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CHAIR'S MESSAGE

The time has come for goodbye. Before I get all weepy and philosophical on you, first let me inform you of a few items.

Since my last letter, we have submitted comments to Congress regarding the proposed carried interest legislation and to the IRS and Treasury regarding proposed regulations aimed at eliminating abuses that are occurring in connection with refund anticipation loans. Moreover, I testified to the Treasury and the IRS concerning their proposed regulations that would add certain transactions involving patented tax strategies to the disclosure regime that currently exists for other abusive transactions. Copies of those comments and my testimony are available on our Website — www.texastaxsection.org. Many thanks to Jeff Wallace and Seth Kaufman, respectively, who headed up these two Comment projects, and as always to Mary McNulty and Dan Baucum, who have served as Chair and Vice Chair, respectively, of our COGS Committee this year. It appears that our Comment output for the year will nearly quadruple our output in any prior year, and to all of you who have helped raise the national profile of the Section of Taxation of the State Bar of Texas by assisting with the submission of Comments, I express to you my heartfelt thanks.

My only remaining wish in this regard is that the legislation banning tax strategy patents that we first proposed in January of 2007 would become law. That project continues to move forward, albeit at a a glacial pace, and I have spent many hours with Congressional staff and fellow laborers in this vineyard working on final language. Hopefully by the time you read this letter, I will have good news to report.

Our Webcasts continue to break new ground, and Tina Green continues to perform extraordinarily above and beyond the call of duty to manage this initiative.

On the Pro Bono front, we had a rousing success at the May 5 calendar call of the United States Tax Court. Under the leadership of Elizabeth Copeland, we had a total of 9 volunteers from our Membership show up at that calendar call to assist *pro se* taxpayers, and those volunteers actually helped 5 taxpayers who would otherwise have been forced to proceed to trial without representation. I am so proud of this initiative and want to give major applause to Elizabeth and our volunteers for this fine effort.

Alyson Outenreath continues to do a wonderful job as the Editor of *The Texas Tax Lawyer*, and I would be remiss in not recognizing her very effective work this year.

And I could go on and on. The entire Council, the Committee Chairs and Vice Chairs, and the Membership at large—you have all been a pleasure to work with and have made my term as Chair a very rewarding one.

As we near the summer, don't forget to register to attend the Texas Federal Tax Institute that will be held in San Antonio on June 5 and 6. Each year I am astounded at the quality of the speakers we continue to attract and wonder how we will top that quality in the ensuing year, but it appears that we have. If you aren't planning to attend, then you are missing the best tax program, pound for pound, in the country.

Finally, our Annual Meeting is scheduled for the morning and lunch of June 27, 2008 in Houston. Gene Wolf and Christi Mondrik have planned a wonderful program, and our incoming Council members will be elected at the formal Annual Meeting of the Section that is a part of that program. The Nominating Committee—consisting of Robert Gibson, David Wheat and Jack Taylor—has nominated David E. Colmenero, James Michael Threet and Mark Martin to serve three-year terms to the Council upon their election by the Membership at the Annual Meeting.

I might also have a few things to say.

Speaking of Council Members—I want to extend a very special thanks to the three Council Members whose terms expire at the Annual Meeting, those being Dan Baucum, Tina Green and Mary McNulty. They have each given stalwart service to the Section in many capacities, and it has been a pleasure to serve with them. Moreover, although their formal three-year terms as Council Members are ending, Dan and Tina have agreed to continue in their leadership roles with the COGS and CLE Committees, respectively, and as such will continue as Council Members in those roles. Mary has been chosed for a different job.

At the meeting of the Council that was held on April 18, 2008, the Nominating Committee nominated Tyree Collier, Patrick O'Daniel and Mary McNulty to serve as Chair-Elect, Secretary and Treasurer, respectively, of the Section for its 2008-2009 year. Dan Micciche will be your new Chair. Congratulations to you all.

Almost finally — I have been truly blessed to serve with Dan, Tyree and Patrick this last year. They have done everything I've asked — and I've asked for a lot. Guys, thanks so much. I'll miss you, although I doubt you'll miss me!

And finally—I started actively working with the Section of Taxation of the State Bar of Texas in 1993. I have served under many extraordinary Chairs in a variety of roles, and my parting words to you would be this—I don't regret a single minute of time spent in service to you and in working with my fellow leaders of the Tax Section. The prophet Haggai, when encouraging the Children of Israel to rebuild the Temple in Jerusalem, exhorted them to "Be strong—and work!" In doing the work of our Section, I've tried to be strong for the good of our profession and our Section, and I leave you with the same exhortation.

Be strong—and work!

It's the least we can do for a profession that has given us so much and for our treasured colleagues, without whom we would lose heart.

Until we meet again,

Kevin

A PRACTITIONER'S GUIDE TO ADDRESSING CODE SECTION 409A ISSUES IN MERGERS AND ACQUISITIONS[1]

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On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 into law, which, among other things, added section 409A to the Internal Revenue Code of 1986, as amended.[3] Code section 409A, and the subsequent guidance issued thereunder, significantly revised the rules affecting the design and operation of many types of compensation arrangements and agreements that are now considered to be "nonqualified deferred compensation." While Code section 409A generally penalizes the employee (and not the employer or plan sponsor) for noncompliance, the employer is actually the party in the best position to evaluate which agreements now constitute "nonqualified deferred compensation" and how best to address issues in mergers and acquisitions relating to these plans. Thus, in light of these new rules, practitioners advising parties to mergers and acquisitions should now add considerations relating to nonqualified deferred compensation plans to their list of issues to address in mergers and acquisitions. This article summarizes some of these considerations, and includes a discussion of the provisions found in the final Treasury Regulations issued on April 17, 2007 under Code section 409A that specifically address issues relevant to mergers and acquisitions. While this article provides a general overview of Code section 409A and how it impacts issues in mergers and acquisitions, it assumes that the reader is somewhat familiar with the general requirements of Code section 409A, and thus, does not provide an in-depth discussion of all of the requirements of Code section 409A.

THIS ARTICLE MAY ANSWER GENERAL QUESTIONS THAT MAY ARISE WITH REGARD TO CODE SECTION 409A AND THE OTHER GUIDANCE ISSUED THEREUNDER, BUT SHOULD NOT BE RELIED UPON TO ANSWER SPECIFIC QUESTIONS. THIS ARTICLE IS FOR EDUCATIONAL PURPOSES ONLY. NOTHING HEREIN SHALL CONSTITUTE LEGAL ADVICE BY THE AUTHOR OR THE LAW OFFICES OF HAYNES AND BOONE, LLP. ANY TAX ADVICE CONTAINED IN THIS OUTLINE IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (I) AVOIDING PENALTIES UNDER THE INTERNAL REVENUE CODE OR (II) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY TRANSACTION OR OTHER MATTER ADDRESSED HEREIN. EACH CASE VARIES DEPENDING UPON ITS FACTS AND CIRCUMSTANCES. ANYONE SEEKING TAX ADVICE SHOULD CONSULT WITH HIS, HER, OR ITS TAX ADVISOR.

Overview of Code Section 409A

Code section 409A provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture and have not been previously included in gross income. Under Code section 409A, a "nonqualified deferred compensation plan" includes any agreement, method, program, or other arrangement, including an agreement, method, program, or other arrangement that applies to one person or individual, that provides for the deferral of compensation (i.e., where the service provider obtains a legally binding right to compensation in one taxable year, but the compensation is not paid until a subsequent taxable year). See Treas. Reg. § 1.409A-1(a), (b), and (c). Nonqualified deferred compensation plans can include programs otherwise subject to section 3(3) of ERISA (for example, severance plans can be subject to Code section 409A) and agreements, methods, programs, or other arrangements offered by a foreign employer. See Treas. Reg. § 1.409A-1(a) and (c). In analyzing what constitutes a "plan" for purposes of Code section 409A, practitioners must apply the requirements of Code section 409A "as if a separate plan or plans is maintained for each service provider" (i.e., for each employee, director, or independent contractor). Treas. Reg. § 1.409A-1(c)(1). The following arrangements and agreements are among the many forms of compensation covered by Code section 409A's broad definition of a nonqualified deferred compensation plan:

- Stock options granted at below market value (discounted options)—options on employer stock granted at fair market value (as determined in accordance with the requirements of Code section 409A) are not covered;
- Supplemental executive retirement plans (SERPs) and other nonqualified retirement arrangements;
- Restricted stock units, phantom stock, and performance share plans;
- Certain severance pay programs;
- Code section 457(f) plans;
- Certain stock appreciation rights (SARs);
- Many long-term or multi-year bonus or commission programs; and
- Any other employment, bonus or compensation agreements, even if covering only one employee, that results in the deferral of the taxation of compensation.

In connection with mergers and acquisitions, practitioners must be particularly careful since retention agreements, change in control agreements, severance arrangements, employment agreements, and the delayed payout of amounts in connection with the cash-out of options or other equity awards could all potentially fall within the broad definition of "nonqualified deferred compensation plan" for purposes of Code section 409A.

Overview of Transitional Guidance

On December 20, 2004, the Internal Revenue Service (the "IRS") released the first round of transitional guidance in the form of Notice 2005-1, which was written in Q&A format and provided much-needed transition relief and interpretations of Code section 409A's key terminology. Notice 2005-1 was the first phase of a series of guidance issued in 2005, 2006, 2007 and 2008. On September 29, 2005, the IRS released the second round of transitional guidance in the form of proposed regulations (referred to herein as the "Proposed

Regulations"). The IRS issued the Proposed Regulations in final form on April 17, 2007, with a January 1, 2008 effective date (referred to herein as the "Final Regulations").

The Treasury Department and the IRS have also issued ten additional notices providing transition guidance with respect to Code section 409A: (1) Notice 2005-94, 2005-52 IRB 1208 (transition guidance with respect to 2005 reporting and withholding obligations); (2) Notice 2006-4, 2006-3 IRB 307 (transition guidance with respect to certain outstanding stock rights); (3) Notice 2006-33, 2006-15 IRB 754 (transition guidance with respect to the application of section 409A(b)); (4) Notice 2006-64, 2006-29 IRB 88 (interim guidance regarding payments necessary to meet Federal conflict of interest requirements); (5) Notice 2006-79, 2006-43 IRB 763 (additional transition relief); (6) Notice 2006-100, 2006-51 IRB 1109 (transition guidance with respect to 2005 and 2006 reporting and withholding obligations); (7) Notice 2007-78, 2007-41 IRB 780 (additional transitional relief); (8) Notice 2007-86, 2007-46 IRB (replaces Notice 2007-78 transition relief and generally extends transition relief until the end of 2008); (9) Notice 2007-89, 2007-46 IRB 998 (transition guidance with respect to 2007 reporting and withholding obligations); and (10) Notice 2007-100, 2007-52 IRB 1243 (additional transition relief and guidance on correction of operational failures).

