inc. v. Natural Res. Def. Council Inc., 467 U.S. 837, 842 (1984).
[80] *See id.*.
[81] *Id.* at 843.
[82] *Id.* at 843 n.9.
[83] RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE 216 (Aspen 2010).
[84] Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 982 (2005).
[85] *Chevron*, 467 U.S. at 843.
[86] *Id.* at 843 n. 11.
[87] *Id.* at 866.

If the administrative implementation of a statutory term does not qualify for *Chevron* deference, then it may merit some level of deference because of the subject matter expertise within the agency and the value of a uniform understanding of what the law requires.[88] This level of deference, labeled as *Skidmore* deference based upon the case in which the Supreme Court announced it, will never bind the reviewing court to the agency's interpretation.[89] Under *Skidmore* deference, the reviewing court may decide to accept an administrative interpretation based upon "the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."[90]

V. JUDICIAL DEFERENCE TO TREASURY REGULATIONS AFTER MAYO

The *Mayo* decision seemingly represented a significant victory for the government. If Treasury Regulations qualify for *Chevron* deference then any reviewing court would be bound to their interpretation of a statutory term regardless of the authority under which it was promulgated.[91] No longer would the Treasury have to establish that a regulation promulgated pursuant to its general rulemaking authority carries out the congressional mandate in a proper manner.[92] No longer would the validity of their regulations depend upon how the regulation fared against the factors outlined in *National Muffler*.[93] To enjoy this privilege, however, the Treasury will have to establish that their regulations qualify for *Chevron* deference.[94]

88 United States v. Mead Corp., 533 U.S. 218, 234 (2001).
89 *See id.*
90 Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944).
91 *Chevron*, 467 U.S. at 842-43.
92 *See Mead*, 533 U.S. at 234.
93 *See id.*
94 *Id.*

1. Congressional Rulemaking Delegation to Treasury Department

Congress has delegated broad interpretative authority over the I.R.C.'s provisions to the Treasury Department.[95] Often, Congress specifically identifies a statutory gap and expressly charges the Treasury with promulgating regulations to fill that gap.[96] Congress has frequently utilized this tool, resulting in the I.R.C. containing several hundred specific authority grants.[97] Additionally, the Treasury has the general rulemaking authority to develop "all needful rules and regulations for the enforcement of the [I.R.C.]" under I.R.C. § 7805(a).[98] Regulations promulgated pursuant to either a specific or general Congressional authorization to engage in rulemaking is "a very good indicator of delegation meriting *Chevron* treatment."[99] Thus, because it appears that "Congress would have intended, and expected, courts to treat [Treasury Regulations] as within . . . its delegation of the agency „gap-filling' authority," Congress has delegated to the agency the authority to make regulations with the force of law.[100]

2. Treasury's Exercise of that Delegated Authority

In addition to any specific grants of authority, the Treasury has the authority to "prescribe all needful rules and regulations for the enforcement of [the Internal Revenue Code]."[101] Thus, any regulation that qualifies as "needful" will fall within the scope of that Congressional delegation. As for the procedural requirements, the Treasury will have to establish that their regulations conform to the procedural requirements of their Congressional mandate as outlined in

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[95] Hickman, *Coloring Outside the Lines*, supra note 16, at 1737,
[96] *Id.*
[97] *Id.*
[98] I.R.C. § 7805(a) (West 2002); Hickman, *Coloring Outside the Lines*, *supra* note 16, at 1735-36.
[99] Mayo Found. for Med. Ed. & Research v. United States, 131 S. Ct. 704, 714 (2011) (quoting United States v. Mead Corp., 533 U.S. 218, 229 (2001)).
[100] *Mayo*, 131 S. Ct. at 714.
[101] I.R.C. § 7805(a).

the A.P.A. and the I.R.C.[102] These procedural requirements will be where the Treasury will have difficulty in establishing that its regulations are entitled to *Chevron* deference. In more than a trivial number of instances, the Treasury has not followed the notice and comment procedures mandated by the A.P.A.[103]

A. Administrative Procedure Act

With few exceptions, the A.P.A. is a generally applicable statute that prescribes the requirements of certain agency conduct and the judicial review thereof.[104] As applicable to Treasury Regulations, the process for formulating any "agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy" is subject to the procedures requirements outlined in A.P.A. § 553.[105] Section 553 imposes three requirements on the Treasury when promulgating its regulations: (1) give notice of proposed rulemaking and interested persons an opportunity to participate in the rulemaking through acceptance of public comments, (2) incorporate a concise general statement of basis and purpose into the rule, and (3) publish the substantive rule in the Federal Register not less than 30 days before its effective date.[106] These represent minimum requirements imposed upon the Treasury and "do not limit or repeal additional requirements imposed by statute or otherwise recognized

102 *See* Gonzales v. Oregon, 546 U.S. 243, 259-60 (2006).
103 *See* Hickman, *Coloring Outside the Lines*, *supra* note 16, 1748 (finding that the Treasury did not use the Traditional A.P.A. process in 40.9% of the 232 rulemaking projects surveyed from January 1, 2003 to December 31, 2005.).
104 Administrative Procedure Act, 5 U.S.C.A. §§ 551-59, 701-06 (2007).
105 *Id.* § 551(4); *see also id.* § 551(5) ("„rule making' means agency process for formulating, amending, or repealing a rule."); *id.* § 553.
106 § 553.

by law."[107] Additionally, the Treasury is obligated to follow these requirements unless a subsequent statute expressly exempts it from complying with them.[108]

i. A.P.A. Rulemaking Requirements

The first step in promulgating an agency rule is for the agency to publish the notice of proposed rulemaking (NPRM) in the Federal Register and give interested parties an opportunity to comment.[109] This NPRM must include three things: (1) "a statement of the time, place, and nature of public rule making proceedings;" (2) a "reference to the legal authority under which the rule is proposed;" and (3) "either the terms or substance of the proposed rule or a description of the subject and issues involved."[110] In determining the sufficiency of a NPRM, a reviewing court will look to see whether it "provide[s] notice sufficient to fairly apprise interested persons of the subjects and issues before the Agency."[111] Following the issuance of the NPRM, "the agency shall give interested persons an opportunity to participate in the rulemaking through submission of written data, views, or arguments with or without opportunity for oral presentation."[112]

After considering the relevant matters presented in the submitted comments, "the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose."[113] This recital should state that such relevant matters have been considered, but "an agency is free to formulate rules upon the basis of material in its files and the knowledge and experience of the

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107 *Id.* § 559 ("This subchapter, [and] chapter 7 . . . do not limit or repeal additional requirements imposed by statute or otherwise recognized by law.").
108 *Id.* ("Subsequent statute may not be held to supersede or modify this subchapter, [or] chapter 7 . . . except to the extent that it does so expressly").
109 § 553(b).
110 *Id.*
111 National Res. Defense Council v. U.S. E.P.A., 279 F.3d 1180, 1186 (9th Cir. 2002) (quoting Natural Resources Defense Council v. E.P.A., 863 F.2d 1420, 1429 (9th Cir.1988)).
112 § 553(c).
113 *Id.*

agency, in addition to the materials adduced in the public rulemaking proceedings."[114] The statement of basis and purpose is important so that the public and courts can use them to interpret the agency's rule.[115] An elaborate analysis of the rule or of the considerations upon which the rules were issued is not necessary; rather, the statement is intended to advise the public of the rule's general basis and the purpose of such rule.[116]

Finally, before a rule can go into effect, the agency must publish the final rule in the Federal Register and it cannot become effective until at least thirty days after that publication.[117] A.P.A. § 552(a)(1) requires each agency to publish in the Federal Register "rules of procedure . . . substantive rules of general applicability . . . statements of general policy or interpretations of general applicability. . . and . . . each amendment, revision, or repeal of the foregoing."[118] That subsection further provides: "Except to the extent that a person has actual and timely notice of the term thereof, a person may not in any manner be required to resort to, or be adversely affected by, a matter required to be published in the Federal Register and not so published."[119] If a statement of policy or interpretation is not "of general applicability," an agency need not publish it in the Federal Register, but the agency must at least make it "available for public inspection and copying."[120]

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114 ATTORNEY GENERAL'S MANUAL ON THE ADMINISTRATIVE PROCEDURE Act 31-32 (1947) [hereinafter AG MANUAL]. The Attorney General's Manual on the Administrative Procedure Act was prepared by the "Office of the Assistant Solicitor General that had advised Congress in the latter stages of enacting the A.P.A., and was originally issued „as a guide to the agencies in adjusting their procedures to the requirements of the Act.'" Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 218 (1988) (quoting AG MANUAL, 6 (1947)). The Supreme Court has repeatedly given this manual great weight. *Id.*
115 AG MANUAL, *supra* note 114, AT 32.
116 *Id.*
117 5 U.S.C.A. § 553(d) (West 2007); *id.* § 552(a).
118 *Id.* § 552(a)(1).
119 *Id.*
120 § 552(a)(2).

An agency must publish a substantive rule "not less than 30 days before its effective date."[121] This required publication date "does not relate back or refer to the publication of [the NPRM], rather it is a requirement that substantive rules which must be published in the Federal Register shall be so published at least thirty days prior to their effective date."[122] The purpose of this time lag is to "afford persons affected a reasonable time to prepare for the effective date of a rule or rules or to take any other action which the issuance of rules may prompt."[123] This thirty-day period is a statutory minimum, which allows agencies to postpone effectiveness for more than the required thirty-day period.[124]

ii. Exceptions to Rulemaking Requirements

The A.P.A. provides exemptions from the notice and comment and publication requirements, but not from providing a concise general statement of basis and purpose.[125] Section 553(b)(A) exempts several types of rules from the notice and comment requirements.[126] The exemption covers general statements of policy, interpretative rules, procedural rules, and rules the agency has "good cause" to issue without using the rulemaking process.[127] Section 553(d) exempts from the advance publication requirement substantive rules that grant or recognize an exemption or relieve a restriction, interpretative rules and statements of policy, and rules which the agency found good cause and published in the rule.[128] These two sets of partial exemptions overlap significantly making many rules exempt from both notice and comment and

[121] *Id.* § 553(d).
[122] AG MANUAL, *supra* note 114, 36.
[123] *Id.* (quoting S. DOC. NO. 248).
[124] § 553(d).
[125] § 553.
[126] § 553(b).
[127] *Id.*
[128] § 553(d).

advance publication on the same basis.[129] Thus, rules that are interpretative or general statements of policy are exempt from both notice and comment and advance publication.[130] Likewise, an agency may forego notice and comment and advance publication if it finds and publishes good cause for failing to do so.[131]

An agency is not required to conform to the notice and comment requirements for "rules of agency organization, procedure or practice."[132] An agency rule is procedural when it does not encode a substantive value judgment, which is when the rule makes a distinction based upon subject matter rather than procedural efficiency.[133] Thus, rules that affect the mechanics and processes of the agency are procedural while rules that impose a new binding obligation on regulated parties are not.[134]

An agency is exempted from the advance publication requirements if it is executing a rule that "grants or recognizes an exemption or relieves a restriction."[135] Recall that the advance publication requirement is based on the unfairness of requiring affected members of the public to conform their conduct to a new rule before they have had an opportunity to read and understand a rule and to modify their conduct to comply to its requirements.[136] If the rule grants an exemption, the regulated public is benefited by it and therefore does not need time to conform their conduct to it to avoid the legal consequences of the violation.[137]

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129 PIERCE, *supra* note 83, 671.
130 *Id.*
131 § 553(d)(1).
132 § 553(b)(A).
133 Pub. Citizen v. Dep't of State, 276 F.3d 634, 640 (D.C. Cir. 2002).
134 *Id.*
135 § 553(d)(1).
136 AG MANUAL *supra* note 114, 36 (quoting S. Doc. No. 248).
137 AG MANUAL *supra* note 114, 37.

If the agency seeks to promulgate a general statement of policy, then it need not follow either the notice and comment or advance publication requirements.[138] A general statement of policy is a statement "issued by an agency to advise the public prospectively of the manner in which the agency proposes to exercise a discretionary power."[139] Thus, a general statement of policy only represents an agency's expression as to how it will exercise its discretion in the future and does not impose any rights and obligations on regulated parties.[140] A general statement of policy must enable the agency to exercise discretion, because if it limits the exercise of an agency's discretion then it is required to adhere to the A.P.A. procedural requirements.[141] "An agency statement, not issued as a formal regulation, binds the agency only if the agency intended the statement to be binding. . . . The primary consideration in determining the agency's intent is whether the text of the agency statement indicates that it was designed to be binding."[142]

"[R]ules or statements issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers" constitute interpretative rules and are exempt from both notice and comment and advance publication requirements.[143] Because legislative rules, those that impose legally binding obligations, often serve a similar function, it can sometimes be difficult to distinguish between a legislative and an interpretative rule.[144] The leading test to distinguish between a legislative and an interpretative rule was announced by the D.C. Circuit in *American Mining Congress v. Mine Safety & Health Administration*.[145] A

138 §§ 553(A) & 553(d)(2).
139 AG MANUAL *supra* note 114, 39.
140 Am. Bus. Assoc. v. United States, 627 F.2d 525, 529 (D.C. Cir. 1980).
141 *Id.*
142 Farrell v. Dep't of Interior, 314 F.3d 584, 590-91 (Fed. Cir. 2002).
143 AG MANUAL *supra* note 114, 39; 5 U.S.C.A. §§ 553(b)(A) & (d)(2) (West 2007).
144 PIERCE, *supra* note 83, 432.
145 Am. Mining Congress v. Mine Safety & Health, 995 F.2d 1106 (D.C. Cir. 1993).

legislative rule has the force of law while an interpretative rule does not.[146] A rule has the force of law only if Congress has delegated legislative power to the agency and if the agency intended to exercise that power in promulgating the rule.[147] To determine whether the agency intended to exercise that power, the reviewing court looks to "(1) whether in the absence of the rule there would not be an adequate legislative basis for enforcement action or other agency action to confer benefits or ensure the performance of duties, . . . (2) whether the agency has explicitly invoked its general legislative authority, or (3) whether the rule effectively amends a prior legislative rule."[148] If the answer to any of these questions is affirmative, then it is a legislative, not an interpretative rule.[149] Another indication that the agency intended to exercise their power to promulgate a legislative rule is whether the agency has published the rule in the Code of Federal Regulations.[150] Although this factor, standing alone, will not be sufficient to find a particular regulation is legislative, rather than interpretative, it is evidence of the agency's intent to exercise its power to promulgate a legislative rule.[151]

Finally, if the agency finds that notice and public comment on a particular rule is "impracticable, unnecessary or contrary to the public interest" then it may dispense with the notice and comment requirements of the A.P.A., so long as it provides an explanation of why it believes the rule in question meets one of these requirements.[152] "A situation is "impracticable"

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[146] *Id.* at 1112.
[147] *Id.* at 1109.
[148] *Id.* at 1112.
[149] *Id.*
[150] *Id.*
[151] Health Ins. Ass'n of Am., Inc. v. Shalala, 23 F.3d 412, 423 (D.C. Cir. 1994).
[152] 5 U.S.C.A. §553(b)(B) (West 2007). The agency must incorporate the finding of good faith and a brief statement of the reasons thereof in the issued rules. *Id.* The good cause exception is to be "narrowly construed and only reluctantly countenanced." Util. Solid Waste Activities Group v. E.P.A. 236 F.3d 749, 755 (D.C. Cir. 2001). The exception is not an "escape clause"; its use "should be limited to emergency situations." *Id.*

"when an agency finds that due and timely execution of its functions would be impeded by the notice otherwise required in [§ 553]."[153] Often, this reason for foregoing notice and comment is used by an agency when there is the agency urgently needs to govern a problematic area of conduct.[154] Notice and comment is a lengthy procedure, sometimes taking over a decade to complete.[155] Sometimes, the agency needs to act quicker than that to regulate some particularly problematic conduct.[156] A rule is "unnecessary" when the agency seeks to promulgate "a minor rule or amendment in which the public is not particularly interested."[157]

Notice and comment procedures would be "contrary to the public interest" when "the interest of the public would be defeated by any requirement of advance notice."[158] This basis for invoking the "good cause" exception is an agency's belief that prior notice of a potential rule change will cause harm by distorting the temporal pattern of a class of transactions.[159] This practice of making rules effective immediately is particularly prevalent in areas of economic regulation.[160] If a regulated firm believes that it will be able to benefit from the rule change then it has a powerful incentive to delay its financial transactions until the agency takes the action.[161] Conversely, if the regulated firm believes that it will be harmed by the future regulation, then it may accelerate its activities to minimize the adverse effects of the expected change.[162]

In addition to being able to forgo notice and comment for good cause, an agency may shorten the advance publication requirement "upon good cause found and published in the

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153 AG MANUAL *supra* note 114, 30.
154 PIERCE, *supra* note 83, 672.
155 *Id.*
156 *Id.*
157 AG MANUAL *supra* note 114, 31.
158 *Id.*
159 PIERCE, *supra* note 83, 674.
160 *Id.* at 675.
161 *Id.*
162 *Id.*

rule."[163] If the agency finds good cause to dispense with the advance publication requirement, then the rule will become effective upon publication in the Federal Register.[164] The good cause must relate to the need to act immediately or within a period less than thirty days.[165] Thus, an agency's finding of good cause to forgo notice and comment does not automatically exempt it from the advance publication requirement.[166] Like the requirements associated with dispensing with notice and comment for good cause, the agency must publish its findings of good cause within the rule.[167]

B. Internal Revenue Code

The I.R.C. does not include any express statement that exempts the Treasury from the A.P.A. rulemaking requirements, so the Treasury is obligated to follow those procedural requirements contained within it.[168] In addition, because the A.P.A. does not act to limit other obligations imposed by statute, the Treasury must likewise ensure that its regulations are promulgated pursuant to any requirements contained within the I.R.C.[169] I.R.C. § 7805 imposes two procedural requirements upon the Treasury to promulgate its regulations.[170] The first requirement involves the effective date for Treasury Regulations.[171] I.R.C. § 7805(b) states that no temporary, proposed, or final regulation issued by the Treasury

> shall apply to any taxable period ending before the earliest of the three dates:
>
> (A) The date on which such regulation is filed with the Federal Register.

[163] 5 U.S.C.A. § 553(d)(3) (West 2007).
[164] AG MANUAL *supra* note 114, 37.
[165] *Id.*
[166] *Id.*
[167] 5 U.S.C.A. § 553(d)(3).
[168] *Id.* § 559.
[169] *Id.*
[170] I.R.C. § 7805 (West 2002).
[171] § 7805(b).

> (B) In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register.
> (C) The date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public.[172]

Read in conjunction with § 553 of the A.P.A., this section simply provides a limitation on the Treasury if it issues a rule that qualifies for an exception from the advance publication requirement in the A.P.A. Even if the Treasury meets the requirements for an exception listed in the A.P.A., their ability to apply a particular regulation to a prior taxable period is further restrained.

The second additional requirement imposed upon the Treasury by I.R.C. § 7805 involves the Treasury's issuance of temporary regulations.[173] I.R.C. § 7805(e) does two things: First, it requires the Treasury to issue temporary regulations simultaneously as proposed regulations, and second, it requires that the temporary regulations expire within three years after the date of issuance.[174] Again, reading this section in conjunction with A.P.A. § 553, this simply restrains the Treasury if they are able to satisfy an A.P.A. exception from notice and comment and advance publication. It enables the Treasury to forgo notice and comment for three years, at which time the regulations expire and the Treasury must issue a final regulation.

C. Treasury Rulemaking Practice

The Treasury Department "annually adopts, modifies, and removes hundreds of pages of Treasury Regulations that interpret the I.R.C."[175] The Office of Associate Counsel of the I.R.S. is responsible for drafting and preparing these regulations.[176] Once the Commissioner of the

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172 *Id.*
173 *Id.* § 7805(e).
174 *Id.*
175 Hickman, *Coloring Outside the Lines*, *supra* note 16, 1728.
176 Treas. Reg. § 601.601(a)(1) (1967).

I.R.S. has approved the proposed regulation, it is forwarded to the Secretary of the Treasury or his delegate for further scrutiny.[177] Once forwarded to the Treasury Department, the Assistant Secretary for Tax Policy, acting as a delegate for the Secretary of the Treasury, is primarily responsible for regulations.[178] Attorney advisors in the Office of Tax Legislative Counsel assist the Assistant Secretary for Tax Policy.[179]

When the Treasury promulgates these regulations, they typically follow one of three patterns.[180] First, the Treasury will follow the traditional A.P.A. rulemaking process.[181] The Treasury will publish a NPRM in the Federal Register, accept comments from interested parties on the proposed regulation, and finally publish the final regulation in the Federal Register.[182] Second, the Treasury will issue temporary regulations simultaneously with a NPRM, accept comments from interested parties on the NPRM, and then issue a final regulation with an effective date as the date on which the temporary regulation and the NPRM were filed with the Federal Register with or without changes from the temporary one.[183] When the Treasury utilizes this method, it does not employ notice and comment for the temporary regulation and treats these temporary regulations as legally binding on taxpayers as well as the government.[184] Lastly, the Treasury will simply issue a final regulation without any notice and comment.[185] Regardless of

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[177] *Id.*
[178] Coverdale, *Chevron's Reduced Domain*, *supra* note 33, 65.
[179] *Id.*
[180] Hickman, *Coloring Outside the Lines, supra* note 16, 1748.
[181] *Id.*
[182] Treas. Reg. § 601.601(a) & (b) (1967); Treas. Reg. § 601.702(a) (1967).
[183] Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1160 (2008).
[184] Hickman, *Coloring Outside the Lines*, *supra* note 16, 1748.
[185] *Id.* at 1749.

the method used, the Treasury will generally make the regulations effective on the publication date.[186]

When the Treasury utilizes full notice and comment procedures to promulgate its regulations, then there is no issue as to whether they were promulgated in the exercise of its delegated authority. When the Treasury promulgates its regulations either without notice and comment, or by using temporary regulations, which it does in more than an insignificant number of instances, there is a question as to whether the Treasury is promulgating that regulation in the exercise of its delegated authority.[187] One such instance where the Treasury utilized the second method of adopting a regulation was with Treas. Reg. §§ 301.6229(c)(2)-1 and 301.6501(e)-1 (overstatement of basis regulations).[188] This Comment will use these regulations to analyze whether this Treasury practice is in accordance with its delegated authority. These regulations are good candidates to serve as an example because they fairly represent Treasury's practice when it uses this method and because these regulations are ones in which the Treasury would like a reviewing court to give them *Chevron* deference.[189]

On September 28, 2009, in response to opinions issued by the Ninth and Federal Circuits, the Treasury Department published Treasury Decision (TD) 9466 in the Federal Register.[190] In both of those cases, the taxpayers were partnerships that used techniques to increase the basis in

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[186] I.R.S., Internal Revenue Manual § 32.1.6.11.1 (Aug. 11, 2004), http://www.irs.gov/irm.
[187] Hickman, *Coloring Outside the Lines, supra* note 16, 1748-49 (finding that 40.9% of the regulations promulgated during the three year time period studied either dispensed with notice and comment altogether or were issued as a temporary regulation without notice and comment along with a NPRM).
[188] T.D. 9466, 2009-43 C.B. 551; T.D. 9511, 2011-6 I.R.B. 45.
[189] *See, e.g.,* Grapevine Imports Ltd. v. United States, 636 F.3d 1368 (Fed. Cir. 2011); Burks v. United States, 633 F.3d 347 (2011); Home Concrete & Supply L.L.C. v. United States, 634 F.3d 249 (4th Cir. 2011); Beard v. Comm'r, 633 F.3d 616 (7th Cir. 2011); Bakersfield Energy Partners v. Comm'r, 568 F.3d 767 (9th Cir. 2009); Salman Ranch Ltd. v. United States, 573 F.3d 1362 (Fed. Cir. 2009).
[190] T.D. 9466, 2009-43 C.B 551; *Bakersfield*, 568 F.3d at 778; *Salman Ranch*, 573 F.3d at 1377.

certain pieces of property, which resulted in a lower gain upon the sale of that property.[191] The Government challenged these transactions six years after the taxpayers filed their returns stating that these transactions were sham transactions because they had no business purpose and lacked economic substance.[192] The taxpayers responded that the notice of deficiency was untimely because it was filed after the three-year limitations period.[193] The Government responded that the notice was timely under the extended statute of limitations because the transactions constituted omissions from gross income and was in excess of twenty-five percent of the gross income stated on the return.[194]

Both the Ninth and Federal Circuits found for the taxpayers finding that an omission from gross income does not include an overstatement of basis.[195] Relying on the Supreme Court's opinion in *Colony Inc. v. Commissioner*, the courts held that an omission from gross income is a situation in which the "taxpayer actually omitted some income receipt or accrual in his computation of gross income, and not more generally to errors in that computation arising from other causes."[196] Thus, because the taxpayers did not omit the receipt or accrual of income on

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[191] *Bakersfield*, 568 F.3d at 769; *Salman Ranch*, 573 F.3d at 1365.
[192] *Bakersfield*, 568 F.3d at 770; *Salman Ranch,* 573 F.3d at 1365.
[193] *Bakersfield*, 568 F.3d at 770; *Salman Ranch*, 573 F.3d at 1365. *See also* I.R.C. § 6501(a) (2010) ("the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) . . . and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.").
[194] *Bakersfield*, 568 F.3d at 770-71; *Salman Ranch*, 573 F.3d at 1365. *See also* I.R.C. § 6501(e) ("in the case of any tax imposed by subtitle A . . . If the taxpayer omits from gross income an amount properly includible therein and . . . such amount is in excess of 25 percent of the amount of gross income stated in the return . . . the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.").
[195] *Bakersfield*, 568 F.3d at 778; *Salman Ranch*, 573 F.3d at 1377.
[196] Colony Inc. v. Comm'r, 357 U.S. 28, 33 (1958); *Bakersfield*, 568 F.3d at 778; *Salman Ranch*, 573 F.3d at 1377.

their tax returns, the extended period for tax assessment does not apply and the Government's notice of deficiency was untimely.[197]

Following these decisions, the Treasury sought to define "omission" to include those situations in which a taxpayer overstated its basis rather than solely when the taxpayer omits the receipt or accrual of income on their tax return.[198] The Treasury did this in TD 9466, which stated that outside the trade or business context, "gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2) has the same meaning as gross income as defined in section 61(a)."[199] Under this definition, "gross income includes „gains derived from dealings in property' and equals "the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged."[200] Thus, "outside the context of a trade or business, any basis overstatement that leads to an understatement of gross income under section 61(a) constitutes an omission from gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2)."[201]

The Treasury issued TD 9466 without notice and comment and made it immediately applicable with an effective date of September 24, 2009.[202] TD 9466 was to expire three years

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197 *Bakersfield*, 568 F.3d at 778; *Salman Ranch*, 573 F.3d at 1377.
198 T.D. 9466, 2009-43 C.B 551. There is a split in the Circuit Courts of Appeals as to whether the Supreme Court's construction of the statutory term rendered it unambiguous and thus would preclude the Treasury from advancing its own interpretation inconsistent with the one announced in *Colony*. *Compare* Burks v. United States, 633 F.3d 347, 360 (2011) (statutory language unambiguous); Home Concrete & Supply L.L.C. v. United States, 634 F.3d 249 (4th Cir. 2011) (same) *with* Grapevine Imports Ltd. v. United States, 636 F.3d 1368, 1378 (Fed. Cir. 2011) (statutory language ambiguous); Bakersfield Energy Partners v. Comm'r, 568 F.3d 767 (9th Cir. 2009) (same).
199 T.D. 9466, 2009-43 C.B 551.
200 *Id.*; I.R.C. § 61(a)(3) (West 2011); Treas. Reg. § 1.61-6(a) (1960).
201 T.D. 9466, 2009-43 C.B 551.
202 *Id.*

following that date on September 24, 2012.[203] Under the Special Analysis Section of TD 9466, the Treasury also stated that "It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations."[204]

On December 17, 2010, the Treasury published TD 9511 in the Federal Register, which contained the final regulations that relate to the temporary regulations contained in TD 9466.[205] Only minor changes were made from TD 9466 to TD 9511.[206] The Treasury received only once comment on the NPRM, which challenged the retroactivity of the regulation.[207] The Treasury responded to this comment and incorporated its findings into a concise general statement of basis and purpose.[208] The regulations were effective on December 14, 2010 and applied to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009, which is the date that the proposed and temporary regulations to which these regulations relate were filed with the Federal Register.[209]

These regulations do not comply with the general rulemaking requirements of the A.P.A. The Treasury failed to follow the notice and comment procedures altogether for the temporary regulation and did not follow the advance publication requirement for the final regulation. Unless these regulations meet one of the exemptions in the A.P.A., a reviewing court will hold them as unlawful and set them aside because of the Treasury's failure to follow the legally

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203 *Id.*
204 *Id.*
205 T.D. 9511, 2011-6 I.R.B. 45.
206 *Id.*
207 *Id.* The only written comment that the Treasury received claimed that the regulations apply with retroactive effect to make taxable years that had been closed become reopened. *Id.* The Treasury stated that because the regulations stated that they apply only to open tax years, they do not reopen closed tax years. *Id.*
208 *Id.*
209 *Id.*

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required procedures.[210] If held unlawful, these regulations would not be promulgated in the exercise of their congressional delegation of authority and would not qualify for *Chevron* deference.[211] As for the Treasury's statement that "section 553(b) of the Administrative Procedure Act does not apply to this regulation," only agency interpretations of a statute that it is responsible for administering are entitled to *Chevron* deference.[212] Thus, a reviewing court will independently determine the adequacy of the Treasury's compliance with A.P.A. requirements as well as whether it qualifies for an exemption.