Under the foregoing cited guidance, nonqualified deferred compensation plans were required to *operate* in good faith compliance with Code section 409A and the various Notices described above and/or the Proposed Regulations throughout 2005, 2006, and 2007. If plans complied with the Proposed Regulations, even if the Proposed Regulations were inconsistent with the provisions of Notice 2005-1, the plans were still considered to be in good faith compliance with Code section 409A. Taxpayers are no longer permitted to rely upon the provisions of the Proposed Regulations other than (i) sections II.E and VI.E of the preamble to the Proposed Regulations (relating to the application of Code section 409A to partners and partnerships) until further guidance is issued, and (ii) sections XI.C (relating to changes in payment elections or conditions) and XI.H (relating to substitutions of non-discounted stock options and stock appreciation rights for discounted stock options and stock appreciation rights) of the preamble to the Proposed Regulations to the extent provided in section 3 of Notice 2006-79, as modified and superseded by paragraph (B) of section 3.01 of Notice 2007-86. See Notice 2007-86.

During 2008, while taxpayers are not required to rely on the provisions of the Final Regulations, they must operate plans in accordance with their terms (to the extent not inconsistent with issued guidance) and to the extent an issue is not addressed in Notice 2005-1 or other applicable guidance, the taxpayers can rely on the Final Regulations. To the extent taxpayers do not rely on the Final Regulations, they must apply a reasonable, good faith interpretation of the statute. Effective for taxable years beginning on or after January 1, 2008:

- Except for certain guidance which remain effective as modified by other applicable guidance, Notice 2005-1 no longer applies;

Notice 2006-4 is superseded by the Final Regulations for stock rights (i.e. options, stock appreciation rights) that are issued in taxable years beginning on or after January 1, 2008;

- Notice 2006-33, Notice 2006-79, and Notice 2006-100 are not affected by the Final Regulations;

- Notice 2006-33 relief is not extended by Notice 2007-78 or Notice 2007-86;

- Notice 2006-64 is superseded by the Final Regulations;

- Notice 2006-100 is generally extended by Notice 2007-89;

- Transition relief in Notice 2007-78 is largely superseded by Notice 2007-86;

- Notice 2007-86 extends transition relief provided in Notice 2006-79 and the Final Regulations; and

- Notice 2007-100 provides limited relief for certain operational failures involving limited amounts occurring before 2010.

It is important to note that although Code section 409A makes a number of extensive changes, it does not alter the application of any other provision of the Code or common law tax doctrine. Thus, Code section 409A should be treated as an "overlay" to existing rules applicable to nonqualified deferred compensation plans.

Because Code section 409A's definition of nonqualified deferred compensation is significantly broader than its traditional meaning, and noncompliance with the new rules results in onerous adverse tax consequences to the affected employees, practitioners should focus on identifying all arrangements of the parties to a merger or acquisition that fall within Code section 409A's purview, developing a strategy to ensure that the parties business objectives in the transaction do not trigger adverse tax consequences to employees on Code section 409A, and making the necessary modifications to the merger or purchase agreement to protect against noncompliance and to document how the parties intend to address any issues with respect to the parties nonqualified deferred compensation plans.

Due Diligence and Pre-Closing Considerations

Identification of Nonqualified Deferred Compensation Plans

The expansion of the definition of "nonqualified deferred compensation plans" by Code section 409A has generated some confusion in mergers and acquisitions when target companies are asked by the buyer to produce copies of all "nonqualified deferred compensation plans and agreements." Depending upon the size of the target, it may not have outside benefits or tax counsel advising it on what plans or agreements it has that are responsive to this request. Accordingly, the target may believe that the only documents it maintains that are responsive to such a request are the nonqualified plans it sponsors that benefit only a select group of management or highly compensated individuals (commonly referred to as "top-hat plans"). Of course, in order to respond to such a request, the target also must review all of its other plans, programs, arrangements and agreements to ensure that they do not fail within the broad definition of nonqualified deferred compensation plans. However, unless the request from the buyer is more specific, the target may not provide a complete response.

Accordingly, practitioners should consider expanding their initial request for documents to include a request such as the following:

> Please list all "nonqualified deferred compensation plans" (as defined by Code section 409A), including

without limitation, severance agreements or plans, top-hat plans, discounted stock options or stock appreciation rights, long-term or multi-year bonus arrangements, supplemental retirement or other nonqualified retirement benefit plans, and any other program that provides for the deferral of compensation. Please include any terminated plans and any plans of non-U.S. employers. With respect to the plans listed in response to the foregoing, please provide copies of all such plans.

While such a request still may not result in a full production of documents, it may at least make the initial response by the target more inclusive. By identifying these programs earlier in the transaction, the parties will have more time to address any planning considerations relating to these programs without delaying the transaction.

Identification of Specified Employees

Code section 409A provides that each nonqualified deferred compensation plan must provide that distributions to "specified employees" may not be made before the date that is six months after the date of the employee's separation from service, or, if earlier, the date of the specified employee's death (commonly referred to as the "six-month delay rule"). See Treas. Reg. § 1.409A-1(c)(3)(v). Generally, a specified employee is an employee employed by a publicly-held corporation who, as of the date of his or her separation from service is a "key employee" (generally an employee who, during the 12-month period ending on the company's specified employee identification date (typically December 31st, unless an alternate date is selected by the employer), meets the requirements of Code section 416(i)(1)(A)(i), (ii),or (iii) (disregarding Code section 416(i)(5))).[4] If an employee is a key employee as of a "specified employee identification date", the employee is treated as a key employee for the entire 12-month period beginning on the "specified employee effective date" (generally the first day of the fourth month following the specified employee identification date). See Treas. Reg. § 1.409A-1(i)(5).

Although Code section 409A sets forth a specific definition of "specified employee", the regulations also permit companies to elect, in accordance with the following requirements, to use any reasonable alternative method to determine who constitutes a specified employee:

- The alternative method must be designated in the plan document;
- The alternative method must be reasonably designed to include all specified employees (determined without respect to any available employer elections);
- The alternative method must be an objectively determinable standard providing no direct or indirect election to any employee regarding its application; and
- The alternative method must result in either all employees or no more than 200 employees being identified in the class as of any date.

Treas. Reg. § 1.409A-1(i)(5). Regardless of which method is selected by the employer, the employer should describe, in writing, its procedures for identifying specified employees. In addition, any election to use an alternative method is effective only as of the date that all necessary corporate action has been taken to make such elections binding for purposes of all affected nonqualified deferred compensation plans. Treas. Reg. § 1.409A-1(i)(8). In order to determine whether all corporate action has been taken, practitioners should review the terms of the applicable nonqualified deferred compensation plans to determine what corporate action is required to amend the terms of the plan document.

In conducting due diligence, practitioners should consider asking the target to not only provide a list of those employees it has identified as specified employees, but also a copy of its procedures used to identify specified employees, the specified employee identification date and specified employee effective date used by the target, and, if an alternative method was used for identification of specified employees, copies of all documents that document the corporate action required to elect to use the alternative method.

In addition to the specific rules provided by the Final Regulations for purposes of determining who constitutes a specified employee, the regulations also provide examples of how to determine who constitutes a specified employee following a merger or acquisition, where significant changes in corporate structure and the employee population will impact who constitutes a specified employee. For purposes of the rules discussed below, the "specified employees" as of the date of a merger or acquisition include any specified employees identified using an alternative method, provided that the alternative method was established and effective as of the closing date of the merger or acquisition. See Treas. Reg. § 1.409A-1(i)(6)(v).

Publicly-traded Company Acquired by Privately-Held Company

If a company that was part of a publicly-traded company is acquired by a privately-held company, and following the acquisition, the acquired company is no longer considered to be a publicly-traded company, the post-acquisition company is not required to comply with the six-month delay rule. Thus, even if an employee would have been subject to the six-month delay immediately prior to the transaction, he or she could receive a distribution immediately following the transaction without any delay in payment. However, in conducting due diligence, it is important to review the target's plans to determine how the plans' payment provisions are drafted. For example, some companies have chosen to provide that all payments from the plans upon a separation from service shall be made on the first day of the seventh month following the participant's separation from service to avoid any risk of improperly identifying specified employees. If the plans contained such a provision, the fact that the company is no longer a publicly-held company will not impact the timing for payment under the plans.

Merger of Two Publicly-Traded Companies

Treasury Regulation § 1.409A-1(i)(6)(i) provides that, if as a result of a merger or acquisition, two or more separate publicly-traded corporations become one publicly-traded corporation following the merger or acquisition, the resulting corporation should use the next "specified employee identification date" and the "specified employee effective date" following the merger or acquisition that the acquiring corporation would have used absent the occurrence of the merger or acquisition. Treas. Reg. § 1.409A-1(i)(6)(i). For purposes of Code section 409A, the "acquiring corporation" in a corporate merger is the surviving or resulting corporation in the merger; in the case of a stock acquisition, it is the corporation that acquired the stock. In cases other than a merger or stock acquisition, the "acquiring corporation" is determined based upon all of the facts and circumstances. Id.

For the period between the closing date of the merger or acquisition and the next specified employee effective date, the Final Regulations provide that the resulting public company should combine the lists of specified employees of all of the companies participating in the merger or acquisition that were in effect at the closing date of the merger or acquisition. Id. The resulting corporation then should rank the employees on the combined lists in order of the amount of compensation used to determined each specified employee's status as a specified employee and treat the top 50 individuals on such list as specified employees. Id. The resulting corporation also should include any 1-percent or 5-percent owners (as described in Code section 416(i)(1)(ii) or Code section 416(i)(1)(iii) and the regulations thereunder) as specified employees. Id.

In addition to the foregoing, the resulting corporation may use an alternative method for the identification of specified employees if: (i) the use of an alternative method complies with the requirements discussed above, (ii) is adopted no later than 90 days after the closing date of the merger or acquisition, and (iii) the parties apply the method prospectively from the date the method is adopted. Id.