The overstatement of basis regulations do not concern "rules of agency organization, procedure or practice," so they do not qualify for the procedural exception.[213] Likewise, rather than granting or relieving an exemption, the regulations actually impose an additional restriction upon taxpayers.[214] The regulations do not qualify as a general statement of policy because they seek to interpret statutory language, not advise the public of how the agency seeks to exercise a discretionary power.[215] The regulations also cannot be a general statement of policy because the Treasury treats the temporary and final regulations as binding on the agency and the public.[216]

The Treasury maintains that most of its regulations are interpretative, and therefore not subject to the provisions of the A.P.A.[217] Recall that a legislative rule has the force of law while an interpretative rule does not.[218] A rule has the force of law only if Congress has delegated legislative power to the agency and if the agency intended to exercise that power in promulgating

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[210] 5 U.S.C.A. § 706(2) (West 2007).
[211] *See* Gonzales v. Oregon, 546 U.S. 243, 259-60 (2006).
[212] Chevron U.S.A. Inc. v. Natural Res. Def. Council, 467 U.S. 837, 842 (1984).
[213] 5 U.S.C.A. § 553(b)(A) (West 2007).
[214] *Id.* § 553(d)(1).
[215] AG MANUAL *supra* note 114, 39.
[216] *Id.*
[217] Internal Revenue Manual, *supra* note 186, § 32.1.5.4.7.5.1.
[218] American Mining Congress v. Mine Safety & Health, 995 F.2d 1106, 1112 (D.C. Cir. 1993); discussion *infra* Part V.2.A.ii.

the rule.[219] To determine whether the agency intended to exercise that power, the reviewing court looks to (1) whether in the absence of the rule there would not be an adequate legislative basis for enforcement action or other agency action to confer benefits or ensure the performance of duties, (2) whether the agency has explicitly invoked its general legislative authority, or (3) whether the rule effectively amends a prior legislative rule.[220] If the answer to any of these questions is affirmative, we have a legislative, not an interpretative rule.[221] Another indication that the agency intended to exercise their power to promulgate a legislative rule is whether the agency has published the rule in the Code of Federal Regulations.[222] Although this factor, standing alone, will not be sufficient to find a particular regulation is legislative, rather than interpretative, it is evidence of the agency's intent to exercise its power to promulgate a legislative rule.[223]

Applying these factors to the overstatement of basis regulations, they do not qualify as an interpretative rule. For both the temporary and final regulation, the Treasury explicitly invoked its general legislative authority under I.R.C. § 7805(a).[224] In addition, these regulations replaced an existing final regulation.[225] In order to replace or amend an existing substantive rule, an agency has to promulgate another substantive rule.[226] Likewise, although publication in the Federal Register is only non-dispositive evidence that the agency intended to promulgate a substantive rule, the fact that the Treasury did so here provides stronger support for the

[219] *American Mining Congress*, 995 F.2d at 1109.
[220] *Id.* at 1112.
[221] *Id.*
[222] *Id.*
[223] Health Ins. Ass'n of Am., Inc. v. Shalala, 23 F.3d 412, 423 (D.C. Cir. 1994).
[224] T.D. 9466, 2009-43 C.B. 551; T.D. 9511, 2011-6 I.R.B. 45.
[225] T.D. 9466, 2009-43 C.B. 551; T.D. 9511, 2011-6 I.R.B. 45.
[226] *American Mining Congress*, 995 F.2d at 1112.

proposition that the overstatement of basis regulations are not interpretative.[227] Finally, regulations that bind both the government and regulated parties are legislative.[228] These regulations bind both the government and the public, in fact substantial penalties are imposed upon a taxpayer who intentionally disregards a regulation.[229] Therefore, the overstatement of basis regulations are substantive, not interpretative, rules and do not qualify for the exception from notice and comment or advance publication under the A.P.A.

Even if the regulation did qualify as interpretative, that would seemingly prevent the Treasury from claiming *Chevron* deference under *Mead*. Courts assume "generally that Congress contemplates administrative action with the effect of law when it provides for a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement of such force."[230] Therefore, because Congress has exempted interpretative rules from the formal notice and comment requirements, that would seem to indicate the absence of a congressional delegation to promulgate rules carrying the force of law as required under the first step of *Mead*.

This leaves the Treasury with only the good cause exemption to excuse their non-compliance with A.P.A. procedural requirements and still qualify for *Chevron* deference. The overstatement of basis regulations may constitute a situation in which the Treasury may be eligible for the good cause exemption. The rulemaking process often takes a long time to complete.[231] If the Treasury proposes a prospective only change in rules, parties will respond to

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[227] *Shalala*, 23 F.3d at 423.
[228] *See American Mining Congress*, 995 F.2d at 1109.
[229] *See* I.R.C. § 6662(b)(1) (West Supp. 2010) (imposing a twenty percent penalty for an underpayment of taxes attributable to negligent or disregard of Treasury Regulations.).
[230] United States v. Mead Corp., 533 U.S. 218, 230 (2001).
[231] PIERCE, *supra* note 83, 672.

the proposal by accelerating their activities to avoid the effect of the expected future change.[232] Treasury might plausibly argue that the legally binding overstatement of basis regulations are necessary to combat tax shelter abuse because issuing proposed regulations alone would prompt taxpayers merely to execute their abusive transactions before Treasury could finalize the regulations.[233] Thus, the advance public knowledge of the overstatement of basis regulations would undermine the goals that the government seeks to accomplish in imposing their requirements.[234] Moreover, the Treasury might argue that proposing a prospective only change in the overstatement of basis rules gives some potentially affected members of the public an unusually powerful incentive to delay the rulemaking process.[235] A reviewing court may accept these two arguments that subjecting the overstatement of basis regulations to the A.P.A. required notice and comment and advance publication would be "contrary to the public interest" and eligible for the good cause exemption.[236]

The overstatement of basis regulations, however, will not be eligible for the good cause exemption from notice and comment or advance publication. An agency seeking exemption from the A.P.A. procedural requirements based upon good cause must expressly state and publish within the rule a brief description of the agency's findings for good cause.[237] Neither TD 9466 nor TD 9511 contain any statement that includes findings that the overstatement of basis regulations qualify for the good cause exemption.[238] Thus, although the Treasury may plausibly assert the good cause exemption for the overstatement of basis regulations, they will not be able

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[232] *Id.* at 675.
[233] Hickman, *Coloring Outside the Lines*, *supra* note 16, 1785.
[234] *Id.*
[235] *See* PIERCE, *supra* note 83, 675.
[236] 5 U.S.C.A. § 553(b)(B) (West 2007).
[237] *Id.* §§ 553(b)(B) & (d)(3)
[238] T.D. 9466, 2009-43 C.B. 551; T.D. 9511, 2011-6 I.R.B. 45.

to obtain its benefits because they did not provide a finding of good cause and the reviewing court will not supply one for them.[239]

The Treasury did not promulgate the overstatement of basis regulations in accordance with the procedural requirements contained within their Congressional mandate. TD 9466 was promulgated without notice and comment or advance publication and TD 9511 was promulgated without advance publication.[240] The overstatement of basis regulations do not qualify for any of the A.P.A. exemptions from these requirements so a reviewing court faced with determining their validity will hold them unlawful and set them aside. This result will preclude the Treasury from qualifying from *Chevron* deference for these regulations because they are unlawful, and as such, not promulgated pursuant to an exercise of their authority to make rules carrying the effect of law.

D. Retroactivity

Although the overstatement of basis regulations' procedural defects will prevent *Chevron* deference, the Treasury does possess a power that may allow them to obtain *Chevron* deference for that statutory interpretation despite these procedural problems. The Internal Revenue Code gives the Treasury the power to make regulations retroactive.[241] For statutes enacted prior to July 30, 1996, the Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.[242] If the regulation relates to a statute enacted after July 30, 1996, then there is a presumption against

239 *See* Sec. & Exch. Comm'n v. Chenery Corp., 332 U.S. 194, 196 (1947)
240 T.D. 9466, 2009-43 C.B. 551; T.D. 9511, 2011-6 I.R.B. 45.
241 I.R.C. § 7805(b) (West 2002).
242 I.R.C. § 7805(b) (West 1986) *amended by* Taxpayer Bill of Rights 2, Pub. L. No 104-168, § 1101, 110 Stat. 1452, 1469 (1996) ("The amendment made by subsection (a) shall apply with respect to regulations which relate to statutory provisions enacted on or after the date of the enactment of this Act.").

retroactivity, but the Secretary may apply regulations retroactively for (1) promptly issued regulations, (2) to prevent abuse, (3) to correct procedural defects in prior regulations, (4) to regulations relating to internal Treasury Department policies, practices or procedures, and (5) anytime that Congress authorizes the Secretary to prescribe the effective date with respect to any regulation.[243]

An examination of the facts of *Bowen v. Georgetown University Hospital* illustrates how the Treasury could use this power to avoid the procedural requirements of the A.P.A.[244] Under the Medicare program, the Government reimburses health care providers for expenses incurred in providing medical services to those eligible for Medicare.[245] Congress authorized the Secretary of Health and Human Services to promulgate regulations that set the limits on the levels of the costs associated with Medicare that the providers will receive reimbursement.[246] On June 30, 1981, the Secretary of Health and Human Services promulgated a cost-limit schedule that changed the method for calculating cost limits.[247] One of the changes that were made were for the "wage index," which is a factor used to reflect different salary levels for hospital employees in different parts of the country.[248] Prior to the change, the providers wage index was calculated by using the average salary levels for all hospitals in the area.[249] The proposed 1981 rule would exclude wages paid by Federal Government hospitals from that computation.[250]

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[243] I.R.C. § 7805(b).
[244] Bowen v. Georgetown Univ. Hosp., 488 U.S. 204 (1998).
[245] *Id.* at 205.
[246] *Id.* at 206.
[247] *Id.*
[248] *Id.*
[249] *Id.*
[250] *Id.*

Hospitals in the District of Columbia sued to have these new rules invalidated.[251] On April 29, 1983, the District Court invalidated the 1981 wage-index rule because the government failed to provide notice and an opportunity to comment on it as required by the A.P.A.[252] Rather than enjoin enforcement of the rule, however, the District Court directed that if the Secretary wished to promulgate a valid wage-index then she should do so in accordance with the procedural requirements of the A.P.A.[253] Following this decision, the Secretary decided to settle with the hospitals using the prior wage index method.[254]

In February 1984, the Secretary published a NPRM seeking public comment on a proposal to reissue the 1981 wage-index rule, retroactive to July 1, 1981.[255] After receiving public comments on the proposal, the Secretary issued the rule on November 24, 1984 and sought to recoup the sums previously paid to the hospital providers following the District Court's ruling.[256] The result was that, if allowed, the Secretary's promulgation of the wage-index method retroactively put the health care providers in the same position as if the original rule had never been set aside.[257]

The Supreme Court held that "an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress."[258] In determining whether or not a legislative grant of power encompasses the power to promulgate retroactive regulations, "a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive regulations unless that power is conveyed by

[251] *Id.*
[252] *Id.*
[253] *Id.* at 206-07.
[254] *Id.* at 207.
[255] *Id.*
[256] *Id.*
[257] *Id.*
[258] *Id.* at 208.

Congress in express terms."[259] Thus, because the Medicare Act did not expressly give the Secretary the authority to promulgate the retroactive wage-index rule, it was not a validly promulgated rule because it exceeded congressional grant of authority.[260]

In the tax context, it would appear that a similar situation would develop if the Treasury decided to utilize its retroactive power following an invalidation of its overstatement of basis regulations. If a reviewing court invalidates the overstatement of basis regulations because the Treasury failed to follow the A.P.A. procedural requirements, I.R.C. § 7805(b) would allow the Treasury to promulgate a new final regulation, following all procedural requirements, and make it retroactively effective to the date of when TD 9466 was first published in the Federal Register.[261] The result would be that the taxpayer challenging these regulations would be subject to the same statutory interpretation for the same period, making it as if the original challenge never happened.[262] If the Treasury has this power, it would make the procedural challenge of little to no use to the taxpayer who is subject to the overstatement of basis regulation.[263]

Because of the immense power associated with the ability to promulgate retroactive rules, courts have imposed several limitations on its use. First, the Congressional grant of legislative rulemaking authority must expressly grant the agency the power to promulgate retroactive rules.[264] Even where there is a substantial justification for retroactive rulemaking, courts are reluctant to find such authority absent such an express statutory grant.[265] I.R.C. § 7805 meets this requirement because it expressly grants the Treasury the authority to promulgate regulations

[259] *Id.*
[260] *Id.* at 209.
[261] *See* Hickman, *A Problem of Remedy, supra* note 183, 1193.
[262] *See id.*
[263] *See id.* at 1194.
[264] *Bowen*, 488 U.S. at 208.
[265] *Id.*

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retroactively under certain circumstances.[266] Second, the rule still must satisfy one of the A.P.A. exceptions from the advance publication requirement unless Congress expressly waives that requirement in the statutory grant of authority.[267] A Congressional conveyance of the power of retroactivity does not exempt the agency from meeting the advance publication requirement of the A.P.A.[268] The Treasury, therefore, will still have to satisfy one of the advance publication exemptions to avoid the A.P.A. procedural requirements and will not be able to use their retroactive power to avoid them. The failure to require the Treasury to qualify for one of these exemptions would "make a mockery . . . of the A.P.A.," since they "would be free to violate the rulemaking requirements of the A.P.A. with impunity if, upon invalidation of a rule, they were free to „reissue' that rule on a retroactive basis."[269]

3. Summary

Returning to the overstatement of basis regulations, if a taxpayer challenges the substantive validity of one of these regulations, they will not qualify for *Chevron* deference. Congress has delegated to the Treasury the ability to promulgate regulations that carry the force of law, but the Treasury has not promulgated these regulations in the exercise of that authority. A reviewing court faced with a procedurally defective regulation will hold them unlawful and set them aside.[270] As such, the Treasury will not receive the powerful *Chevron* deference but rather will have to earn the reviewing court's deference according to the factors outlined in *Skidmore*.

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[266] I.R.C. § 7805(b) (West 2002).
[267] 5 U.S.C.A. § 559 (West 2007).
[268] *Id.*
[269] *Bowen*, 488 U.S. at 225 (Scalia, J., concurring).
[270] 5 U.S.C.A. § 706(2)(D).

This reality leaves the Treasury with a situation very similar to one that they argued to be relieved of in *Mayo*.[271] The factors that a reviewing court will utilize to determine the force of a procedurally defective agency rule are very similar to those that the court would have used to review a general authority regulation. Under *Skidmore*, the relevant factors are "the thoroughness evident in [the rule's] consideration, the validity of [the rule's] reasoning, [the rule's] consistency with earlier and later pronouncements, and all those factors which give [the rule] power to persuade, if lacking power to control."[272] Under *National Muffler*, the relevant factors were "contemporaneous construction," "the manner in which [the regulation] evolves," "the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute."[273] Under both standards, the agency's consistency is a relevant factor, which means that the Treasury will still find deference unavailable for regulations that represent a change in their position on the meaning of a statutory term. Thus, rather than the Treasury being in a stronger position following *Mayo*, they still will have to earn deference from a reviewing court in a substantially similar manner as they did under *National Muffler.*

VI. CONCLUSION

The Supreme Court's *Mayo* decisions seemingly heralded a new era regarding the deference that a reviewing court will accord a Treasury Regulation. Following that decision, general authority regulations are no longer categorically excluded from receiving *Chevron*

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[271] Mayo Found. for Med. Educ. and Research v. United States, 131 S.Ct. 704, 712 (2011).
[272] Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944).
[273] Nat'l Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 477 (1979).

deference.[274] So long as they qualify for *Chevron* deference, the statutory interpretations would bind the reviewing court so long as the government is able to establish that the statutory term at issue was ambiguous and the regulatory interpretation was permissible.[275] This is not, however, the situation that the Treasury has put themselves in following that decision.