Merger Between Privately and Publicly-Traded Companies

In the event a privately-held company merges with a publicly-traded company, and the resulting corporation is a publicly-traded company, the resulting corporation's next specified employee identification date and specified employee effective date following the merger are the dates the publicly-traded company would have been required to use had the merger not occurred. Treas. Reg. § 1.409A-1(i)(6)(ii). During the period beginning on the closing date of the merger and ending on the next specified employee effective date, the specified employees of the publicly-traded company prior to the merger continue to be specified employees of the resulting corporation. Id. The Final Regulations do not require any of the employees of the privately-held company to be treated as specified employees. Id.

Spinoffs

In the event a publicly-traded company in connection with a merger, acquisition, or sale becomes two or more separate publicly-traded corporations, the separate companies must continue to treat those individuals identified as specified employees prior to the transaction as specified employees until the next specified employee identification date. Treas. Reg. § 1.409A-1(i)(6)(iii) In addition, both corporations must continue to use the next specified employee identification date that the pre-transaction publicly-traded corporation would have used had the transaction not occurred. Id. If a publicly-traded company becomes two or more separate corporations, one of which is privately held, the publicly-traded company would follow the rules for publicly-traded companies in a spinoff, and the privately-held company would no longer have to apply the six-month delay, since it is no longer considered a publicly-traded company.

Review Option Granting Practices

Code section 409A treats the following categories of stock options as "nonqualified deferred compensation", if the stock options have an exercise price that is less than the fair market value of the underlying stock on the date of grant:

- Options granted on or after January 1, 2005;
- Options granted before January 1, 2005, but which were not fully vested as of January 1, 2005 (provided, however, that Code section 409A will only apply to the unvested portion of the option); and
- Options granted and vested before January 1, 2005, if they were "materially modified" on or after October 3, 2004.

A "material modification" is generally defined as the material enhancement of a benefit or right existing as of October 3, 2004 or the addition of a new material benefit or right, that affects the amount earned and vested before January 1, 2005. Treas. Reg. § 1.409A-6(a)(4). Code section 409A does not treat a stock option as "nonqualified deferred compensation" if:

- The option has an exercise price equal to or greater than the fair market value of the underlying stock at the time of grant, regardless of when it was granted, so long as the stock option does not contain any additional "deferral" feature (such as, for example, a feature that would allow individuals to defer the gains from the exercise of their option to a later date); and
- The option was granted and fully vested before January 1, 2005 (and not materially modified after October 3, 2004), regardless of whether the option was an "at-market" grant or a "below-market" grant and regardless of when it is exercised.

Since whether a stock option will be subject to Code section 409A depends upon whether the option was granted with an exercise price equal to or greater than fair market value, practitioners should include a review of the target's option granting practices in its due diligence. This review should focus on whether the target's board of directors or compensation committee adopted resolutions approving the option grants, the date of the option grants in relation to the date of those resolutions, the methodology used by the board of directors or compensation committee to determine fair market value, and whether any material amendments have been made to the options since their original date of grant.

This review becomes particularly important if the parties in the transaction intend to accelerate vesting for the options and "cash-out" the options at closing. If the options are discounted options and the parties accelerate vesting of the awards or pay cash to the optionees in connection with the termination of the options, the parties may unintentionally subject the optionee to taxation under Code section 409A.

Currently, and through the end of 2008, the guidance issued under Code section 409A provides a transition period, during which companies can correct these discounted stock options either to be exempt from Code section 409A (by repricing the options to the fair market value of the underlying stock at the date of grant) or to otherwise comply with the requirements of Code section 409A (by setting a fixed time or date for exercise). The transition period generally extends until December 31, 2008, except that, for options granted to individuals who, at the time of grant, were "officers" under Section 16(a) of the Securities Exchange Act of 1934, if the company has reported or reasonably expects to report a financial expense due to the issuance of back-dated options, the transition period ended on December 31, 2006. (See "Overview of Transitional Guidance" above). The transition relief extends only to unexercised options; currently, there is no mechanism to correct an already exercised option to retroactively comply with Code section 409A. However, any correction must be completed prior to the cash-out of the options. Accordingly, any proposed "correction" should be

considered prior to execution of the purchase agreement, and implemented prior to the closing date. Thus, identification of these issues during the due diligence phase is imperative.

Review of Other Equity Granting Practices

In addition to a review of the target's option granting practices, practitioners also should ensure that other equity awards granted by the target are either exempt from or compliant with the requirements of Code section 409A. For instance, while restricted stock awards are generally exempt from the requirements of Code section 409A, if the restricted stock has a subsequent deferral feature (such as the deferral of the receipt of shares upon vesting), the award may be subject to Code section 409A. Treas. Reg. § 1.409A-1(b)(6). Stock appreciation rights, like stock options, must be granted with an exercise price that is equal to or greater than the fair market value of the underlying stock on the date of grant in order to be exempt from the requirements of Code section 409A, warranting a close review of how the target has determined the fair market value of its stock for equity awards. Treas. Reg. § 1.409A-1(b)(5)(1)(B). In addition, restricted stock units or other stock-based awards that do not provide for receipt of stock or cash within the year that the award vests (or within the 2 ½ month period following the close of such year), may also be subject to Code section 409A. In order to avoid possible adverse tax consequences associated with the cash-out of awards in connection with a transaction, practitioners must evaluate each type of award granted, and whether the award, either on its face or based on the target's granting procedures, is subject to the requirements of Code section 409A.

Review of Nonqualified Plans for Operational Compliance

As discussed above, there is a transition period currently in effect, during which companies have the opportunity to amend their nonqualified deferred compensation plans to comply with the requirements of Code section 409A. However, even though there is a transition period, nonqualified deferred compensation plans still need to be operated in compliance with the terms of the plans to the extent not inconsistent with the transition guidance in effect, beginning with the first transition guidance issued, Notice 2005-1, as well as in good faith compliance with Code section 409A. (See "Overview of Transitional Guidance" above). Accordingly, during the due diligence review, counsel to both the target and the buyer should review the target's operation of its nonqualified deferred compensation plans to ensure that payments have not been impermissibility accelerated, payments to specified employees upon their separation from service were delayed for the six month period when required, and that the operation of the plans did not otherwise violate the guidance in effect during the transition period.

New Severance and Employment Agreements for Target's Employees

In mergers and acquisitions, it is not uncommon for the buyer or resulting corporation to enter into new employment agreements with any employees of the target that continue employment with the buyer or resulting corporation at closing. In addition, those employees who will not be continuing employment with the buyer or resulting corporation are often offered severance agreements effective post-closing. When drafting these new agreements, practitioners must make sure that any payment or benefit, or entitlement to a payment or benefit, included in the new agreement does not act as a substitute for, or replacement of, amounts considered to be "deferred compensation" under another plan or program covering such employee (or a prior agreement with respect to that employee that is still in effect). If an employee, director, or independent contractor receives a payment or a new agreement and also has a legally binding right to a payment or has a prior agreement in effect subject to Code section 409A that would be forfeited upon receipt of the new payment or new agreement, the right to the new payment or the new agreement may, depending upon the facts and circumstances, constitute an impermissible acceleration of payment of the forfeited deferred compensation or a change in the time and form of payment under the prior agreement, which may cause the service provider (i.e., the employee, director, or independent contractor) to be subject to taxation under Code section 409A. See Treas. Reg. § 1.409A-1(b)(9)(i) and Treas. Reg. § 1.409A-3(f). Moreover, the Final Regulations provide that, in the case of payments made upon a separation from service where the separation from service is voluntary, it is presumed that the new payments result from an acceleration of vesting followed by a payment of the deferred compensation that is subject to Code section 409A, which would potentially trigger taxation under Code section 409A. Id. This presumption that a right to payment is not a new right, but is instead a right substituted for a pre-existing forfeited right, may be rebutted if the parties can demonstrate that the service provider would have obtained the right to the payment regardless of the forfeiture. Treas. Regs. § 1.409A-1(b)(9) and § 1.409A-3(f). Practitioners should ensure that the individuals negotiating the business terms of the transaction (including the employment and severance agreements with the target's employees) understand that there may be limitations on what the parties can do without triggering adverse tax consequences to the employees, directors, and independent contractors.

Termination of Nonqualified Deferred Compensation Plans

Practitioners should consider whether the parties want to continue the nonqualified deferred compensation plans post-closing, or if they want to terminate the plans and make distributions to the employees. There is some relief provided in the Final Regulations that allows the parties to prevent distributions to employees in connection with their separation from service in connection with an asset sale (as discussed below in "Merger or Purchase Agreement Issues"). However, there are no similar provisions that allow the parties to treat a participant to have incurred a separation from service in connection with a stock sale or merger. Thus, even if the nonqualified deferred compensation plan is sponsored at the parent level, the subsidiary's stock is sold and the employees no longer work for the same "controlled group" that sponsors the nonqualified deferred compensation plan, the merger or acquisition would not be treated as a "separation from service" entitling the participant to a distribution under Code section 409A.

Under the Final Regulations, however, the parties can still provide for distributions to these participants by terminating or liquidating the portion of the nonqualified deferred compensation plan that covers the participants impacted by the transaction. Specifically, Treasury Regulation § 1.409A-3(j)(4)(ix) provides that a nonqualified deferred compensation plan or arrangement can provide for the acceleration of the time and form of payment under the plan, if the following conditions are met:

- The portion of the plan covering the participants is terminated or liquidated pursuant to irrevocable action by the plan sponsor within the 30 days preceding or

the 12 months following a change in control event (as defined in the Final Regulations);

- All agreements, methods, programs, and other arrangements sponsored by the plan sponsor immediately after the time of the change in control event that are treated as a single plan (within the meaning of Treasury Regulation § 1.409A-1(c)(2)) are terminated and liquidated with respect to each participant that experienced the change in control event; and

- All participants in such plans that experienced the change in control event are required to receive all amounts of compensation deferred under the terminated agreements, methods, programs, and other arrangements within 12 months of the date the plan sponsor irrevocably takes all necessary action to terminate and liquidate the agreements, methods, programs, and other arrangements.