An administrative interpretation of a statutory term is entitled to *Chevron* deference when Congress delegated to that agency the power to promulgate rules carrying the force of law, and the agency promulgated that rule in the exercise of that authority.[276] Congress has clearly authorized the Treasury to enact regulations that carry the force of law, but the Treasury has not promulgated all of its rules in the exercise of that authority.[277] Specifically, the Treasury's practice of issuing legally binding temporary regulations followed by final regulations that relate back to the date that the temporary regulation was published in the federal register does not meet the procedural requirements imposed upon the agency by the A.P.A.

Rather than disposing of the hierarchy of deference levels, the *Mayo* decision simply changed the categories. Prior to *Mayo*, those regulations promulgated pursuant to a specific congressional grant reigned supreme and were controlling upon the reviewing court unless contrary to that grant of power.[278] Those promulgated pursuant to the Treasury's ability to "prescribe all needful rules and regulations for the enforcement of [the Internal Revenue Code]" were accorded a lower degree of deference and were upheld only if the statutory interpretation contained therein carried out the congressional mandate in a proper manner.[279] Now, those

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[274] *Mayo*, 131 S.Ct. at 707.
[275] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, 467 U.S. 837, 842-43 (1984).
[276] United States v. Mead Corp., 533 U.S. 218, 226-27 (2001).
[277] I.R.C. § 7805(a) (West 2002).
[278] Rowan Cos. Inc. v. United States, 452 U.S. 247, 253 (1981).
[279] I.R.C. § 7805(a); Nat'l Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 477 (1979).

regulations in which the Treasury utilized full notice and comment procedures or that qualify for an A.P.A. exception from those procedures stand alone atop the judicial deference hierarchy. Those in which the Treasury failed to follow those procedures will remain at the bottom, with the result being that the Treasury will have to earn deference to advance a statutory interpretation contained in these regulations.

Apart from the tactical reasons to utilize full notice and comment procedures to promulgate their regulations, the Treasury should strive to meet these procedural requirements for several policy reasons. "In enacting the A.P.A., Congress made a judgment that notions of fairness and informed administrative decisionmaking require that agency decisions be made only after affording interested persons notice and an opportunity to comment."[280] Congress thought that this process, coupled with judicial overview of compliance therewith, serves as a very good alternative to the legislative process when an agency seeks to legally bind the public to a particular statutory interpretation.[281] Thus, these procedures not only facilitate government rulemaking, but are also intended to protect individual rights through public participation in the agency rulemaking process.[282]

The Treasury's practice of promulgating legally binding temporary regulations and then seeking public comment may undermine these intentions by stifling public comments on any of these regulations because the Treasury is sending a message that it has made up its mind regarding a particular statutory interpretation.[283] As a result, this practice not only reduces taxpayer participation in the rulemaking process, but also undermines taxpayer respect for the tax

[280] Chrysler Corp. v. Brown, 441 U.S. 281, 316 (1979).
[281] Hickman, *A Problem of Remedy, supra* note 183, 1204.
[282] *Id.*
[283] *Id.* at 1205.

system generally.[284] The U.S. tax system is much more pervasive than any other federal regulatory scheme.[285] As a result, no other area of federal government regulation falls under a darker cloud of public suspicion as the tax system.[286] By discouraging taxpayer participation with its current rulemaking practices, the Treasury is encouraging the public cynicism about the legitimacy of the tax system.[287] In a voluntary tax system that relies so heavily upon public participation, this loss of legitimacy threatens the entire system.

Apart from these more general concerns, the Treasury's failure to follow the legally imposed requirements for promulgation of its regulations also undermines its credibility in enforcing the I.R.C.'s provisions.[288] The Treasury is currently fighting an extended battle with both sophisticated tax shelter participants and unsophisticated tax protestors.[289] While neither group may use the Treasury's procedural shortcoming as a defense to their own actions, the Treasury does not help itself by aggressively pursuing those who seek to avoid paying taxes while at the same time failing to play by the rules themselves.[290]

Mayo Foundation for Medical Education & Research v. United States significantly changed the process of judicial review of Treasury Regulations by clarifying that *Chevron* deference applies to all Treasury Regulations so long as they qualify for it. Nevertheless, because of the Treasury's past practice of promulgating regulations, the government will find *Chevron* deference unavailable leaving them with having to earn deference from the reviewing court. Following this change in framework for determining the substantive validity of Treasury

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[284] *Id.* at 1206.
[285] *Id.*
[286] *Id.*
[287] *Id.*
[288] *Id.*
[289] *Id.*
[290] *Id.*

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Regulations, the extent to which it will change the Treasury's rulemaking practice remains to be seen.

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THE REVISED TEXAS FRANCHISE TAX: PLANNING OPPORTUNITIES AND PITFALLS

By: Ronald J. Rucker[1]

BACKGROUND

On May 18, 2006, Texas Governor Rick Perry signed House Bill 3 ("HB 3") into law repealing and replacing the taxable capital and earned surplus components of the former franchise tax with a revised franchise tax on taxable margin (often referred to as, the "margin" tax).[2] HB 3, and the subsequent tax code and Texas Comptroller of Public Accounts ("Comptroller") regulatory provisions, is effective for franchise tax reports due on or after January 1, 2008.[3]

Unlike the former franchise tax regime imposed only on corporations and limited liability companies ("LLCs"), the revised franchise tax is imposed on almost all businesses granted liability protection under state law, including most non-corporate entities. As defined by the revised provisions, a "taxable entity" is any partnership, corporation, banking corporation, savings and loan association, LLC, business trust, professional association, business association, joint venture, joint stock company, holding company or other legal entity.[4] The term also includes a "combined group."[5]

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[1] Ronald J. Rucker, University of Houston Law Center, Class of 2010
[2] Tex. Tax Code § 171.001(a).
[3] HB 3, Section 26.
[4] Tex. Tax Code § 171.0002(a).
[5] *Id*.

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CALCULATION OF TEXAS FRANCHISE TAX

Beginning with the 2008 privilege period, Texas taxpayers will determine their Texas franchise tax liability based on their taxable margin.[6] Generally, an entity's taxable margin equals the lesser of the following three calculations:

- 70% of total revenue (as dined by the Texas tax code) from the taxable entity's entire business;
- Total revenue less cost of goods sold ("COGS"); or
- Total revenue less compensation.

Taxable margin must then be apportioned to Texas utilizing the ratio of gross receipts from business done in Texas to gross receipts from business done everywhere.[7] The appropriate tax rate is then applied to the taxable margin apportioned to Texas to determine a taxable entity's franchise tax liability.[8]

Total Revenue

The computation of Texas total revenue for purposes of the franchise tax begins with a number that approximates gross receipts for many companies. The statute identifies two sets of specific federal-tax-return line items includible in Texas total revenue, one set for corporations and one set for partnerships.[9] The use of specific lines on the federal income tax form allows

[6] HB 3, Section 26.
[7] Tex. Tax Code § 171.106(a).
[8] *Id*.
[9] Tex. Tax Code § 171.1011(c)(1)(A)(corporate provisions); Tex. Tax Code § 171.1011(c)(2)(A)(partnership provisions).

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

Generally includable lines from the federal Form 1120 ("U.S. Corporation Income Tax Return") will include:

- Gross receipts or sales, less returns and allowances (line 1c); and

- Federally reported dividends, interest, gross rents, gross royalties, capital gain net income, net gain or loss, and other income (lines 4 through 10).

Generally includable lines from the federal Form 1065 ("U.S. Return of Partnership Income") will include:

- Gross receipts or sales, less returns and allowances reported on federal return (line 1c);
- Ordinary income from other partnerships, estates, and trusts, new farm profit or loss, net gain or loss, and other income or loss (lines 4 through 7); and
- Net rental real estate income or loss, other net rental income or loss, guaranteed payments, interest income, ordinary dividends, qualified dividends, royalties, new short-term capital gain or loss, net long-term capital gain or loss, collectibles gain or loss, un-recaptured Internal Revenue Code ("IRC") § 1250 gain or loss, net IRC § 1231 gain or loss, other income or loss (Schedule K, lines 2 through 11).

Total revenue begins with these numbers, from which certain specified items are subtracted.[10] Such exclusions include foreign royalties; foreign dividends; and bad debts corresponding to items of gross receipts included for the current or past reporting period.[11] These subtractions are limited, to the extent that the items must be related to gross receipts included in total revenue.

The Texas tax code specifically provides that a combined group must compute its total revenue by determining the revenue of each member of the combined group as if the member were an individual taxable entity. [12] Total revenues for each member entity are then summed and, to the extent originally includable in total revenue, items of total revenue received from other members of the group are deducted.[13]

PLANNING OPPORTUNITY:
EXCLUSION FOR NON-UNITARY REVENUE

As mentioned in the preceding discussion, a number of specific exclusions from a taxable entity's federal gross income are provided for in the revised franchise tax statutes and/or regulations relating to the calculation of total revenue. For example, under the Comptroller's revised franchise tax rules, revenue that Texas cannot tax because the activities generating that item of revenue do not have sufficient unitary connection with the entity's other activities conducted in Texas under the U.S. Constitution is excluded from total revenue.[14] Although there were similar statutory provisions under the former franchise tax regime, no similar language is found in the revised Texas Tax Code. By adding this language to its revised franchise tax rules, the Comptroller acknowledges that there may be some items of revenue that should not be

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[10] Tex. Tax Code §§ 171.1011(c)(1)(B) and (c)(2)(B).
[11] *Id.*
[12] Tex. Tax Code § 171.1014(c).
[13] *Id.*
[14] 34 Tex. Admin. Code § 3.587(c)(9).

included in a taxable entity's apportionable taxable margin on the basis that the income is not unitary. The Comptroller, however, has yet to identify under what circumstances a taxpayer should, or could, exclude such items from total revenue.

When a taxable entity sells an interest in a subsidiary, any resulting capital net gain or net loss will generally be included in the selling entity's federal income tax gross income and Texas total revenue. Although there is no specific statutory exclusion provided for this type income, an analysis of the business relationship between the payor and the payee is warranted to determine if the exclusion for non-unitary income applies.

As noted above, no specific guidance on this issue has been received from the Comptroller or any other authoritative body in Texas. However, given the Comptroller's pronouncement that it will consider guidelines from United States Supreme Court ("Court") decisions regarding the unitary business principle, the Court's body of law on the subject is particularly instructive.[15]

The Unitary Business Principal

The constitutional principle that a state may not tax activities with which it lacks a concrete connection generally confines the exercise of a state's power to tax activities conducted within its borders. It is often difficult, however - if not impossible - for a state to determine with precision the value of property or the amount of income attributable to a multistate or multi-national taxpayer's in-state activities.[16] Recognizing these difficulties, the Court has long

[15] 34 Tex. Admin. Code § 3.590(b)(6)(B).

[16] *See, e.g., Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164, 103 S. Ct. 2933 (1983); *Butler Bros. v. McColgan*, 315 U.S. 501, 507-509, 62 S. Ct. 701 (1942); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120–121, 41 S. Ct. 45 (1920).

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permitted the states to determine the property, income, or receipts of a multi-jurisdictional taxpayer attributable to a state by apportionment.

Under the apportionment method, the state considers the property, income, or receipts related to all of the taxpayer's activities - out-of-state as well as in-state - and then apportions a share of such property, income, or receipts to the taxing state by means of a formula that compares the taxpayer's in-state activities to all of its activities. While permitting the states to include property, income, or receipts from a taxpayer's out-of-state activities in the taxpayer's apportionable tax base, the Court has not thereby abandoned the requirement that there be a "definite link" or "minimum connection" between the state and the taxpayer's in-state activities.[17] Rather the Court has insisted on such a link by reference to the unitary business principle.

The Court has described a unitary business as one characterized by "functional integration, centralization of management, and economies of scale."[18] It has emphasized the fundamental notion that, for a business to be unitary, "the out-of-state activities of the purported 'unitary business' must be related in some concrete way to the in-state activities" and that there must be "some sharing or exchange of value not capable of precise identification - beyond the mere flow of funds arising out of a passive investment or a distinct business operation."[19] The Court has also made clear that everything a taxpayer happens to own does not necessarily comprise part of its unitary business:

> We repeat that while the unity which exists may not be a physical unity, it is something more than a mere unity of ownership. It is a unity of use, not simply for the convenience

[17] *Shell Oil Co. v. Iowa Dep't of Revenue*, 488 U.S. 19, 30-31, 109 S. Ct. 278 (1988).
[18] *Mobil Oil Corp. v Commissioner of Taxes*, 445 U.S. 425, 438, 100 S. Ct. 1223 (1980).
[19] *Container*, 463 U.S. at 166.

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> or pecuniary profit of the owner, but existing in the very necessities of the case - resulting from the very nature of the business.[20] (Emphasis Added).

These federal constitutional restraints on state taxation of corporate income have largely shaped the state statutory framework governing such taxation. Most states' corporate income tax regimes reflect the principal constitutional restraint of the unitary business principle. The unitary business principle finds expression in the line the states have drawn between allocable and apportionable income.

The modern Court standard for identifying under what circumstances gains from dispositions of stock are considered unitary business income subject to apportionment is found in the Court's decision in Allied Signal. The central issue in Allied-Signal was whether or not New Jersey could tax a gain realized on the sale of an approximate 20% interest in ASARCO, an unrelated mining corporation by a manufacturing corporation (Bendix) based in Michigan and domiciled in Delaware.[21] Bendix did not engage in any common business activities with ASARCO; rather, it merely held its stock in ASARCO for purposes of investment and diversification. New Jersey argued that Bendix's business involved acquisitions and divestitures; consequently, capital gains derived from such activities constituted apportionable business income. More broadly, New Jersey essentially took the position that, as a conglomerate, all corporations in which Bendix held stock were part of a single unitary business.

In reversing the New Jersey Supreme Court and striking down the tax, the U.S. Supreme Court reiterated that it has not abandoned the requirement that to tax an activity a state must have

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[20] *Adams Express Co. v. Ohio*, 165 U.S. 194, 222, 17 S. Ct. 305 (1897).
[21] *Allied Signal, Inc. v. Director, New Jersey Div. of Tax'n.*, 504 U.S. 768 (1992).

a connection to the activity itself, rather than a connection only to the targeted taxpayer.[22] It also noted that "New Jersey's sweeping theory cannot be reconciled with the concept that the Constitution places limits on a State's power to tax value earned outside of its borders."[23] Rejecting New Jersey's claim that any distinction between operational and investment assets is artificial, the Court concluded that the relevant inquiry is one that focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state.

In summary, the constitutional requirements for state taxation, including the taxation of an acquisition which is part of the taxpayer's unitary business, remain functional integration, centralization of management, and economies of scale.[24] The Court in Allied-Signal also reaffirmed that "a unitary business may exist without a flow of goods between the parent and subsidiary, if instead there is a flow of value between the entities."[25] Relevant factors include a management role by the parent based on its own operation expertise and strategy or the operation of similar lines of business. The Court, however, made it clear that apportionment does not always require that the payee and payor be engaged in the same unitary business.[26] The focus remains on whether the capital transaction serves an operational rather than an investment function.

An opportunity exists for Texas taxpayers to consider and analyze dispositions of investments and the resulting inclusion of such gains for purposes of Texas total revenue. Taxpayers are encouraged to review the functional integration, centralization of management and

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[22] *Id* at 777, quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954).
[23] *Id.* at 754.
[24] *Id.* at 783; *See also Hercules Inc. v. Comptroller*, 699 A.2d 461 (Md. App. 1997).
[25] *Id.*
[26] *Id.*

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economies of scale between the investment and Taxpayer and any observed characteristics of a unitary business as established by the Court's precedents. To the extent Taxpayer's ownership and sale of the invested stock stock is not sufficiently linked to its day-to-day operations to make the resulting gain business income under the traditional definition, consistent with the Court's guidance, an opportunity exists to treat the capital net gain as revenue not unitary with Taxpayer's other activity in Texas, and therefore excludable from total revenue.

FRANCHISE TAX DEDUCTIONS

A taxable entity computes its Texas franchise by subtracting from total revenues its unilateral choice of either COGS or compensation, although the taxable franchise is capped at 70% of total revenue from the entire business.[27] Furthermore, entities required to file as a combined group will make an election that applies to all the members; thus, as a practical matter, separate companies in a combined group are not permitted to choose which deduction to use.[28] Taxpayers may change the election to deduct either COGS or compensation annually.[29]

The Cost of Goods Sold Deduction

If eligible, a taxable entity may elect to deduct COGS from its total revenue in computing its "taxable margin." Texas statutes and regulations provide that the election to deduct COGS is available only to those taxable entities that acquire or produce goods that are sold in the ordinary course of business.[30] Thus, with certain exceptions, entities eligible for the COGS deduction generally include manufacturers/producers, wholesalers and retailers but excludes service

[27] Tex. Tax Code §§ 171.101(a)(1)(A) and (a)(1)(B)(ii).
[28] Tex. Tax Code § 171.1014(d).
[29] Tex. Tax Code § 171.101(d).
[30] Tex. Tax Code § 171.1012(c); 34 Tex. Admin. Code § 3.588(d).

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providers and/or other similarly situated companies that do not take ownership of any goods that may be sold.[31]

"Production" is broadly defined as construction, installation occurring during the manufacturing or construction process, manufacture, development, mining, extraction, improvement, creation, raising or growth.[32] For purposes of the COGS deduction, "goods" are limited to real or tangible personal property sold in the ordinary course of business of a taxable entity.[33] Tangible personal property is specifically defined as personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner and does not include either intangible property or services.[34] Real property is not defined by the franchise tax statutes or regulations. However, in a June 17, 2008 administrative pronouncement, the Texas Comptroller stated that oil and gas wells are considered real property.[35]

Whether a taxable entity owns goods is determined based on all the facts and circumstances.[36] Such a determination includes an analysis of which taxable entity the benefits and burdens of ownership vests.[37] Furthermore, "[a] taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance…of real property is considered to be an owner of the labor or materials and may include the costs…in the computation of [COGS]."[38] In an administrative pronouncement, the Comptroller

[31] *See* Tex. Tax Code §§ 171.1012(i), (k), and (k-1) for exceptions available to certain lending institutions, leasing companies, and construction businesses.
[32] Tex. Tax Code § 171.1012(a)(2); 34 Tex. Admin. Code § 3.588(b)(7).
[33] Tex. Tax Code § 171.1012(a)(1); 34 Tex. Admin. Code § 3.588(b)(3).
[34] Tex. Tax Code § 171.1012(3)(B)(ii); 34 Tex. Admin. Code § 3.588(b)(9)(B).
[35] *Revised Franchise Tax Frequently Asked Questions: Cost of Goods Sold*. Window on State Government. Updated, June 19, 2008; *See also* Letter Ruling 200811216L, Texas Comptroller of Public Accounts (November 17, 2008).
[36] Tex. Tax Code § 171.1012(i); 34 Tex. Admin. Code § 3.588(c)(7).
[37] *Id.*
[38] *Id.*

specifically stated that entities which drill for and extract oil and gas are allowed a COGS deduction for the Texas franchise tax.[39] Moreover, the Comptroller has stated that entities which provide oilfield services that pertain to the construction, improvement, remodeling, repair, or industrial maintenance of oil and gas wells can deduct COGS for franchise tax purposes.[40]

Rather than directly incorporating federal income tax or generally accepted accounting principle ("GAAP") computations, the revised Texas law defines COGS at length.[41] The deduction generally includes direct costs of acquiring or producing goods, as well as some pre-production, post-production and a capped amount of administrative or indirect overhead costs.

Direct costs that are specifically identified as eligible COGS include (but are not limited to): labor; materials; handling; storage; depreciation, depletion, and amortization; research and development; production taxes; renting or leasing equipment, facilities or real property used for production of goods; repair and maintenance of such equipment, facilities or real property; intangible drilling costs and geological and geophysical cost of locating mineral properties.[42]

Also included in COGS are certain related costs such as deterioration, obsolescence, and spoilage; insurance; utilities; quality control; and licensing and franchise costs.[43]

Additionally, a taxable entity is entitled to subtract as COGS up to four percent of indirect or administrative overhead costs, including all mixed service costs (e.g. security

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[39] *Revised Franchise Tax Frequently Asked Questions: Cost of Goods Sold*. Window on State Government. Updated, April 23, 2008.
[40] *Revised Franchise Tax Frequently Asked Questions: Cost of Goods Sold*. Window on State Government. Updated, June 19, 2008; *See also* Letter Ruling 200811216L, Texas Comptroller of Public Accounts (November 17, 2008).
[41] Tex. Tax Code § 171.1012.
[42] Tex. Tax Code § 171.1012(c); 34 Tex. Admin. Code § 3.588(d).
[43] Tex. Tax Code § 171.1012(d); 34 Tex. Admin. Code § 3.588(e).

services, legal services, data processing, accounting, personnel, general financial planning and financial manage costs) that are allocable to the acquisition or production of goods.[44]

Certain costs are specifically excluded from COGS, including (but not limited to) the cost of facilities, equipment, and real property not used for the direct production of goods; selling and distribution costs; advertising; interest and financing costs; income and income-based franchise taxes; and compensation paid to officers and undocumented workers.[45]

Taxable entities seeking to qualify particular costs for the COGS deduction will have to institute special record keeping procedures to track the expenses for purposes of the franchise tax. Although the Texas COGS deduction is based in part on the cost of goods sold used for federal income tax purposes it differs sufficiently to require taxable entities to modify the record keeping procedures used to track inventory for federal income tax purposes. For example, the overhead administrative costs deductible for purposes of Texas COGS must be shown to be allocable to the acquisition or production of the goods. Taxable entities may be tempted to assume that 4% of their overhead administrative costs are allocable to the acquisition or production of goods, without any substantiation, but will run the risk that this shortcut will not be accepted by the Comptroller.

COMBINED REPORTING

With the enactment of the revised franchise tax, Texas joins several other states in adopting the "unitary business" concept. Pursuant to HB 3, HB 3928 and Comptroller regulations, taxable entities that are part of an affiliated group engaged in a unitary business are required to file a combined group report – based on the overall group's business – in lieu of

[44] Tex. Tax Code § 171.1012(f); 34 Tex. Admin. Code § 3.588(f).
[45] Tex. Tax Code § 171.1012(e); 34 Tex. Admin. Code § 3.588(g).

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individual reports, generally eliminating intercompany transactions between unitary group members.[46] The combined group is a single taxable entity for purposes of calculating the franchise tax due based on margin.

Comptroller Rule 3.590 summarizes the general rules and provides guidance on when two or more entities are required to report as a combined group:

1. All entities in the combined group must be taxable entities;
2. The taxable entities must be part of an "affiliated group";
3. The taxable entities must be engaged together in a "unitary business";
4. No taxable entity in the group may be "beyond the water's edge" of the United States or its territories.[47]

If two or more entities together meet this test, they must report together on the same combined report for the accounting period that the test is met.

Affiliated Group

According to Comptroller rule, an "affiliated group" is made up of entities – with or without nexus in Texas – in which a controlling interest is owned by a common owner, either corporate or noncorporate, or by one or more of the member entities.[48] Whether an owner has a "controlling interest" in an entity is precisely defined by Texas statute and turns upon what type of entity is owned:

[46] 34 Tex. Admin. Code § 3.590; Tex. Tax Code § 171.1014(a).
[47] Tex. Tax Code §§ 171.0001(7) and 171.1014(a).
[48] 34 Tex. Admin. Code § 3.590(b)(1).

Corporations. An owner has a controlling interest in a corporation when it holds, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock of the corporation, or it holds, directly or indirectly, more than 50 percent of the beneficial interest in the voting stock of the corporation.[49]

Limited Liability Companies. An owner has a controlling interest in a limited liability company when it holds, directly or indirectly, more than 50 percent of the total membership interest of the limited liability company, or it holds, directly or indirectly, more than 50 percent of the beneficial ownership interest in the membership interest of the limited liability company.[50]

All other entities. For all other entities, including partnerships, associations, and trusts, an owner has a controlling interest when it holds, directly or indirectly, more than 50 percent of the capital, profits, or beneficial interest in the entity.[51]

Unitary Business

The law addressing the circumstances constituting a unitary business has been developed through legislation, regulation, and case law in the several states that have adopted the unitary business concept. The specific Texas definition is unique among the unitary business concept states and holds that a business is unitary when it is:

[49] Tex. Tax Code § 171.0001(8)(A).
[50] Tex. Tax Code § 171.0001(8)(C).
[51] Tex. Tax Code § 171.0001(8)(B).

> "[A] single economic enterprise made up of separate parts of a single entity or of a commonly controlled group of entities that are significantly interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts."[52]

For purposes of the combined reporting rules, all affiliated entities are presumed to be engaged in a unitary business.[53] However, the Comptroller may consider any other relevant factor when determining if an affiliated group is unitary, including whether: (1) the activities of the members are in the same general line of business – for example, manufacturing, retailing, finance – or are steps in a vertically structured enterprise or process (e.g., exploration, mining, refining, and marketing, which are all steps in the production of natural resources); and (2) the members are functionally integrated through strong centralized management, such as authority over purchasing, financing, personnel, and marketing.[54]

What constitutes strong central management will depend, to a considerable extent, on the facts in any particular case. However, this inquiry is expected to require more than the mere existence of "common officers or directors" or an allegation that the various business segments are under the ultimate control of the same person or group of people. Comptroller rule clearly contemplates that the central managers will, among other things, play a regular operational role in the business activities of the various divisions or affiliates.

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[52] Tex. Tax Code § 171.0001(17).
[53] 34 Tex. Admin. Code § 3.590(b)(6)(B); Tex. Tax Code § 171.0001(17).
[54] 34 Tex. Admin. Code § 3.590(b)(6)(A); Tex. Tax Code § 171.0001(17).

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Ultimately, in determining whether a unitary business exists for purposes of the Texas Franchise tax, and a detailed factual analysis will be required.

COMBINED CALCULATION OF TEXAS FRANCHISE TAX

A combined group must compute its total revenue by determining the revenue of each member of the combined group as if the member were an individual taxable entity. Total revenues for each member entity are then summed and, to the extent originally includable in total revenue, items of total revenue received from other members of the group are eliminated.[55]

Additionally, for purposes of the Texas tax code, a combined group shall make an election to subtract COGS that applies to all of its members.[56] A member of a combined group may claim as COGS those costs that qualify under §171.1012 if the goods for which the costs are incurred are owned by another member of the combined group.

As with total revenue, each member entity calculates its COGS as if it were a standalone entity, except that unlike a standalone entity, a member can take a COGS deduction for goods it does not own if the goods for which the costs are incurred are owned by another member of the group. Each member's COGS is then summed, and any COGS paid to other members of the combined group – to the extent that the corresponding item of total revenue was subtracted, is eliminated.[57]

[55] Tex. Tax Code § 171.1014(c).
[56] Tex. Tax Code § 171.1014(d).
[57] Tex. Tax Code § 171.1014(e).

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PLANNING OPPORTUNITY:
THE CAPTIVE MANUFACTURING / PURCHASING COMPANY

There are a number of industries that are at a distinct disadvantage when it comes to the availability of the COGS deduction. For example, pipeline companies will not be able to elect to deduct their COGS, as pipelines generally do not own the goods they are transporting and because they are providing a service. Therefore, pipeline companies will likely be relegated to the 30% deduction from revenues. Furthermore, submanufacturers will likely not qualify for the COGS deduction. They will be disqualified as they normally do not own the products that they have been subcontracted by the manufacturer/owner to process.

An opportunity exists for such taxpayers to create a manufacturing and/or procurement company structure to generate or maximize the company's COGS deduction ("NEWCO"). Target companies would include, but may not be limited to, those enterprises losing deductions attributable to rental and service activities (e.g., pipeline companies, submanufacturers, etc.).

NEWCO will be established as a wholly-owned subsidiary of an operating company. The NEWCO will operate as a manufacturer of goods or purchaser of the raw materials, supplies and capital expenditures, and as subsequent seller of those manufactured or purchased items to the related operating company. As a result, the "manufacturing" or "buying" of service (including rental) goods and subsequent intercompany sale of such goods creates eligibility (and eligible costs) for the Texas COGS deduction as the NEWCO produces or acquires goods in the ordinary course of its business. The combined group will take a COGS deduction for the qualifying third party manufacturing costs or expenses paid to the third-party vendor(s) for initial purchase of goods and materials which are currently ineligible for COGS.

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The captive manufacturing / purchasing company structure is particularly ideal for those taxable entities with the following characteristics:

- Service oriented enterprises with recurring purchases of equipment, materials, and other costs;

- Undergoing change in procurement culture, particularly the centralization of purchasing activities;

- Implementing strategic sourcing, e-procurement or value change transformation strategies; and

- History of significant franchise and/or sales/use tax assessments and/or overpayments.

Additionally, under this strategy, multistate sales/use tax may also be deferred until its collection on the subsequent sale to the operating company. Moreover, since establishment of a purchasing company results in centralized purchasing, it also provides the opportunity to more accurately apply sales/use tax rules, resulting in permanent saving of sales/use tax by capturing available exemptions and claiming collection allowances. Further sales tax benefits may flow from those companies manufacturing equipment for their own use, as such entities may be considered eligible for state "sales for re-lease" exemptions.[58]

Economic Substance / Transfer Pricing

On March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act of 2010.[59] As part of that legislation, Section 7701 of the IRC was amended to clarify a long-standing federal tax common law doctrine regarding "economic substance."[60] The new statutory language specifies that "[i]n the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[61] This definition, which adopts a conjunctive test, effectively overrules the disjunctive test that some courts used in their interpretation of what qualifies under the economic substance doctrine.