See Treas. Reg. § 1.409A-3(j)(4)(ix)(B). For purposes of determining which entity (buyer, seller, or in a merger, the resulting corporation) has the discretion under this provision of the Final Regulations to terminate and liquidate the nonqualified deferred compensation plans, the Final Regulations look to the entity that is primarily liable immediately *after* the transaction for the payment of the deferred compensation under the plans. Id. If the transaction is a stock sale and the nonqualified deferred compensation plans are maintained at the parent level, arguably this action can be taken any time within the 30 day period immediately prior to or the 12 month period following the change in control event, because the entity primarily liable *after* the transaction for payment of the deferred compensation would be the parent company, not the buyer. However, if the transaction is a merger or a stock sale of the company that sponsors the plan, the entity primarily liable for paying the deferred compensation immediately *after* the change in control event is the buyer or the resulting corporation. Thus, if the employees impacted by the transaction who participated in the terminated plans prior to the transaction also begin participating in similar plans of the buyer or resulting corporation following the closing date, then the parties may not be able to rely on this provision to terminate the plans without also terminating those same employees' participation in the buyer's similar plans. The following are sample resolutions for a board of directors to adopt to terminate or liquidate plans in accordance with Treasury Regulation § 1.409A-3(j)(4)(ix):

WHEREAS, the Company previously entered into a Merger Agreement by and among the Company, **[Insert Names of Other Parties to the Merger Agreement]**, pursuant to which **[Insert Name of Acquiror]** will merge with and into the Company (the "Merger");

WHEREAS, the Merger is scheduled to close on ____________;

WHEREAS, the Merger constitutes a "change in control event" with respect to the Company, as such term is defined by the final regulations issued on April 17, 2007 under Section 409A of the Internal Revenue Code of 1986, as amended (the "Final Regulations");

WHEREAS, the Company sponsors the **[Insert Plan Name]** for the benefit of its eligible employees (the "Plan");

WHEREAS, the Final Regulations permit the Company to terminate and liquidate the portion of the Plan with respect to each participant in the Plan who experienced a "change in control event", so that following such termination and liquidation all such participants are required to receive all amounts of compensation deferred under the Plan within twelve (12) months of the date the Company irrevocably takes all necessary action to terminate and liquidate the Plan with respect to such participants;

WHEREAS, Section ___ of the Plan authorizes the Company to amend and to terminate the Plan; and

WHEREAS, the Company desires to irrevocably terminate and liquidate the portion of the Plan with respect to each participant in the Plan who experienced a "change in control event", in accordance with the Final Regulations.

NOW, THEREFORE, BE IT RESOLVED, that, as of ____________, the portion of the Plan with respect to the participants in such Plan who experienced a "change in control event" in connection with the Merger be and hereby is irrevocably terminated and liquidated; and, be it

RESOLVED FURTHER, that the proper members of the Company be, and each of them hereby is authorized and directed to take any and all actions and to execute any and all documents as they may deem necessary or advisable to carry out the intent of these resolutions, including, without limitation, taking all actions necessary to ensure that the amounts of compensation deferred under the Plan with respect to the participants in such Plan who experienced a "change in control event" are distributed to such participants no later than the date that is 12 months following the date of this Unanimous Written Consent.

Merger or Purchase Agreement Issues

The nature of the transaction will dictate whether practitioners will want to add any provisions to the merger or purchase agreement relating to Code section 409A. The following outlines the provisions practitioners may want to consider for inclusion based upon the type of transaction.

Asset Purchase

In an asset purchase, since the buyer generally will not assume the target's liabilities and will not assume any of the nonqualified deferred compensation plans of the target, absent unusual facts or circumstances, there likely will be no need to include specific Code section 409A provisions in the asset purchase agreement. However, if the target does sponsor nonqualified deferred compensation plans, the parties should consider whether they want those plans to make distributions to the impacted participants in connection with their termination of service with the target. Code section 409A provides additional flexibility regarding whether a sale or other disposition of assets by one service recipient (the seller) to an unrelated service recipient (the buyer), would constitute a separation from service. See Treas. Reg. § 1.409A-1(h)(4). Typically, a service provider of the seller would experience a separation from service in the event of a sale of substantially all of the assets of the company or a division of the company for which the service provider works. However, Treasury Regulation § 1.409A-1(h)(4) provides that in a sale of assets from a seller to an unrelated buyer (as determined in accordance with the Final Regulations), the parties may specify that the participants who were employed

by the seller prior to the transaction and are employed by the buyer after the transaction have not incurred a "separation from service" and thus, would not be entitled to a distribution from the seller's nonqualified deferred compensation plans, so long as:

- The asset purchase results from bona fide, arm's length negotiations;
- All participants providing services to the seller immediately before the transaction and providing services to the buyer after and in connection with the transaction are treated consistently (regardless of position at the seller) for purposes of applying the provisions of any nonqualified deferred compensation plan; and
- Such treatment is specified in writing no later than the closing date of the asset purchase.

See Treas. Reg. § 1.409A-1(h)(4). For purposes of this provision, an "asset sale" only refers to a transfer of substantial assets, such as a plant or division or substantially all the assets of a trade or business. Id. If the asset sale is the sale of a division or a product line and the seller will continue as an on-going concern, the parties may want to avoid having the transaction result in a taxable distribution to participants, in which case, the parties may want to rely upon this provision in the Final Regulations.

Stock Purchase or Merger

If the transaction is a stock purchase where the nonqualified deferred compensation plans are sponsored by a target whose stock is being purchased, or if it is a merger, the buyer generally assumes the liabilities of the target and the nonqualified deferred compensation plans the target sponsors and maintains. Accordingly, the buyer should consider including provisions in the representations and warranties and the covenants of the purchase or merger agreement that specifically address Code section 409A. The following are sample representations and warranties set forth in recent merger and purchase agreements filed with the Securities and Exchange Commission:

> No compensation paid or required to be paid under any Employee Plan is or will be subject to additional tax under Section 409A(1)(B) of the Code. Zevex Int'l, Inc., Current Report (Form 8-K), at 19 (January 17, 2007).
>
> Except as listed in Schedule 3.7(e) of the Disclosure Schedule, neither the Company nor the Subsidiary maintains, or sponsors any nonqualified deferred compensation plan subject to 409A of the Code. With respect to any such nonqualified deferred compensation plan listed in Schedule 3.7(e) of the Disclosure Schedule, (i) such plan has been operated in good faith with 409A of the Code and the guidance issued thereunder, and (ii) the transaction contemplated by this Agreement will not result in 409A of the Code imposing any tax consequences to the participants in such plan (including the inclusion in income of deferred amounts, or any additional tax pursuant to 409A(a)(1)(B) of the Code. Steel Dynamics, Inc., Current Report (Form 8-K), at Exhibit 10.6, 23 (July 6, 2007).
>
> Section 4.20(f) of the Company Disclosure Letter lists each Employee Plan maintained, contributed to or under which the Company, Company Sub or any ERISA Affiliate has had any Liability for the period after December 31, 2004 providing for deferred compensation that constitutes a "nonqualified deferred compensation plan" (as defined in Section 409A(d)(1) of the Code and regulations and notice promulgated thereunder, hereinafter "IRS Guidance") for any service provider to the Company, Company Sub or any ERISA Affiliate (or any entity that together with the Company, Company Sub or any ERISA Affiliate would be a "service recipient" as defined in Code Section 409A and IRS Guidance) (the "Deferred Compensation Plans"). Each Deferred Compensation Plan (i) complies with requirements of Code Section 409A and IRS Guidance, or (ii) is exempt from compliance under the "grandfather" provisions of such IRS Guidance, and has not been materially modified since October 3, 2004, or (iii) may, without the consent of any service provider or other Person and without any Liability to the Company, Company Sub or any ERISA Affiliate (or any entity that together with the Company, Company Sub or any ERISA Affiliate would be a service recipient), other than for the payment of benefits due thereunder, the full amount of which has been reflected on the GlasCraft Balance Sheet, be amended or terminated to comply with or to be exempt from, the requirements of 409A of the Code and IRS Guidance. Each "nonqualified deferred compensation plan" has been operated in good faith compliance with any applicable IRS Guidance for the period after December 31, 2004. Cipar, Inc., General Form For Registration of Securities of Small Business Issuers (Form 10-SB), at Exhibit 10.1, 31-32 (January 8, 2008).
>
> Except as set forth in the Disclosure Schedule, (i) each Section 409A Benefit Plan complies in form with Section 409A of the Code, and (ii) no service provider under any Section 409A Benefit Plan is subject to the additional income tax under Section 409A of the Code. Am. Med. Sys. Holdings, Inc., Current Report (Form 8-K), at Exhibit 10.1, 25 (May 9, 2006).
>
> Each Acquired Company Employee Plan, Acquired Company Employment Agreement, or other contract, plan, program, agreement, or arrangement that is a "nonqualified deferred compensation plan" (within the meaning of Section 409A(d)(1) of the Code) has been operated in good faith compliance with Section 409A of the Code and the applicable provisions of IRS Notice 2005-1, proposed Treasury Regulation §§ 1.409A-1 through 1.409A-6, and any subsequent guidance relating thereto; and no additional tax under Section 409A(a)(1)(B) of the Code has been or is reasonably expected to be incurred by a participant in any such Acquired Company Employee Plan, Acquired Company Employment Agreement, or other contract, plan, program, agreement, or arrangement. Conexant Sys., Inc., Current Report (Form 8-K), at Exhibit 10.1 (October 2, 2006).
>
> Neither the Company nor any Subsidiary has any obligation to make any Tax gross up payments as a result of the interest and penalty provisions of Section 409A of the Code to any individual. Golden

> Telecom, Inc., Current Report (Form 8-K), at Exhibit 2.1 (December 27, 2007).

The following are sample covenants found in recent merger and purchase agreements filed with the Securities and Exchange Commission:

> Notwithstanding the foregoing, except as set forth in Section 4.1 of the Company Disclosure Schedule, the Company shall not, and shall not permit any of its Subsidiaries, without the prior written consent of Parent and Merger Sub (which consent shall not be unreasonably withheld or delayed), to: … (g) except as required to comply with Law and except as described in Section 4.1(g) of the Company Disclosure Schedules, (i) adopt, enter into, terminate, amend, or increase the amount or accelerate the payment or vesting of any benefit or award or amount payable under, any Employee Plan or other arrangement for the current or future benefit or welfare of any current or former director, officer or Employee, other than to the extent necessary to avoid adverse tax consequences under Section 409A of the Code and the proposed regulations and guidance thereunder. Zevex Int'l, Inc., Current Report (Form 8-K), at 31-32 (January 17, 2007).