Texas specifically adopts the IRC and regulations there under as of January 1, 2007 for purposes of the Texas franchise tax. As a result, Texas does not specifically adopt the recently enacted federal economic substance provisions. Moreover, under the Comptroller's longstanding policy of respecting the form of a transaction, a taxpayer generally had the ability to plan and shape a transaction's tax consequences by selecting a particular form of transaction. Most

[58] See e.g., Tex. Tax Code §151.302(a), which provides that tangible personal property or a taxable service to a purchaser who intends to resell it within the U.S. in the regular course of business in the form or condition acquired or attached to or as an integral part of other tangible personal property or a taxable service are not subject to Texas sales tax.
[59] P.L. 111-152.
[60] The language clarifying the federal economic substance doctrine is codified as IRC § 7701(o).
[61] IRC § 7701(o)(1). In addition, "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." IRC § 7701(o)(5)(C). It should be noted that "any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect. IRC § 7701(o)(3).

notably, in June 1996, the Comptroller prepared and presented a white paper, entitled "Methods of Franchise Tax Avoidance Prepared at the Request of the Ways and Means Committee," acknowledging that a taxpayer desires to increase profit through the reduction of expenses, including minimizing taxes. The Comptroller's identification of the strategies discussed in the white paper as legitimate tax avoidance methods is a strong indication that these methods are acceptable to the agency and will not be treated as tax evasion activities. These strategies involve the use of non-taxable entities and the use of unique apportionment rules.

However, within the last 12 months, the Comptroller's office has began signaling a policy shift by stating that it would begin reviewing the economic substance of certain types of transactions. On August 6, 2009, the Comptroller issued a ruling openly embracing the economic substance doctrine, and calling into question the historic form-over-substance framework which is an accepted principle of Texas tax jurisprudence.[62]

The Comptroller's ruling is the first - and so far the only - time the Comptroller's office has used the phrase "economic substance" to look through the form of a transaction for purposes of the Texas sales tax. The ruling addressed two hypothetical aircraft transactions. In the first hypothetical, an individual purchased an aircraft outside of Texas and attempted to make a tax-free contribution to his wholly-owned corporation before the aircraft entered Texas. In the second hypothetical, a broker sold an aircraft to one individual outside of Texas, who sold the aircraft to a second individual. The individuals attempted to claim that the sale from one individual to the other individual was an "occasional sale" exempt from sales tax.

The Comptroller did not expressly recast either transaction. Rather, the ruling merely describes the framework within which the Comptroller will analyze transactions. For example,

[62] Letter Ruling 200908387L, Texas Comptroller of Public Accounts (August 6, 2009).

the ruling provides that the Comptroller may recast an intercompany transaction that does not generate an "adequate return on capital." Additionally, the Comptroller lists several questions addressing various factors to be considered, including whether a series of transactions is pre-planned or has substantial economic effect, whether there is economic risk or a business purpose to the transaction (or series of transactions), and whether the parties are related.

As the very least, one should consider the August ruling as a warning sign. Although the facts of the August ruling relate specifically to the sales tax consequences of an intercompany aircraft transaction and a situation in which a taxpayer sought an "occasional sale" exemption, taxpayers should act with the expectation that the Comptroller will fully extend the ruling's framework to other industries, exemptions, and taxes to the extent the economic substance doctrine does not already exist. Specifically, it appears that the Comptroller's office will apply the doctrine to any transaction or tax planning technique in which there is no profitability or valid business reason for the transaction or structure.

In light of the Comptroller's increased scrutiny of intercompany transactions between related entities a taxpayer will want to review the accuracy of transfer pricing structures and prepare required documentation before implementing the captive structure. To successfully protect transfer pricing tax planning strategies and sustain their validity if challenged by the Comptroller, there will be a need to demonstrate a sufficient business purpose, provide an appropriate arm's-length compensation for goods and services between the related parties, and provide supporting documentation for the transaction.[63]

[63] The Texas tax code specifically permits a deduction for COGS for payments made from one member of an affiliated group to another affiliate that is not a part of the combined group but only if the payment is at "arm's-length."

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TEXAS CREDITS AND INCENTIVES

The economic incentive credits provided for in Subchapters L, M, N, O, P, Q, R, S, T, and U of the Texas Franchise Tax Act were repealed by the Legislature in enacting HB 3. No replacement credits were enacted. That repeal, however, does not affect a credit that was established under Texas Tax Code Chapter 171 (Subchapter L-U) before the effective date of HB 3, including the Texas research and development credit ("R&D Credit").[64]

The Texas R&D Credit

The former Texas R&D credit is based on a taxpayer's increase in spending compared to an established pattern.[65] The credit is permitted for incremental qualified research expenditures ("QREs") and basic research payments. As an added inducement, Texas provides that the credit rate be doubled if expenditures are made in a strategic investment area ("SIA"). An SIA is a specific area:

1. designated by the Comptroller to be a county with above-average unemployment and below-average per capita income;
2. federally designated urban enterprise community or an urban enhanced enterprise community; or
3. defense economic readjustment zone.

Definitions of terms for the Texas R&D credit are identical to those found in IRC § 41, with the exception that the credit applies only to expenditures for research conducted in Texas. QREs

[64] HB 3, § 18(b).
[65] Former Tex. Tax Code § 171.723, as repealed by 2006 H.B. 3, effective Jan. 1, 2008.

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include expenses for research that the taxpayer performs, including wages for employees involved in the research activity, costs of supplies that are used in research, and payments to others for the use of computer time in qualified research. Also, QREs include a portion of the expenses for research that other parties perform on behalf of the taxpayer.[66]

The amount of Texas R&D credit is equal to the sum of five percent of Texas QREs in excess of the Texas base amount, plus five percent of the taxpayer's Texas basic research payments determined in accordance with IRC § 41(e)(1)(A).[67] The base amount is the product of the fixed-base percentage and the average annual gross receipts of the taxpayer for the four years preceding the tax year. Gross receipts for this purpose include only Texas gross receipts.[68] The Texas qualified research base amount can be no less than 50 percent of current year QREs.[69]

The fixed-base percentage is computed by dividing a taxpayer's total qualified research expenses for all taxable years beginning after December 31, 1983, and before January 1, 1989, by the taxpayer's aggregate gross receipts for such years.[70] With the exception of start-up companies the fixed-base percentage cannot exceed 16%. A start-up company is defined as a company that did not have both gross receipts and QREs in at least three of the base period years, or the first taxable year in which there were both QREs and gross receipts began after December 31, 1983.[71] For a start-up company, Texas assigns a fixed-base percentage of 3 percent.[72]

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[66] 34 Tex. Admin Code § 3.578.
[67] *Id.*
[68] Former Tex. Tax Code §§ 171.723(f), 171.1032 as repealed by 2006 H.B. 3, effective Jan., 2008.
[69] Texas Comptroller Clarifies Research, Development Credit Amount Limits for franchise tax Purposes, *State Tax Today* (September 17, 2001).
[70] IRC § 41(c)(3).
[71] IRC § 41(c)(3)(B).
[72] Instructions to Form 05-154-A, Schedule F, Texas Franchise Research and Development Credit.

A taxpayer may elect to compute the R&D credit for QREs incurred in Texas in a manner consistent with the federal alternative incremental credit for the corresponding federal tax period, provided:

- a federal election is made to compute the federal credit under IRC § 41(c)(4);
- the taxpayer was a member of a consolidated group for which a federal election was made; or
- the taxpayer did not claim the federal credit under IRC § 41(a)(1).

In that case, the credit percentages for the various brackets of QREs described in IRC § 41(c)(4)(A)(i), (ii), and (iii) are 0.41 percent, 0.55 percent, and 0.69 percent, respectively.

The alternative simplified method, which was added to the IRC by the Tax Relief and Health Care Act of 2006, does not apply in Texas. The Texas credit statute only adopts parts of IRC § 41 and does not adopt IRC § 41(c)(5)(A), which is the provisions offering the alternative simplified method.

The R&D credit may not reduce the franchise tax liability in a year by more than 50 percent of the tax due before reduction by other credit.[73] Excess credits may be carried forward for 20 years.

PLANNING OPPORTUNITY:
CARRYFORWARD OF TEXAS FRANCHISE TAX CREDITS

As discussed, for Texas franchise tax reports originally due on or after January 1, 2008, all franchise tax credits under the former Texas franchise tax regime are repealed.

[73] Former Tex. Tax Code § 171.724, as repealed by 2006 H.B. 3, effective Jan. 1, 2008.

However, the repeal of the Texas R&D credit does not affect a credit authorized before January 1, 2008. A taxpayer that has established, but not used, credits by the effective date of the revised franchise tax may claim the unused credits. These credits may be claimed on or with the franchise tax report for the period in which the credits were accrued, and can be used to reduce franchise tax liability after the effective date to the extent the credits earned have carryforward provisions in existing law and the carryforward period is still open under the Texas statute of limitations for the taxpayer who earned the credits.[74] The transition provisions to the revised franchise tax and former franchise tax provisions do not require that the franchise tax report be originally filed prior to January 1, 2008.[75]

The former law under which the credits accrued is continued in effect for purposes of determining the amount of the credit the taxpayer can claim.[76] Thus, as under the former regime, the total R&D credit carryforward that a taxable entity may claim for a report may not exceed 50% of the amount of franchise tax that is due for the report before any other tax credits are applied.[77]

Moreover, a taxable entity that is a combined group may claim the unused credit carried forward for each member entity. The limitation in Texas Administrative Code title 34, § 3.593(d) and report limitation in Texas Administrative Code title 34, § 3.593(e)(2) must be applied to the amount of franchise tax due of the combined group before any other tax credits are applied.[78]

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[74] HB 3, § 18(d); 34 Tex. Admin Code § 3.593(e)(1).
[75] 34 Tex. Admin. Code § 3.593.
[76] HB 3, § 18; 34 Tex. Admin Code § 3.593(e).
[77] 34 Tex. Admin Code § 3.593(e)(1).
[78] 34 Tex. Admin Code § 3.593(e)(3).

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The Comptroller has provided further administrative guidance regarding various franchise tax credits including the R&D credit. Within a policy letter, the Comptroller states the following:

> Advance approval from the Comptroller is not required to claim credits. To claim the credits, qualifying corporations must complete and submit with their franchise tax report Schedule D, Texas franchise tax Credit Summary, along with the specific credit worksheet. All qualifying conditions must be met in order to establish eligibility for the credits and the credit calculations have to be made in accordance with the Tax Code requirements.[79] (Emphasis Added).

Based on the above-referenced letter ruling and former franchise tax rule, a taxable entity establishes a credit by meeting all qualifying conditions (i.e., performing qualifying R&D activities in Texas) rather than filing a form and claiming the credit on a franchise tax report. Thus, a taxable entity can amend prior year franchise tax reports (i.e., 2005-2007 report years) to claim any available economic development (including R&D) credits and then carryforward any excess credits into the subsequent revised franchise tax report years to offset franchise tax liability for the combined group.[80] Taxable entities are permitted to carryforward the unused credits until the earlier of the date the credit would have expired under the terms of Subchapter O, Chapter 171, Tax Code, had it continued in existence, or December 31, 2027.[81]

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[79] Letter Ruling 200412931L, Texas Comptroller of Public Accounts (December 8, 2004).
[80] See Former 34 Tex. Admin. Code § 3.544(d)(1); 34 Tex. Admin. Code § 3.584(f)(1), which provides that for reports originally due before and after January 1, 2008, a taxpayer is permitted to file an amended report to correct a mathematical error or other technical error on a prior report, or to support a claim for refund.
[81] HB 3, § 18(d); 34 Tex. Admin Code § 3.593(e)(1).

STATE APPORTIONMENT

The franchise tax provisions import most of the former regime's concepts for apportioning the tax base. Therefore, in determining taxable margin, a taxable entity relies on a single-factor formula that multiplies the tax base by the ratio of a taxable entity's Texas gross receipts to total gross receipts everywhere.[82] Receipts for apportionment purposes do not include any receipts that are excluded from total revenue.[83]

In a holdover from the earned-surplus component of the pre-margin franchise tax, "gross receipts" are to be determined under federal-tax gross-income principles.[84] However, because partnerships are now subject to the franchise tax, the apportionment factor for any single entity owning a partnership interest does not include a pass-through of the partnership's factors. In addition, Texas has eliminated its long-standing "throwback rule," which sourced to Texas any receipts from sales of tangible property shipped from Texas into a state in which the seller has insufficient contact to be subject to state income tax.[85]

For a unitary combined group, the numerator of the receipts factor includes the Texas-sourced receipts of only those group members that have their own separate nexus with Texas.[86] In contrast, the unitary combined group's receipts factor denominator includes the gross receipts of each taxable entity that is a member of the combined group, without regard to whether the particular entity has income tax nexus with Texas.[87] Intercompany transactions are eliminated

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[82] Tex. Tax Code § 171.106(a).
[83] Tex. Tax Code § 171.1055 (a).
[84] Tex. Tax Code § 171.1011.
[85] Tex. Tax Code § 171.103.
[86] *Id.*
[87] Tex. Tax Code §§ 171.103(b) and 171.105(c).

from a combined unitary group's total Texas apportionment factor to the extent the receipts are eliminated from the total revenue calculation.[88]

PLANNING OPPORTUNITY:
MULTISTATE TAX COMPACT ("MTC") THREE FACTOR FORMULA ELECTION

Article III of the Multistate Tax Compact ("MTC") generally provides the following taxpayer election that is available in compact states that impose an income tax (as defined by the compact):

> Any taxpayer subject to an income tax whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party State or pursuant to the laws of subdivisions in two or more party States may elect to apportion and allocate his income in the manner provided by the laws of such states and subdivisions without reference to this compact, or may elect to apportion and allocate in accordance with Article IV. This election for any tax year may be made in all party states or subdivisions thereof or in any one or more of the party states or subdivisions thereof without reference to the election made in the others.[89] (Emphasis Added).

Article III explicitly confirms that the article, and therefore the ability to make this election, applies solely to the reporting of income taxes.[90] Although the compact allows for a taxpayer to elect equally weighted three-factor apportionment on an annual basis, the compact does not provide additional details on how to the election is made, including whether the it must be made

[88] Tex. Tax Code § 171.1055 (b).
[89] Multistate Tax Compact, Article III.1.
[90] Multistate Tax Compact, Article III.3.

on an original return, can be made on an amended return, or how the election is to be disclosed to the relevant state tax authority.

In 1981, Texas adopted the MTC under Chapter 141 of the Texas Tax Code. However, when the earned surplus component of the former franchise tax was introduced in 1991, the legislature included a provision that specifically excluded the MTC provisions in Chapter 141 from applying to the franchise tax.[91] As a result, under the former franchise tax regime, the Comptroller exercised a great deal of independence in deciding how gross receipts are to be sourced. Guidance in this area comes from constitutional limitations, legislation, and the Comptroller's rules.