> Parent will cause the Surviving Corporation to assume and perform all of the payment obligations only (and not any other obligations) of Company under the terms of the Executive Employment Agreements and to pay the employees under the Executive Employment Agreements within three (3) Business Days of the Effective Time of the Merger the change of control payments due under such Executive Employment Agreements to the extent not paid prior to the Effective Time of the Merger. Parent and the Surviving Corporation shall be entitled to deduct, withhold and transmit to the proper tax authorities from the consideration otherwise payable to any such employee such amounts as are required to be withheld under the Code, or any applicable provision of state, local or foreign Tax law. To the extent that amounts are so withheld and transmitted, such withheld and transmitted amounts shall be treated for all purposes of this Agreement as having been paid to such employees in respect of which such deduction and withholding was made. In the event Section 409A(a)(1)(B) of the Code requires a deferral of any payment to an employee who is a "key employee" as that term is defined in Code 409A, such payment shall be accumulated and paid in a single lump sum on the earliest date permitted by Code 409A. Notwithstanding the Surviving Corporation's assumption of the payment obligations under the Executive Employment Agreements, the non-competition provisions therein shall be void and of no effect and the employees under the Executive Employment Agreements shall be bound solely by the provisions in the Restrictive Covenant Agreements. As a condition to Surviving Company paying any amounts under the Executive Employment Agreements, the employees to be receiving such amounts must execute release agreements, in form and substance acceptable to Parent. All amounts payable by the Surviving Corporation to employees under the Executive Employment Agreements are included as Transaction and Retention Bonuses and, in turn, as Assumed Transaction Expenses and Debt. Cipar, Inc., General Form For Registration of Securities of Small Business Issuers (Form 10-SB), at Exhibit 10.1, 53 (January 8, 2008).

> Company and Parent will cooperate in good faith to mitigate the effects of Sections 280G and 409A of the Code on the Company, Company employees and directors, including obtaining waivers and seeking shareholder approval of the payments and benefits as set forth in Section 5.1 of the Company Disclosure Schedule of any "excess parachute payment" under Section 280G of the Code. Nationsrent Cos., Inc., Current Report (Form 8-K), at Exhibit 10.1 (July 21, 2006).

> As soon as practicable after the Effective Time, Parent shall deliver, or cause to be delivered, to each person receiving a Substitute Option as a result of the Merger an appropriate notice setting forth such holder's rights pursuant thereto. Parent shall also take such action that it deems appropriate for the Company Stock Options that are intended to be exempt from the application of Section 409A of the Code to be adjusted as Substitute Options in a manner that complies with Treasury Regulation § 1.409A-1(b)(5)(v)(D). Wits Basin Precious Minerals, Inc., Current Report (Form 8-K), at Exhibit 10.1, 9 (April 26, 2007).

> In the event Section 409A(a)(1)(B) of the Code requires a deferral of any payment to an employee who is a "key employee" as that term is defined in Code 409A, such payment shall be accumulated and paid in the single lump sum on the earliest date permitted by Code 409A. Enpath Med., Inc., Current Report (Form 8-K), at Exhibit 2.1, 55 (April 30, 2007).

> Notwithstanding the preceding sentence, payment of the portion of an account that is subject to Section 409A of the Code to a specified employee within the meaning of Section 409A of the Code who has a separation from service on or before the Company Merger Effective Time shall be delayed to the date six months following such participant's separation from service in the event, and only in the event that, prior to the Company Merger Effective Time the Company Board determines that such delay is necessary to comply with the requirements of Section 409A of the Code. Highland Hospitality Corp., Current Report (Form 8-K), at Exhibit 2.1, 50 (April 27, 2007).

> If any outstanding Company Equity Award has an exercise price that is less than fair market value of the Shares underlying such Company Equity Award on the date such Company Equity Award was granted, the Company shall, in consultation with Parent, take such steps as are approved in writing by Parent to amend, prior to December 31, 2008, or such later date as is permitted under the applicable regulations or guidance issued by the Internal Revenue Service, the terms of such Company Equity Award to the extent reasonably required to avoid the imposition of a tax under Section 409A of the Code. Golden Telecom, Inc., Current Report (Form 8-K), at Exhibit 2.1 (December 21, 2007).

The foregoing provisions have been included as illustrations of what other practitioners have drafted for purposes of addressing Code section 409A issues in the merger or purchase agreement. Their inclusion in this article is not intended as a recommendation that any of these provisions be used in other transactions. Of course, practitioners must based their decision on whether a specific provision should be included in an agreement based upon the facts and circumstances with respect to the merger or acquisition.

Post-Closing Payments Based on the Value of Stock

In connection with mergers and acquisitions, it is not uncommon for the payment terms of change in control bonuses or the cash-out of equity awards to be linked to the timing of receipt of the sale proceeds by the selling stockholders or the selling corporation. For example, if the purchase price is payable partially in cash at closing, with an additional amount subject to a holdback or earn-out, the selling company may want to make the employees' bonuses or option-holders' payments contingent upon release of the proceeds from the holdback or satisfaction of the earn-out provisions. However, under the initial guidance issued under Code section 409A, these types of payment provisions were problematic because the payments under a holdback or earn-out would generally span more than one taxable year and would not be paid at a fixed time or in accordance with a fixed schedule. In response to comments from practitioners, the Final Regulations offer a solution to this problem by providing that payments of compensation to service providers (i.e., employees, directors, independent contractors) in connection with a "change in control event" (as defined by the Final Regulations) upon the purchase of the target's stock or an option (or other equity award) held by the service provider or as a bonus calculated by reference to the value of the target's stock, will not violate the initial or subsequent deferral election rules of Treasury Regulation § 1.409A-2(a) and (b) if the compensation is paid: (i) on the same schedule and under the same terms and conditions as apply to payments to shareholders generally with respect to stock of the target pursuant to a change in control event or as they apply to payments to the target pursuant to a change in control event and (ii) not later than five years after the change in control event. See Treas. Reg. § 1.409A-3(i)(5)(iv)(A). Practitioners should evaluate whether the transaction will actually constitute a "change in control event" as defined by Code section 409A before proposing this approach to their clients, and, if the parties intend to rely on this provision of the Final Regulations, they should ensure that any provisions of the purchase or merger agreement that address these type of transaction-based compensation arrangements clearly provide that the payments will be made in accordance with the requirements of the Final Regulations. The following is an example of a provision that relies on this exception for purposes of paying amounts to optionholders:

> Payment of the Per-Share Holdback Consideration to the holders of Company Options shall be made no later than five (5) years after the Effective Time and in accordance with the requirements of Treasury Regulation Section 1.409A-3(i)(5)(iv).

In addition, the Final Regulations provide that if before and in connection with a change in control event (as defined by the Final Regulations), the parties subject compensation that would otherwise be payable in connection with the transaction to a payment condition that constitutes a substantial risk of forfeiture (as defined in Treas. Reg. § 1.409A-1(d), without regard to the provisions of that section under which additions or extensions of forfeiture conditions are disregarded, and provide that the compensation is payable under the same terms and conditions as they apply to payments made to shareholders generally with respect to stock of the target in connection with to the change in control, then, the compensation may constitute a "short-term deferral". Treas. Reg. § 1.409A-3(i)(5)(iv). In order to determine whether such compensation does constitute a short-term deferral, the Final Regulations permit the parties to apply the requirements of Treasury Regulation § 1.409A-1(b)(4) as if the legally binding right to such transaction-based compensation arose on the date that it became subject to such substantial risk of forfeiture. Id. Of course, it is imperative that if practitioners are going to advise their clients to rely on this exception in the regulations that they ensure that the condition on payment actually constitutes a "substantial risk of forfeiture" under the Final Regulations.

Conclusion

Although the service provider (i.e., the employee, director, or independent contractor) is the party ultimately responsible for the taxes due in the event a nonqualified deferred compensation plan violates Code section 409A, most service providers do not have the ability to revise or modify their current nonqualified deferred compensation plans without the cooperation of the employer, and may not even be aware of the potential issues under Code section 409A that should be addressed in these plans, whether in normal operations or in the context of a merger or acquisition. Accordingly, practitioners should begin discussing the possible implications Code section 409A may have on the nonqualified deferred compensation plans sponsored by the parties to a transaction as early as possible in the transaction, so that the parties can properly consider Code section 409A's impact on their business goals for the transaction. With proper planning, the parties to a transaction should be able to avoid a violation of Code section 409A, while still achieving the overall business objectives that caused them to contemplate the transaction in the first place.

ENDNOTES

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3 All references to the "Code" shall be references to the Internal Revenue Code of 1986, as amended, unless the context clearly indicates otherwise.

4 An officer of the employer having an annual compensation greater than $130,000 ($150,000 for 2008) (no more than 50 employees (or, if lesser, the greater of 3 employees or 10 percent of the employees) shall be treated as officers); a 5-percent owner of the employer; or a 1-percent owner of the employer having an annual compensation from the employer of more than $150,000.

THE IMPACT OF THE 2007 SMALL BUSINESS TAX ACT ON CIRCULAR 230

M. Todd Welty
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On May 25, 2007 the Small Business and Work Opportunity Act of 2007 was enacted into law, amending code Section 6694. The 2007 Small Business Tax Act brought about four big changes to Section 6694, the most controversial being an increase in tax return preparer standards from the "realistic probability of success" standard to the "more-likely-than-not" standard. The standard for disclosed positions also increased, from the "not frivolous" standard to the "reasonable basis" standard. Other changes include an extension of Section 6694 to all tax returns, and increased penalties. These changes were effective for returns prepared after May 25, 2007, but were subsequently delayed until the end of 2007. Following the enactment of the 2007 Small Business Tax Act, Circular 230, Section 10.34 was changed to reflect the revised Section 6694.

Congress amended Section 6694, changing the standards for disclosure, and the resulting penalties for non-disclosure. The "realistic possibility of success" standard was replaced with a "more likely than not" standard. The new standard is, not surprisingly, a higher standard. A "realistic possibility of success" is a one-in-three chance (33%) of prevailing on the merits of an issue[2], whereas "more likely than not" is a greater than fifty percent chance (51%) of prevailing on the merits.[3] Similarly, the minimum standard for a nondisclosed position is now higher. The former "not frivolous" standard, was replaced with a "reasonable basis" standard. The stakes are now higher as well, with an increase in penalties from a maximum of $250 to a maximum of $1,000.

This amendment caused several problems, the biggest problem being the disparity in reporting requirements for the taxpayer and tax return preparer which may lead to conflicts of interest. If the taxpayer has an understatement, and the preparer does not meet the "more likely than not" standard, that preparer may be penalized. Further, the return preparer may be penalized even if the taxpayer has substantial authority for that position and is not penalized. Thus the "more likely than not" requirement could lead to cases in which the return preparer would be subject to penalties, but the taxpayer would not.

Other problems are economic in nature, resulting form the increased scope of Section 6694's application. For example, the increased application of the heightened "more likely than not" standard increases the time, effort, and cost of preparing a return. This problem is compounded by the expansion of the statute to cover all return preparers, not just tax return preparers. Thus, Section 6694 penalties may even be issued in a case where an employee is mischaracterized as an "independent contractor", and a return preparer issues a Form 1099 instead of a W-2.

Circular 230 sets forth the rules that govern the conduct of individuals who are eligible to practice before the Internal Revenue Service. These rules determine who can engage in such practices, the duties and restrictions relating to such practice, sanctions for violating the rules and discipline proceedings. Historically, Circular 230 has been aligned with Code Section 6694, which set forth, among other things, the "realistic possibility of success" standard. Since code Section 6694 was amended under the Small Business and Work Opportunity Act there has been a conforming change to Circular 230 section 10.34.[4] These changes raised many questions.

On September 26, 2007, treasury published proposed amendments to Circular 230 §10.34 to conform the Circular 230 standards to the new standards for applying the preparer penalty in §6694(a).[5] The proposed regulation made a few clarifications. For example, it explained reasonable basis:

> A position is considered to have a reasonable basis if it is reasonably based on one or more of the authorities described in 26 CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations. Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.[6]

The proposed amendment establishes standards that are, in some ways, higher than the standards in Section 6694. Section 6694 applies only to tax return preparers, which are defined as:

> any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund. [7]

Thus, a person who "prepares a return or claim for refund of the employer (or of an officer or employee of the employer) by whom he is regularly and continuously employed," is not a return preparer under Section 6694.[8] But, Circular 230 §10.34(a) applies 6694(a) standards to returns prepared by the taxpayer or its employees if they are Circular 230 "practitioners"; consequently, the 6694(a) standards are expanded to those specifically exempted under the statute. The proposed Circular 230 Section 10.34 would require practitioners to establish a reasonable belief that all positions on the return meet the "more likely than not" standard, even though Section 6694 extends those obligations only to positions that the practitioner knows, or has reason to know of. The proposed regulation makes every practitioner who gives advice subject to 6694 penalties because they could be considered a "nonsigning practitioner".[9] A "nonsigning practitioner" violates Section 10.34 if a position is not disclosed on the return. But the nonsigning advisors cannot control whether client chooses to disclose a position on their return.[10]

On June 11, 2007, the IRS published Notice 2007-54 to provide "guidance and transitional relief for the return preparer penalty provisions under section 6694."[11] The Notice stated that pre-small business act rules would apply for all returns that were due on or before December 31, 2007.[12]

On December 31, 2007, the IRS released Notice 2008-11, Notice 2008-12, and Notice 2008-13. These Notices were intended to provide answers to some of the questions created when Section 6694 was amended. Treasury Tax Legislative

Counsel Michael Desmond stated that the government hoped the new guidance would "ensure there's an honest discussion between the taxpayer and the representative."[13] He further explained that the treasury is "trying to balance reconciling the statute with the regulations and at the same time ensure that [they're] not interrupting the filing season."[14]

Specifically, Notice 2008-11 clarifies which returns qualify for transitional relief. Notice 2008-12 identifies the returns required to be signed by a tax return preparer in order to avoid a section 6695(b) penalty under current regulations, and those that be required to be signed by a tax return preparer in order to avoid a section 6695(b) penalty under future regulations published by the Treasury Department and IRS. The list includes most types of individual returns on Forms 1040, partnership returns, and corporate returns. Notice 2008-12 also clarifies that if multiple people are preparing the return, the practitioner who "has the primary responsibility as between or among the preparers for the overall substantive accuracy of the preparation of such return or claim for refund" is the one who is to sign the return.

Notice 2008-13 is the more robust of the three Notices, providing comprehensive guidance on the changes to Section 6694, and the definition of return preparer in Section 7707(a)(36). Notice 2008-13 also provides helpful examples regarding the interim guidance for Section 6694 penalties. This guidance includes a list of "returns to which Section 6694 could apply." The returns are categorized as either (1) tax returns reporting tax liability, to which Section 6694 applies[15]; (2) information returns and other documents, to which Section 6694 applies "if the information reported on the information return or other document constitutes a *substantial portion* of the taxpayer's tax return;"[16] or, (3) returns that "would not subject a tax return preparer to the Section 6694(a) penalty unless prepared willfully in any manner to understate the liability of tax on a return or claim for refund or in reckless or intentional disregard of rules or regulations."[17] The definition of "tax return preparer" is revised by eliminating the word "income" as a modifier to "tax return preparer," making the regulation consistent with the statute. The Notice also allows the return preparer to rely on an analysis of the pertinent facts and authorities under § 1.6662-4(d)(3)(ii)[18] instead of the standard in § 1.6694-2(b)[19]. For purposes of making this determination, the return preparer may rely on information provided by the taxpayer and third parties, so long as that information does not appear to be incomplete or incorrect. A tax return preparer can also rely on third party advice in good faith when that third party is "not in the same firm as the tax return preparer" and the return preparer has reason to believe that third party "was competent to render the advice."[20]

Under Notice 2008-13, until further guidance is issued, a signing tax return preparer will avoid the Section 6694 preparer penalty for a position that meets the "reasonable basis" standard, but not the "more likely than not" standard if the return preparer meets **any** of the following requirements:

1. The position is disclosed in accordance with § 1.6662-4(f) (which permits disclosure on a properly completed and filed Form 8275, Disclosure Statement, or 8275-R, Regulation Disclosure Statement, as appropriate, or on the tax return in accordance with the annual revenue procedure described in § 1.6662-4(f)(2));

2. If the position would not meet the standard for the taxpayer to avoid a penalty under section 6662(d)(2)(B) without disclosure, the tax return preparer provides the taxpayer with the prepared tax return that includes the disclosure in accordance with § 1.6662-4(f);

3. If the position would otherwise meet the requirement for nondisclosure under section 6662(d)(2)(B)(i), the tax return preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 and the penalty standards applicable to the tax return preparer under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided; or

4. If section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C), the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between these standards and the standards under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided.

Nonsigning return preparers will avoid Section 6694 penalties in the same situation if they advise the taxpayer of the possibility of avoiding penalties by disclosing the position if there exists that possibility.

The new guidance is a step in the right direction, and a good sign that the Service is working on reconciling the statute and regulations. However, more guidance is still needed, and is anxiously awaited by practitioners.

ENDNOTES

1 By M. Todd Welty, a Partner at Meadows, Collier, Reed, Cousins, & Blau, LLP. and Claire I. Wade, an associate attorney at Meadows, Collier, Reed, Cousins, & Blau, LLP (adapted from the ABA Section of Taxation 2007-2008 Important Developments Report).

2 Treas. Reg. § 1.6694-2(b)(1).

3 Prop. Reg. § 10.34(e)(1) defines "more likely than not" as follows:

> A practitioner is considered to have a reasonable belief that the tax treatment of a position is more likely than not the proper tax treatment if the practitioner analyzes the pertinent facts and authorities, and based on that analysis reasonably concludes, in good faith, that there is a greater than fifty-percent likelihood that the tax treatment will be upheld if the IRS challenges it. The authorities described in 26 CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis.

4 Prop. Reg. § 10.34(e)(2).

5 Prop. Reg. § 10.34.

6 Prop. Reg. § 10.34(e)(2)

7 § 7701(a)(36).

8 § 7701(a)(36)(b)(ii).

9 Prop. Reg. §10.34(a)

10 The current sections 10.34(a) does not require that the nonsigning practitioner police the preparation.

11 Expanded or superseded by Notice 2008-11, Notice 2008-12, and Notice 2008-13.

12 Later January 2008 dates applied to estimated tax returns, employment and excise tax returns.

13 Alison Bennett, Demond Says Preparer Penalty Guidance Intended to Promote "Honest Discussion," BNA Daily Tax, January 22, 2007, at G-7.

14 *Id*.

15 Includes, among others, Form 1040, Form 1120, and Form 706.

16 (emphasis in original). Includes, among others, Form 1042-S, Form 1065, and Form 1120S.

17 Includes, among others, Form 1099, Form W-2, and Form SS-8.

18 "The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. . . There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision."

19 "A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits . . ."

20 Applies to both written and oral advice.

RECENT DEVELOPMENTS APPLICABLE TO TAX-EXEMPT ORGANIZATIONS

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The following article summarizes selected recent developments in the area of tax-exempt organizations during the October 2006-February 2008 period since the last Texas Tax Lawyer article relating to tax-exempt organizations was published.[2] The media and governmental agencies have increasingly focused scrutiny on tax-exempt organizations, leading to more pressure on such organizations to adopt best practices standards with respect to corporate governance and disclosure. Acknowledging the lack of legislative requirements governing tax-exempt organizations, the Internal Revenue Service ("IRS") has, in the past year, been particularly active in generating publications reflecting the IRS's ideal standards of conduct for such entities.[3] Also relevant was new guidance relating to political campaign activities, a revised Form 990, as well as a new mandatory "e-filing" requirement for tax-exempt organizations previously exempt from annual IRS filings.

1. IRS Issues Good Governance Practices for Section 501(c)(3) Organizations.[4]

In March 2007, the IRS issued a four-page document entitled "*Good Governance Practices for 501(c)(3) Organizations.*" This relatively simple document is intended for distribution to tax-exempt governing bodies, ostensibly to minimize recurring problems the IRS and other regulators have found within the industry. Many of the following are reflected in questions in the revised Form 990, issued later in 2007.[5]

a. The Mission Statement. The IRS recommends a "clearly articulated mission statement" that serves as a guide to the organization's purpose.

b. Code of Ethics and Whistleblower Policy. The code of ethics and whistleblower policies reflect similar requirements under the Sarbanes-Oxley rules applicable to public, for-profit corporations regulated by the Securities & Exchange Commission ("SEC").

c. Due Diligence Policies and Procedures. Such policies and procedures should be in place to inform the executives of the organization's activities and whether goals are met. The executives should be fully informed of financial and other details, and should have regular access to this information.

d. Duty of Loyalty. The IRS states that this duty is in part fulfilled by the adoption, adherence, and regular evaluation of a conflicts of interest policy.

e. Transparency. The Form 990 should be reviewed carefully and posted on the public web site.

f. Fundraising Policy. The IRS recommends that organizations have a written fundraising policy and keep costs reasonable. Care should be taken to document any relationship between outside fundraisers and organization executives and ensure compensation is arms'-length and assure the parties are not receiving excessive benefits from such relationships.

g. Financial Statements. The IRS recommends independent auditors if the organization has substantial assets or annual revenue, and recommends rotating firms every five years. This rotation ensures a fresh look at financials and compensation practices regularly.

h. Compensation Practices. The IRS restates the requirement of reasonable compensation determined by a compensation committee – this relates to the need to have a conflicts of interest policy and have that policy followed. It recommends that the compensation committee be comprised of people who are not compensated by the organization and have no financial interest in the determination.

i. Document Retention Policy. There should be a written document retention policy. The IRS refers to its brochure, Publication 4221 ("Compliance Guide for 501(c)(3)

Tax-Exempt Organizations"), which outlines suggested times for retaining various tax and corporate records.