For a brief period of time, Texas taxpayers were able to elect to use a three-factor apportionment factor to compute the franchise tax. Specifically, Texas Tax Code § 171.108 stated that if the allocation and apportionment provisions in the Tax Code did not fairly represent the extent of a taxpayer's business done in Texas, the taxpayer could request, and the Comptroller could grant, permission for the taxpayer to use an alternate allocation and apportionment method, including separate accounting, the inclusion of additional factors, or any other method that equitably allocates and apportions the taxpayer's capital. This provision is similar in nature to Texas Tax Code § 141.001, Article IV.18, of the MTC adopted by the legislature. However, neither statute was available to a taxpayer seeking to use an alternate apportionment formula to the single-factor gross receipts method. Texas Tax Code § 171.108 was repealed effective for report periods after 1988, and Chapter 141 of the Texas Tax Code was declared inapplicable to the franchise tax under Texas Tax Code § 171.112(g).

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[91] Former Tex. Tax Code § 171.112(g).

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The adoption of the revised franchise tax changes also resulted in a full repeal of Texas Tax Code § 171.112(g), providing that the MTC at Chapter 141 of the Texas Tax Code does not apply to the franchise tax. As Texas has indicated its desire to apply the MTC provisions in there entirely to the revised franchise tax, a position exits for taxpayers to elect to use the three-factor apportionment formula authorized under Texas Tax Code § 141.001 for originally filed reports when calculating their franchise tax liability. This is an annual election that would have to be made on each subsequent year's franchise report.

Note that the Comptroller has provided that it does not consider the revised franchise tax to be an income tax.[92] However, the MTC definition appears to support this conclusion. As defined by the Texas Tax Code an "income tax" is a tax:

> "[I]mposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transactions."[93]

The issue of whether the Texas franchise tax can be considered an income tax measured by net income is made more complicated by the relative lack of definitional guidance in the compact and the fact that the compact was written many years before alternative taxes such as this were enacted or even anticipated. However, the deduction for COGS, compensation, or the 30% deduction from total revenue, as well as the various total revenue exclusions and industry-specific exclusions, from total revenue supports the argument that a number of expense are

[92] HB 3, § 21.
[93] Tex. Tax Code § 141.001, Art. II (4).

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deducted from a measure of gross income, and those items are not directly related to particular transactions. Accordingly, the revised franchise tax would likely be classified as an income tax under the compact

As discussed above, the compact provides no details on how to make the MTC election. Similarly, the Texas franchise tax forms do not note the ability to make an election to use the equally weighted three-factor apportionment formula, and provide no place on the form to calculate property and payroll factors. Accordingly, a taxable entity will need to make significant disclosures to first claim the election and then calculate equally weighted three-factor apportionment. Furthermore, the compact does not provide guidance on whether the election must be made on an original return, or whether an amended return can be filed to make the election. Absent such guidance, amended returns within the standard Texas statute of limitations may suffice to allow a taxable entity to make the MTC election.[94]

Regardless of the amended report filing position, it is expected that any taxpayer taking the MTC alternative apportionment position on a Texas refund claim will be subject to contentious audit by the state of Texas and invite litigation. While an opportunity exists, finality on the ability of a Texas taxpayer to utilize the MTC three-factor alternative apportionment formula will likely be settled at the Court level. In general, such an election will benefit those companies that are commercially domiciled outside of Texas, as the equally weighted three-factor apportionment method provides greater apportionment dilution.

[94] Tex. Tax Code § 111.104(b).

LOCATION OF PAYOR

The most notable apportionment provisions under the Texas franchise tax is the "location of payor" rule. This rule, a result of both Texas state case law and Comptroller Rule, specifies that many types of income resulting from, among other things, the sales of intangibles, receipt of dividends and/or interest, or similar types of revenue streams are to be sourced based upon the "legal domicile of the payor."[95] The determination of legal domicile can vary depending upon the payor entity's legal status. Thus, the legal domicile of a corporation or limited liability company is defined to be its state of incorporation/formation.[96] Alternatively, the legal domicile of a partnership or trust is the location of its day-to-day operations or, if that is not easily ascertainable, its commercial domicile.[97] Commercial domicile is defined as the principal place from where an entity's trade or business is directed.[98]

Furthermore, the Comptroller's apportionment regulation provides that receipts from the sale of securities are to be apportioned based on the location of the payor.[99] If securities are sold through an exchange, and the buyer cannot be identified, 7.9% of the revenue is a Texas receipt.[100]

PLANNING OPPORTUNITY:
ALLOCATION OF NONUNITARY INCOME

Unlike the former franchise tax, the revised Texas franchise tax provisions provide no mechanism to allocate or apportion those items of non-unitary revenue excluded from total revenue under Comptroller Rule 3.587(c)(9). Under the former franchise tax provisions, in

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95 34 Tex. Admin. Code § 3.591(e)(8)(C).
96 34 Tex. Admin. Code § 3.591(b)(7).
97 *Id.*
98 34 Tex. Admin. Code § 3.591(b)(2).
99 34 Tex. Admin. Code § 3.591(e)(25).
100 *Id.*

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response to the Court's decision in Allied-Signal, the Texas legislature realized that if the Court could exclude income from the tax base in a full apportionment state like New Jersey, the same treatment could occur for corporations operating in Texas. Because of the potential drain on state revenues, the legislature passed former Texas Tax Code § 171.1061, effective for reports due on or after January 1, 1994 and prior to January 1, 2008, requiring a corporation commercially domiciled in Texas to allocate all non-unitary income, except interest and dividends, to Texas.[101]

Former Texas Tax Code § 171.1061 was further interpreted by the Texas Comptroller by regulation.[102] First, the Comptroller established a presumption that all income is unitary.[103] This was consistent with the unitary cases imposing the distinct burden on showing by clear evidence that the state is taxing extraterritorial values.[104] The rule also incorporated the three factors discussed by the Supreme Court in Allied-Signal to determine when income can be allocated: centralization of management, functional integration, and economics of sales, as well as the investment nature of the income.[105]

While the Court has not established any rules as to how the states can tax non-unitary income, it has set the stage for state legislatures to rely on its precedents to allocate intangible non-unitary (nonbusiness) income. As the Court noted in Allied-Signal:

> …[I]f anything would be unworkable in practice, it would be for us now to abandon our settled jurisprudence defining the limits of state power to tax under the unitary business

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[101] Acts 1993, 73rd Leg., ch. 546, § 5, effective January 1, 1994.
[102] 34 Tex. Admin. Code § 3.576.
[103] 34 Tex. Admin. Code § 3.576(b).
[104] *Container Corp.*, 463 U.S. at 180, n. 19.
[105] 34 Tex. Admin. Code § 3.576(b)(6).

> principle. State legislatures have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary state… [W]ere we to adopt [the state's] theory, we would be required to invalidate those statutes or authorize what would be certain double taxation…[W]e would defeat the reliance interest of those corporations that have structured their activities and paid their taxes based upon the well-established rules we here confirm.[106] (Emphasis Added).

Thus, according to the Court, state legislatures are afforded the opportunity to define how they will tax items of non-unitary (nonbusiness) income.

The overwhelming majority of states have sought to capitalize on this constitutional right by adopting the Uniform Division of Income for Tax Purposes Act ("UDITPA") or similar statutory schemes. These taxing regimes provide rules that attribute the income of a taxpayer, whose income is taxable both within and without the state, to the various states in which the taxpayer is taxable. The determination whether a taxpayer's income is allocated under rules that generally attribute the income to a single state or is apportioned under rules that attribute the income to all of the states in which the taxpayer has nexus depends on whether the income is determined to be "business income" or "nonbusiness income." Under UDITPA and similar taxing regimes, all business income is apportioned; all nonbusiness income is allocated.[107]

UDITPA defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute

[106] *Allied-Signal*, 112 S. Ct. at 2262.
[107] UDITPA §§ 4, 9.

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integral parts of the taxpayer's regular trade or business operations."[108] Nonbusiness income is defined as "all income other than business income."[109] There is little substantive difference between UDITPA's definition of apportionable business income and the Supreme Court's definition of income arising from a unitary business.[110]

Texas has never adopted the above referenced UDITPA provisions. Under the former Texas franchise tax regime the legislature was clear in defining the scope of its authority to tax items of non-unitary (nonbusiness) income: any corporation commercially domiciled in Texas was required to allocate all non-unitary income to Texas. However, under the revised franchise tax regime, this language was removed completely and replaced by Comptroller rules solely requiring that such income be excluded from the calculation of Texas total revenue. In the absence of anything specifically on point for such non-unitary income under the revised franchise tax provisions, an opportunity exists to exclude such non-unitary income from Texas total revenue and the gross receipts apportionment factor.

However, taxable entities commercially domiciled in Texas are left questioning what to do in the face of Texas' apparent refusal to explicitly capitalize on its constitutional right to tax such non-unitary income of Texas domiciled taxable entities. Because the Texas regulations state that such non-unitary revenue is to be excluded from both total revenue and the Texas gross receipts apportionment factor, and provides no provision to allocate the non-unitary revenue directly to Texas as it did under the former franchise tax regime, a position may exist to exclude net gains on the dispositions of interests from Texas taxable margin.

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108 UDITPA § 1(a).
109 UDITPA § 1(e).
110 *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 112 S. Ct. 2251, 2262 (1992) ("business income" definition "quite compatible with the unitary business principle").

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PLANNING OPPORTUNITY:

NATURAL GAS AND NATUARL GAS LIQUIDS ("NGLS") AS INTANGIBLES

Commodities

As discussed above, for purposes of calculating the numerator of the Texas single-factor formula, sales of intangibles are apportioned based on the location of the payor.[111] While the term "intangibles" is not defined for Texas franchise tax purposes, Comptroller Rule provides examples of intangibles.[112] These examples suggest that Texas treats natural gas and NGLs as intangibles since one of the enumerated examples is a "commodity," a term that is commonly understood to include natural gas and NGLs.

While Texas does not define the term "commodity" for purposes of the franchise tax, Black's Law Dictionary defines a commodity as:

> An article of trade or commerce…[t]he term embraces only tangible goods, such as products or merchandise, as distinguished from services…[a]n economic good, esp[ecially]. a raw material or an agricultural product..[113]

The Commodity Exchange Act, a law that provides federal regulation of all futures trading activities, further defines the term "commodity" inclusively and embraces: wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and

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[111] 34 Tex. Admin. Code § 3.591(e)(21)(B).
[112] 34 Tex. Admin. Code § 3.591(e)(2).
[113] *Black's Law Dictionary*, Ninth Edition, (2009).

oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in Public Law 85-839, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.[114]

Under both the Black's Law and Commodity Exchange Act's definition, nearly every article of movable or personal property would be considered a commodity, including natural gas and NGLs. However, it is unlikely that Texas intended the term to be given such a broad meaning for purposes of the Texas franchise tax and are unlikely to serve as guidance to Texas in interpreting what items are intangibles.

Most notably, IRC § 475(e) defines the term "commodity" to mean:

a. Any commodity which is actively traded (within the meaning of section 1092(d)(1))[115];

b. Any notional principal contract with respect to any commodity described in subparagraph (A);

c. Any evidence of an interest in, or a derivative instrument in, any commodity described in subparagraph (A) or (B), including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity; and

d. Any position which:

[114] 7 U.S.C.S. § 1a(4).

[115] IRC § 1092(d)(1) provides that the term "personal property" means any personal property of a type which is actively traded.

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i. Is not a commodity described in subparagraph (A), (B), or (C),

ii. Is a hedge with respect to such a commodity; and

iii. Is clearly identified in the taxpayer's records as being described in this subparagraph before the close of the day on which it was acquired or entered into (or such other time as the Secretary may by regulations prescribe).[116]

In reviewing the various authorities where the term commodity is defined, the IRC definition stands out as one of the more restrictive definitions, but even this limiting definition is likely to include natural gas and NGLs. Natural gas is a physical commodity that is frequently traded on national exchanges, including the New York Mercantile Exchange, the world's largest commodity futures exchange. NGLs are physical commodities that are regularly traded on a number of exchanges, including the Houston Mercantile Exchange, an independent and neutral online commodity exchange for energy, chemicals, metals, plastics and other industrial raw materials. Therefore, because natural gas and NGLs are commodities actively traded on exchanges, natural gas and NGLs meet the requirement under IRC § 475(e)(A), and thus, may be characterized as commodities for Texas franchise tax purposes.

The federal income tax definition is more restrictive than the definitions provided in Black's Law or Commodity Exchange Act, and therefore, Texas would likely defer to the IRC's narrow definition of the term "commodity." Moreover, Texas courts have a history of looking to the IRC for guidance. For example, in Anderson-Clayton Bros. Funeral Home, Inc., v. Staryhorn,

[116] IRC § 475(e).

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the taxpayer argued that the same accounting methods used to report federal income tax should be used to apportion investment earnings, and because the Taxpayer's trusts were ignored for federal income tax purposes, the trusts should likewise be ignored for Texas franchise apportionment purposes.[117]

In reaching its decision, the court examined the relevant IRC sections in order to construe a Texas statute but ultimately determined that while the federal statute was relevant, Texas precedent trumped the IRC analysis. In the case of the proper apportionment methodology for natural gas and NGLs, if a Texas court were to examine the IRC precedent, natural gas and NGLs would likely be included in the definition of the term commodity. Unlike Anderson-Clayton there does not appear to be contrary precedent in Texas law, thus the IRC interpretation is likely to have significant weight.

The treatment of natural gas and NGLs as commodities, and thus intangibles, is further supported by the examples of intangibles provide by Comptroller rule, which provides that "[e]xamples of intangibles include, but are not limited to, stocks, bonds, commodities, futures contracts, patents, copyrights…[118] Although the Comptroller expressly included futures contracts, the Comptroller only included the term commodities, and not commodities contracts. Accordingly, it may be inferred that the Comptroller specifically intended to include physical commodities within the meaning of the term intangible.[119]

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[117] *Anderson-Clayton Bros. Funeral Home, Inc. v. Strayhorn*, 149 S.W.3d 166 (Tex. App. - Austin, 2004).

[118] 34 Tex. Admin. Code § 3.591(e)(2).

[119] It should be noted that 34 Tex. Admin. Code § 3.591(e)(2) which provides examples of intangibles is entitled Capital Assets and Investments. Under 34 Tex. Admin. Code § 3.557(b)(2), the predecessor of 34 Tex. Admin. Code § 3.951(b)(6), an investment was defined to include "Any non-cash asset that is not a capital asset and that is neither held as inventory nor proceeds from the sale of inventory." Under 34 Tex. Admin. Code § 3.951(b)(6), investment is simply defined as: "any non-cash asset that is not a capital asset." Capital asset is defined as "any asset, other than an investment, that is held for use in the production of income, and that is subject to depreciation, depletion or amortization." 34 Tex. Admin. Code § 3.591(b)(1) With the elimination of the inventory language from the definition of investment under the revised Comptroller Rules, every non-cash asset must be either an investment or a capital asset for Texas franchise tax apportionment purposes.