2. IRS Issues Report on Exempt Organization Compensation.

Concurrently with the "Good Governance" document, the IRS issued its *Report on Exempt Organizations Executive Compensation Compliance Project (Parts I and II)*,[6] outlining findings from an executive compensation study of exempt organizations begun in 2004. During this process, the IRS contacted 1,826 exempt organizations, requesting various disclosures on executive compensation. The report resulted in the following general conclusions.

- Accurate reporting of executive compensation on the Form 990 was the main and most widespread problem. There were substantial omissions with respect to excess benefit transactions and transactions with disqualified persons.

- The IRS Exempt Organizations ("EO") Division intends to further educate the public charity sector about the section 4958 rebuttable presumption standard (relating to independent governing body, reliance on comparable data, and adequate documentation) and how to satisfy the requirements of the presumption.

- Problems with excessive compensation were not widespread, but where problems were found, the excise taxes assessed were significant. As such, "continued enforcement presence" in the area was warranted.

3. Notice 2007-45 (Guidance Regarding Public Inspection of Unrelated Business Income Returns) .

The Pension Protection Act of 2006 ("PPA") requires public disclosure of a section 501(c)(3) organization's Form 990-T (Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))) following the August 17, 2006 enactment date of the PPA. These forms are used by all tax-exempt entities reporting "unrelated business income," and previously were not open to public inspection. The PPA changed this Form's nondisclosure status, and now, Form 990-T now must be made available in the same manner as Form 990s must generally be made available for all section 501(c)(3) organizations, and subject to similar penalties for failure to comply.

Under the interim guidance provided by Notice 2007-45, I.R.B. 2007-22 (May 9, 2007), the IRS clarified that all public charities must comply with the disclosure requirement, regardless of whether Form 990 itself is required. For example, churches must now make public Form 990-Ts, even if the church does not file the basic Form 990 or 990-EZ. In addition, the IRS discussed the unique situation of state colleges and universities (and wholly owned corporations of such entities). These governmental entities are exempt from tax under section 115 of the Code ("Income of States, Municipalities, etc.") but may often nevertheless apply for, and receive, a section 501(c)(3) determination letter. If such a 501(c)(3) determination letter has been received, the IRS will require public disclosure of Form 990-Ts (even though governmental entities may not actually file the basic Form 990.

An exception to disclosure exists of the Form 990-T is filed solely to request a refund of the federal telephone excise tax.

4. Revenue Ruling 2007-41 (Participation and Intervention in Political Campaigns).

In a timely ruling acknowledging the increased political activity in the 2008 Presidential election year, the IRS provided further guidance in *Rev. Rul. 2007-41, 2007-25 I.R.B.* (June 18, 2007) on what constitutes prohibited participation or intervention in political campaigns on behalf of (or in opposition to) any candidate for public office. Twenty-one factual situations were outlined in the ruling, and the IRS applied its interpretation of the law – as described below.

a. Voter Education, Voter Registration and Get Out the Vote Drives.

These types of activities must be conducted carefully. Situation 1 discusses a section 501(c)(3) organization setting up a booth where citizens may register to vote. Information disclosed was limited to the name of the organization, the date of the upcoming state elections, and notice of an opportunity to register. No candidate names or parties were shown; thus, such facts indicated no political campaign intervention occurred. Situation 2 describes a telephone bank established by a section 501(c)(3) organization which calls registered voters and inquires as to voter's views on environmental issues. Voters who respond in a manner favoring a particular candidate are reminded about an upcoming election and offered assistance in transportation. In this case, the facts indicate prohibited political campaign intervention.

b. Individual Activity by Organization Leaders.

Four situations are outlined by the IRS, all involving the activities of tax-exempt organization leaders, describing permissible and prohibited activities. A situation whereby a CEO of a tax-exempt hospital permitted a candidate to publish an ad showing personal endorsements was permitted, where the ad stated, "Titles and affiliations of each individual are provided for identification purposes only." The ad was entirely paid by the candidate and was not an official publication of the hospital. In contrast, other situations whereby costs were paid by the tax-exempt organization, held or otherwise associated with official organization activities, were not permissible.

c. Candidate Appearances.

The IRS notes that candidates may be invited to speak at a tax-exempt organization event either in their capacity as candidates, or as individuals (not as a candidate). They may also appear without invitations. When speaking in a candidate capacity, the IRS looks to several factors to determine whether prohibited campaign activities occur.

- Whether the organization provides to other political candidates an equal opportunity to participate (the nature of particular events are considered, in addition to the manner of presentation).

- Whether the organization indicates any support for or opposition to the candidate (which looks to introductions and communications relating to candidate attendance).

- Whether any political fundraising occurs at the event.

Parameters relating to several candidates speaking at a public forum are outlined as well. The IRS considers whether the questions are prepared and presented by nonpartisan panels, whether the topics are of a broad range of issues, whether an equal opportunity to present views are offered, and whether a moderator comments or implies approval/disapproval.

d. Candidate Appearances Where Speaking or Participating as a Non-Candidate.

Relatively innocuous appearances by political candidates, just by virtue of celebrity or expertise, in public events must be considered to see if political intervention occurs. Appearance per se is permissible; however, if the candidate is publicly recognized or invited to speak, the IRS will look to the following facts:

- Whether the individual is chosen to speak for reasons other than candidacy.
- Whether the individual speaks in a non-candidate capacity.
- Whether the individual or any representative of the tax-exempt organization makes any mention of his or her candidacy.
- Whether any campaign activity occurs in connection with the candidate's attendance.
- Whether the tax-exempt organization maintains a nonpartisan atmosphere on the premises or at the event.
- Whether the tax-exempt organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the event.

e. Issue Advocacy vs. Political Campaign Intervention.

Tax-exempt organizations may take positions on public policy issues, but must avoid any advocacy of issues which function as political campaign intervention. Even implied support for a specific candidate can cause problems. Factors to review include:

- Whether the public policy statement identifies one or more candidates for a public office.
- Whether the statement indicates approval or disapproval of a candidate's positions and/or actions.
- Whether the statement is delivered close in time to an election.
- Whether the statement refers to voting or an election.
- Whether the issue addressed in the statement has been raised as an issue distinguishing candidates for a given office.
- Whether the statement is a part of an ongoing series of communications by the organization on the same issue which is made independent of the timing of any election.
- Whether the timing of the statement and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate.

f. Business Activity.

Activities relating to goods, services, and activities offered by tax-exempt organizations such as selling or renting mailing lists, leasing office space, or acceptance of paid political advertising can have political intervention implications. In these situations, the tax-exempt organization should consider:

- Whether the good, service, or facility is available to candidates in the same election on an equal basis.
- Whether the good, service, or facility is available only to candidates and not the general public.
- Whether the rates charged to candidates are at the organization's customary and usual rates.
- Whether the activity is an ongoing activity of the tax-exempt organization, or conducted only for a particular candidate.

g. Web Sites.

The IRS makes it clear that any materials posted on a web site shall be treated as distributed printed material, oral statements or broadcasts that favored or opposed a candidate. Web links are specifically discussed. The tax-exempt organization should consider the content of the web link, whether all candidates are represented, any exempt purpose served by offering the link, and the directness of links between the tax-exempt organization's web site and the web page that offers material favoring or opposing a candidate.

5. IRS Releases Hospitals and Community Benefit Interim Report.

An excellent recap of the general IRS rules on hospital community benefits (the principal standards relating to whether a hospital maintains section 501(c)(3) status as set forth in Rev. Ruls. 69-545, 1969-2 C.B. 117 and 83-157, 1983-2 C.B. 94) is outlined in the *Hospital Compliance Project Interim Report (Summary of Reported Data)*, released by the IRS on July 19, 2007.[7] The Interim Report, largely a statistical summary, summarized responses to a detailed questionnaire sent to tax-exempt hospitals in 2006. The IRS expects to issue further reports which will analyze the reported data. Key issues to be addressed will be differences in bad debt and uncompensated care reporting, and community benefit expense calculations.

6. IRS Electronic Health Records Directive.

On May 11, 2007, the IRS issued an internal "directive" (a guideline provided to reviewers and agents within the EO Division) that outlines its policy regarding tax-exempt hospitals' provision of discounted electronic health records ("EHR") systems to physicians.[8] The providers of such systems work with exempt health care organizations to implement their products - often at greatly reduced fees.

To provide at least some guidance to alleviate private inurement concerns, the directive presents two steps towards a safe harbor for EHR arrangements. First, the hospital should provide EHR systems within the parameters permitted under the Department of Health and Human Services ("HHS") final regulations. Under these regulations, the provision of EHR software and technical support ("Health IT Items and Services") will not violate the federal anti-kickback law (42 U.S.C. § 1320a-7b) and the physician self-referral law (42 U.S.C. § 1395nn). Once HHS parameters are met, the IRS safe harbor requires that:

a. The provision of EHR systems (called a "Health IT Subsidy Arrangement") must require both the hospital and the participating physicians to comply with the HHS rules on a continuing basis.

b. The Health IT Subsidy Arrangement provides that to the extent permitted by law, the hospital may access all of the electronic medical records created by the physician under the Health IT Subsidy Arrangement.

c. The hospital ensures that the Health IT Items and Services are available to all of its medical staff physicians.

d. The hospital provides the same level of subsidy to all of its medical staff physicians or varies the level of subsidy by applying criteria related to meeting the healthcare needs of the community.