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Additional persuasive authority for the treatment of natural gas and NGLs as an intangible item is further supported by the Pennsylvania Supreme Court's decision in Equitable Gas Co. v. School District. of Pittsburgh.[120] At issue in the case was whether natural gas met the definition of "goods," "wares," or "merchandise" under the Mercantile License Tax. In Equitable Gas, the court described natural gas as an invisible, volatile, ephemeral and fugacious commodity that, although not subject to touch, is capable of being possessed, has weight and volume, and is subject to precise measurement and sale in metered amounts. The court examined the definitions of the terms "goods," "wares" and "merchandise" and stated that "none of those definitions describes an invisible, volatile, ephemeral, fugacious gas. The court held that "[w]e repeat, goods, wares or merchandise according to their common popular meaning denote tangibles not intangibles like 'natural gas.'"

It should be noted that Comptroller Rule § 3.591(e)(29)(E) appears to treat oil and gas sold to an interstate pipeline with delivery in Texas as the sale of tangible personal property. However, this rule addresses a specific transaction (i.e. sales to an interstate pipeline). With the adoption of Federal Energy Regulatory Commission ("FERC") Order No. 636, which federally requires interstate pipelines subject to FERC regulation to "unbundle" (i.e., separate) their sales services from their transportation services and to provide all transportation services on a basis that is equal in quality for all gas supplies, natural gas is rarely sold to an interstate pipeline. Similarly, Comptroller Rule § 3.591(f)(1) treats certain natural gas revenues realized by a natural gas producer as sales of tangible personal property. Again, this provision is inapplicable to the

As such, the provisions under 34 Tex. Admin. Code § 3.591(e)(2) should apply to every non-cash asset even if held as inventory.

[120] 404 Pa. 321 (Pa. 1961).

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treatment proscribed herein, as it addresses only sales by natural gas producers, rather than natural gas transporters.

Furthermore, the inclusion of these provisions may suggest that natural gas is actually considered an intangible in Texas. If natural gas was characterized as tangible personal property, it would not be necessary to enact specific rules sourcing sales of natural gas as sales of tangible personal property. A more logical reading of these rules would be that the Comptroller understood natural gas to be other than tangible personal property, but chose to source these specific sales (gas producer and interstate pipeline) as sales of tangible personal property based upon destination.

It should also be noted that in an administrative ruling request, the Comptroller determined that receipts from the sale of future contracts were intangibles sourced based upon location of payor; however, once the contract matured, receipts from the sale of the matured contract or receipts from the sale of warehouse receipts must be sourced to the place of delivery.[121] At the time of the decision, however, Texas did not define the term "intangibles" nor did it provide any examples of intangibles in its regulations.[122] As a result, the Comptroller was free to determine the proper treatment of commodities. Subsequent to this decision, however, Texas addressed this problem by specifically stating in its regulations that commodities are intangibles. Accordingly, a different conclusion may be reached today.

Securities

Under Comptroller Rule § 3.591(e)(25), receipts from the sale of securities are apportioned based upon location of payor; if the securities are sold through an exchange, and the

[121] Letter Ruling 8004T0186D01, Texas Comptroller of Public Accounts (April 8. 1980).
[122] See Rule 013, adopted December 31, 1975, effective August 15, 1980.

buyer cannot be identified, then 7.9% of the revenue is a Texas receipt.[123] "Security" was not defined under the former Texas franchise tax law; however, a definition of security was added under the revised Texas franchise tax. Under the Texas franchise tax, "security" is defined as an instrument defined under IRC § 475(c) (2), and includes instruments described by §475(e)(2)(B), (C), and (D) of that code.[124]

IRC § 475(e) defines the term "commodity" for the purpose of determining if a commodity would be required to be "marked to market," if the taxpayer makes an election under IRC § 475. Specifically, IRC § 475(e) defines the term "commodity" to mean:

(A) Any commodity which is actively traded (within the meaning of § 1092(d)(1))[125];

(B) Any notional principal contract with respect to any commodity described in subparagraph (A);

(C) Any evidence of an interest in, or a derivative instrument in, any commodity described in subparagraph (A) or (B), including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity; and

(D) Any position which:

   a. Is not a commodity described in subparagraph (A), (B), or (C),

   b. Is a hedge with respect to such a commodity; and

   c. Is clearly identified in the taxpayer's records as being described in this subparagraph before the close of the day on which it was acquired or

[123] 34 Tex. Admin. Code § 3.591(e)(25).
[124] Tex. Tax Code § 171.0001(13-2); 34 Tex. Admin. Code § 3.591(b)(9).
[125] IRC § 1092(d)(1) provides that the term "personal property" means any personal property of a type which is actively traded.

> entered into (or such other time as the Secretary may by regulations prescribe).[126] (Emphasis added).

IRC § 475(e)(2)(A) allows a taxpayer's physical inventory of a commodity, such as natural gas in a salt dome or grain in an elevator, to be marked to market. IRC § 475(e)(2)(B) permits a taxpayer's purely financial contracts, with no requirement or expectation of physical settlements to be marked to market. IRC § 475(e)(2)(C) allows a taxpayer's contracts for the physical sale of a commodity to be marked to market.

Natural gas and NGLs appear to meet the definition of security under IRC § 475(e)(2)(A). Although Texas specifically excludes IRC § 475(e)(2)(A) from its definition of security, it expressly includes IRC § 475(e)(2)(C), which incorporates IRC § 475(e)(2)(A) by reference. Specifically, IRC § 475(e)(2)(C) provides: Any evidence of an interest in, or a derivative instrument in, any commodity described in subparagraph (A) or (B), including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity.[127] Therefore, it appears that any commodity which is actively traded may be considered a security.

As discussed above, natural gas and NGLs are physical commodity that is frequently traded on national exchanges. Therefore, because natural gas and NGLs are commodities actively traded on exchanges, it appears that they meet the requirement under IRC § 475(e)(A), and thus, may be characterized as a security for Texas franchise tax purposes.

Although Texas' definition of security specifically includes IRC § 475(e)(2)(C), which incorporates IRC § 475(e)(2)(A) by reference; Texas may not permit the inclusion of physical

[126] IRC § 475(e).
[127] IRC § 475(e)(2)(C).

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commodities found in IRC § 475(e)(2)(A) in its definition of security since IRC § 475(e)(2)(A) was specifically excluded from Texas' definition of security. In such event, the definition of commodity under IRC § 475(e)(2)(C) may be used to classify the majority of the natural gas sales as sales of securities. As stated above, the Texas franchise tax defines "security" as an instrument defined under IRC § 475(c)(2), and includes instruments described by §475(e)(2)(B), (C), and (D) of that code. IRC § 475(e)(2)(C) defines a commodity to include "[a]ny evidence of an interest in, or a derivative instrument in, a commodity, including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity…"

Natural gas is purchased and sold through forward contracts. When a seller satisfies it obligation under a forward contract, either by delivery or purchasing an offsetting forward contract, a sale occurs by virtue of closing the forward contract. The sale proceeds thus relate to the security (forward contract) rather than the sale of the delivered commodity. This is necessitated by the fact that the forward contracts are subject to a mark-to-market election, and therefore, receipts are recognized as the value of the contracts increase or decrease rather than at satisfaction of the contracts.

Therefore, the closing of a forward contract may be considered a sale of the forward contract, and thus the receipts derived from the closing of the contract may be characterized as receipts from the sale of securities as defined for Texas franchise tax purposes.[128]

Contractual Rights

A position also exists that a seller of natural gas and NGLs is not actually selling the physical commodity but rather a contractual right to a specific quantity of natural gas or NGLs located in pipelines. A contractual right is typically not considered tangible personal property but an

[128] Tex. Tax Code § 171.0001(13-2); 34 Tex. Admin. Code § 3.591(b)(9).

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intangible. While the purchaser can state for certain that he has a right to a fixed amount of gas or liquids in the pipeline, it has no rights to any particular gas molecule or drop of liquid. Rather, the purchaser has a contractual right to withdraw natural gas or NGLs from the pipeline.[129]

In this way a pipeline system is similar to a bank. When gas or liquid is injected into the system, either by the pipeline owner or the pipeline customers, it is immediately commingled with one molecule being completely indistinguishable from the next. Thus, by injecting the gas or liquids into the system, the ownership of the gas and liquids are relinquished in exchange for a contractual interest allowing the withdrawal of an identical amount of gas or liquids. Similarly, when a natural gas or NGL seller makes a sale, it is not making a sale of gas or liquids; rather it is making a sale of a right to withdrawal a certain amount of gas or liquids from the pipeline system.

Accordingly, the sale of natural gas and NGLs may be considered the sale a contractual right. A contractual right is generally considered an intangible and as such, the receipts from the sale of the contractual right should be sourced based upon location of payor for Texas franchise tax purposes.

It should be noted that in Texas Hearing Number 7270, the Comptroller determined that advertising receipts are receipts for the performance of a service and not the receipts from the sale of an intangible property right.[130] The Comptroller determined that although the holder possessed an intangible property right when the contractual obligation was established, the

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[129] To the extent that the natural gas and NGLs are not commingled with natural gas and NGLs owned by unrelated parties in the pipeline, the position that seller is not actually selling the natural gas or NGL, but rather, a contract right to pull a certain amount of gas or NGLs from the pipeline would not apply.
[130] Texas Hearing No. 7270, 8205H0431B12 (December 31, 1981).

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fulfillment of the contract by the performance of a service creates receipts from the performance of a service rather than a sale of an intangible right.[131]

In a Texas administrative hearing, the contractual right was created by virtue of the selling of the advertising services. Although there existed a contractual obligation, the purchaser was actually purchasing identifiable advertising services. With regard to the sale of natural gas or NGLs in a pipeline, the purchaser has no rights to any particular gas molecule or drop of liquid, but only a contractual right to draw down a certain amount of gas or NGL. Therefore, because the purchaser has not underlying rights to the actual commodity, it is actually the contractual right being sold and not the underlying commodity.

Sourcing Sales of Natural Gas

To the extent the receipts from the sale of natural gas and NGLs are considered receipts from the sale of a commodity, security or contractual right, the receipts should be considered receipts from the sale of intangibles and sourced based upon the location of the payor for Texas franchise tax purposes.[132]

As previously discussed, the location of the payor is the legal domicile of the payor. For a corporation or limited liability company, its legal domicile is its state of incorporation or formation.[133] The legal domicile for a partnership is its principal place of business, i.e., the location of its day-to-day operations. If the day-to-day operations are conducted equally or fairly evenly in more than one state, then the principal place of business is the commercial domicile.[134]

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[131] *Id.*
[132] 34 Tex. Admin. Code §§ 3.591(e)(2), 3.591(e)(21)(B) & 3.591(e)(25).
[133] 34 Tex. Admin. Code § 3.591(b)(7).
[134] *Id.*

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Therefore, to the extent that natural gas and NGLs are being sold to purchasers legally domiciled outside of Texas, the receipts from such sales should be sourced outside of Texas and excluded from the numerator of the Texas receipts factor for Texas franchise tax apportionment purposes.

Inclusion of Gross or Net Receipts from Sales of Natural Gas

Under the Texas franchise tax, a taxable entity apportions its franchise by multiplying the franchise by the ratio of "gross receipts" from business done in Texas to "gross receipts" from business done everywhere. Texas Tax Code § 171.1121(a) provides that "'gross receipts' means all revenues reportable by a taxable entity on its federal tax return, without deduction for the cost of property sold, materials used, labor performed, or other costs incurred, unless otherwise specifically provided in this chapter."[135] In addition, Comptroller Rule § 3.591(d)(5) provides that "when a taxable entity computes gross receipts for apportionment, the taxable entity is deemed to have elected to use the same methods that the taxable entity used in filing its federal income tax return." Texas law further provides that "[i]f a taxable entity sells an investment or capital asset, the taxable entity's gross receipts from its entire business for taxable franchise includes only the net gain from the sale."[136] However, "if a loan or security is treated as inventory of the seller for federal income tax purposes, the gross proceeds of the sale of that loan or security are considered gross receipts."[137]

Based upon the above provisions, it appears that the gross proceeds from the sale of natural gas and NGLs may be included in the receipts factor to the extent (1) the natural gas and NGLs

[135] Tex. Tax Code § 171.1121(a).
[136] Tex. Tax Code § 171.105(b).
[137] Tex. Tax Code § 171.106(f).

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are considered a "security" under the Texas franchise tax and (2) the natural gas and NGLs are treated as inventory by the seller for federal income tax purposes.

To the extent that natural gas and NGLs does not meet the definition of "security" for Texas franchise tax purposes but is considered an intangible as either a commodity or contractual right, it is less clear whether the net or gross proceeds from the sale of natural gas and NGLs will be included in the receipts factor. Based upon the broadening of the definition of investment to include every non-cash asset that is not a capital asset, natural gas and NGLs may be considered investments under Comptroller Rule § 3.591(b)(6). As an investment, only the gain from the sale of natural gas and NGLs would be included in the receipts factor. However, to the extent that the natural gas and NGLs are held as inventory, the inclusion of only the net gain is inconsistent with how such receipts are reported for federal income tax purposes, and thus, inconsistent with the Texas Tax Code § 171.1121(a) which defines gross receipts in reference to the revenue reported on the entity's federal income tax return. Furthermore, Comptroller Rule § 3.591(d)(5) provides that in computing gross receipts for apportionment purposes, a taxable entity is deemed to have elected the same methods the taxable entity used in filing its federal return. To report the receipts from the sales of natural gas and NGLs at gross on the federal return and include only the net gain in the sales factor appears to be in contradiction of this provision. Therefore, it appears that a better interpretation of the Texas law is that regardless of whether an asset is classified as an investment under the new Texas franchise tax rules, the gross rather than the net receipts from the sale of such asset should be included in the receipts factor to the extent the asset is treated as inventory for federal income tax purposes and the gross revenues are reported on the federal income tax return.

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operating on a global level for fear that their earnings and profits will be further decreased by Uncle Sam‘s greed.

Instead the United States and similar taxation bodies should shift their economic focus to encouraging investors to expand business operations. As one commentator put it, ―[i]t is better for the United States to abandon taxation on foreign subsidiaries than to continue the farce of stated taxation that does not actually occur.”[195] By allowing these companies to repatriate the foreign-earned profits back into the United States without fear of high taxation rates, the economy would reap the benefits, as shareholders would reintroduce these monies back into the U.S. economy and the Treasury would be able to tax accordingly. As Congress aimlessly continues its search for a more effective substitute for the previously enacted § 965,[196] more domestically-owned corporations will be drawn to implement measures to increase profit-margins for the benefit of their shareholders. Ironically, the greedy taxing powers of the United States should heed the words of Google‘s corporate slogan—―Don‘t be evil.”

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[195] *See* Mauntel, *supra* note 69**,** at 127.

[196] *See id.* (―Section 965 was helpful as a herald for change in the taxation of international controlled corporations, but that call was ignored in 2004. Now with the economic crisis in full force, the United States Congress has a duty to reevaluate the international corporate taxation system, beginning with a reintroduction of section 965. The financial gains from repatriations will then fuel a more complete overhaul of the system, closing loopholes which allow transfer of assets abroad and eliminating taxes that other developed nations have abandoned. These steps will ensure a more effective taxation system and more robust competition by U.S.-based multinationals.”).