7. IRS Releases Redesigned Form 990**.**

A revised, final version of a new *Form 990* (Return of Organization Exempt From Income Tax) was delivered in December of 2007.[9] The new Form 990, circulated for public comment in June 2007, will be used for the 2008 tax year (and first due during the calendar year 2009). In addition to a "core" Form 990, supplemental Schedules may be required for tax-exempt public charities, who are conducting particular activities. The group return filing mechanism was retained.

There are phase-in provisions for small organizations, permitting a Form 990-EZ to be filed for 2008 and 2009 tax years.[10] In addition, Schedules H and K (relating to hospitals and tax-exempt bonds, respectively) are partly optional for the 2008 tax year and fully implemented for the 2009 tax year. Draft instructions were not released as of submission date of this Article.

The following is a brief discussion of the "core" Form 990 and selected supplemental Schedules.

a. Summary of Core Form.[11]

The new Form 990 has a summary first page which discloses key substantive information immediately. The idea is to present core information first, alleviating "prospecting" work for reviewers.

Part I (Summary), Lines 1 through 7 (*Activities & Governance*), discloses the exempt organization's overall mission and activities (in general terms), along with the number of voting members of the body, employees, volunteers, and "unrelated business revenue and taxable income."

Lines 8-19 (Expenses) and Lines 20-22 (*Net Assets or Fund Balances*) of the new Form 990 require summary financial statement figures on the first page. The abbreviated format discloses items the IRS found most relevant during its compliance initiatives - grants paid to recipients, benefits paid to members, salaries and employee benefits, and fundraising expenses paid to professionals. The rest of the detail is lumped into a one-line listing for "other expenses," although later parts of Form 990 require more detail.

Part III (*Statement of Program Service Accomplishments*) on Page 2 is a detailed reporting page for activities and accomplishments of the exempt organization. The "program service accomplishment" section was always required in the original Form 990, but the reporting page has been moved closer to the front.

Part IV (*Checklist of Required Schedules*) consists of Pages 3 through 4 and may eventually be the most time-consuming part of the new Form 990. The IRS now asks 37 specific questions designed to highlight key issue areas where the IRS has found problems in the past. Part IV should be reviewed most carefully by officers and directors. While the questions are phrased in a simple "yes-no" format, answering "yes" to any requires completion of additional supporting schedules and forms.

Key questions within Part IV relate to whether the tax-exempt organization participated in campaign or lobbying activities, prepared audited financial statements, operated any hospitals, have a tax-exempt bond issue, made any loans to officers and directors, or participated in any "excess benefit" transactions. Reporting an excess benefit transaction, for example, requires completion of new Schedule L ("*Transactions with Interested Persons*").

Part V (*Statements Regarding Other IRS Filings and Tax Compliance*) contains some new questions never asked in the past. Since the IRS has found periodic tax reporting (W-2s, 1099s, etc.) within exempt organizations sometimes lacking, the new Part V solicits information relating to the number of information reports submitted and the number of employees.

Part VI (*Governance, Management, and Disclosure*) solicits more detailed disclosures on the governing body of an exempt organization. The prior Form 990 had somewhat scattered governance questions; now, relevant information relating to those in control of the exempt organization exists neatly in one place. Section A of Part VI asks questions relating to the number of governing board members, and whether such members had family or business relationships with other members. The new Form 990 now asks if the governing body contemporaneously documents meetings (such that the board needs to review documentation policies to make sure it can answer this question affirmatively). In addition, the IRS now asks if a draft Form 990 was provided to the governing body *before* it was filed.

Section B of Part VI (*Policies*) now asks whether the exempt organization has numerous written policies, and reflects many "good governance" principles required by Sarbanes-Oxley for public companies, but technically inapplicable to nonprofit organizations. In addition to conflicts of interest policies, the new Form 990 now asks if the organization has a written whistleblower policy and a document retention and destruction policy. The IRS also asks if there is a written policy or procedure relating to the participation in joint venture arrangements, along with steps taken to safeguard the organization's exempt status when participating in such arrangements. Most significantly, Section B now directly asks if the process for determining executive and key employee compensation follows a review and approval process by independent persons, using

comparability data and contemporaneous substantiation of the decision-making process.

Part VII (*Compensation of Officers, Directors, Employees, Contractors Etc.*), Pages 7 through 8, contains redesigned disclosure pages for reporting compensation to all types of recipients. The new compensation disclosures now require showing the actual reportable compensation to certain persons as per the underlying W-2 or 1099s - from both the entity filing the Form 990 and related organizations. In most large exempt organizations, however, additional disclosures will be required on new Schedule J.

Parts VIII through Part XI, Pages 9 through 11, contain the detailed overall financial information which is only summarized in Part I. Part XI now asks whether the financial statements were complied, reviewed, or audited by an independent accountant, and whether such processes were required due to other federal or state laws.

b. Summary of Schedule H (Hospitals).[12]

If the exempt organization operates a hospital, Schedule H must be filed. The new Schedule H solicits much of the information about tax-exempt hospitals which have been identified as problem areas during the IRS compliance initiative. All but the last part (Part V (Facility Information)) is *optional* for the 2008 filing period; to ease transition burdens, the IRS is only requiring all Parts of Schedule H to be completed starting for the 2009 filing period (in other words, all of Part H will be mandatory for returns due in 2010).

Part I (*Charity Care and Certain Other Community Benefit at Cost*) solicits more detailed information about charity care policies and community benefit reports. This part asks, for example, if the organization uses Federal Poverty Guidelines in providing free or discounted care to low income individuals, and whether community benefit reports are required. For the first time, the new Schedule H, informs the IRS of such requirements. Those organizations in states which already require community benefit activities will be ahead of the game; in states which do not have such requirements, this mandatory reporting will be a first.

Part II (*Community Building Activities*) requests a detailed breakdown of programs, revenues, and expenses relating to the more general charitable activities of hospitals, such as physical improvements, community support, and community health improvement. Hospitals will, therefore, be able to disclose costs associated with less obvious ways of providing benefits to the community.

Part III (*Bad Debt, Medicare, & Collection Practices*), entirely new, asks for details on the bad debt reporting methods of the organization, such as whether bad debt is reported in accordance with Healthcare Financial Management Association Statement No. 15. The amount of total revenue from Medicare is requested, as well as whether a surplus or shortfall exists after deducting allowable costs of care. The IRS also asks if a written debt collection policy exists. These items are separate from the Part on "community benefits," which means that state calculations of community benefit costs may reflect different aggregate figures.

Part VI (*Supplemental Information*) follows up with requested information on how the organization assesses healthcare needs within the communities served, and asks how the public is informed on who may be billed for patient care.

c. Summary of Schedule J (Compensation Information).[13]

New Schedule J (*Compensation Information*) is a more extensive compensation disclosure schedule which will likely be completed in addition to the core Form 990's compensation disclosures for most large exempt organizations. Payment of more than $150,000 in aggregate compensation to any officer, director, or key employee, payments to former such persons, or payments from related organizations for services rendered to the exempt organization, triggers the Schedule J requirement. Schedule J will require disclosure of non-financial perks such as first-class or charter travel, spousal travel, and personal services (which the IRS actually defines to include maids, chauffeurs, and chefs).

d. Other Schedules.

In addition to the Schedules discussed above, other Schedules were retitled and/or modified. Schedule A (now titled "*Public Charity Status and Public Support*")[14] splits out the compensation information and political activity questions in old Schedule A and now focuses solely on public charity and public support tests. Schedule C ("*Political Campaign and Lobbying Activities*")[15] replaces the old Schedule A political questions and requires separate disclosure of direct and indirect campaign activities, including volunteer hours. Schedule G ("*Supplemental Information Regarding Fundraising or Gaming Activities*")[16] replaces old questions relating to fundraising that were scattered within the old Form 990. New Schedule R ("*Related Organizations and Unrelated Partnerships*")[17] requests detail on the controlled entities previously disclosed on the original Form 990's basic form.

8. New Mandatory Reporting for Small Exempt Organizations (Under $25,000 in Gross Receipts) – First E-Postcards For Calendar Year Exempt Organizations Due May 15, 2008.

Until recently, small tax-exempt organizations with gross receipts of under $25,000 were not required to file Form 990 with the IRS. The PPA implemented a mandatory requirement for all tax-exempt organizations regardless of gross receipts, with few exceptions.[18] The requirement is the filing of an "e-Postcard" by responding to questions via an online form.

Fortunately the disclosures are simple, requiring the following.

a. The legal name of the organization.
b. Any assumed name under which such organization operates or does business.
c. The organization's mailing address and Internet web site address (if any).
d. The organization's taxpayer identification number.
e. The name and address of a principal officer.
f. If applicable, a statement that the tax-exempt organization has terminated.

Links to the current e-filing site can be found through the IRS site at http://www.irs.gov/charities/article/0,,id=169250,00.html. The link refers to the IRS partner for the e-Postcard, the Urban Institute.

Exceptions from this requirement exist for churches, governmental units (including agencies and instrumentalities (described as "affiliates") and entities included on a group

return. In addition, the IRS has indicated the gross receipts threshold of $25,000 may be increased in later years (i.e., $50,000 beginning with the tax year 2010).

9. State Tax Developments.

Corporate and most partnership entity taxpayers doing business in Texas will file the first tax returns based on the revised Texas franchise tax[19] on May 15, 2008.[20]Partnerships in particular will be filing their first franchise tax reports, and many tax-exempt organizations who are partners in limited partnerships or general partnerships may have to review filing obligations not previously required.

For the most part, the Texas franchise tax exemption regime remains in place for the Texas margin tax. Subchapter B of the Texas Tax Code, beginning with Section § 171.051, outlines the requirements for exemptions from the margin tax. The tax-exempt organization must file evidence establishing the qualifications for an exemption within fifteen (15) months after the last day of the calendar month in which the entity's charter or certificate of authority is dated. The exemption is recognized if it is finally established, as of the date of the charter or certificate. Unfortunately, the most common method for establishing the state exemption, providing a copy of the section 501(c)(3) determination letter, does tie to the deadline for filing the federal Form 1023 (which is 27 months from the date of incorporation).

Texas Administrative Code Rule § 3.583 ("Margin: Exemptions") outlines procedural requirements for obtaining exemptions and appears similar to its predecessor. Nevertheless, the rules still warrant a review due to discrepancies in deadlines with federal exemptions.

The requirements for provisional, or temporary, exemptions from margin tax filings are particularly important. As stated above, while Form 1023 is not due until 27 months after the date of a tax-exempt organization's incorporation, deadlines for margin tax exemptions are different. For margin tax exemptions, the organization must show that:

a. The application for recognition of exemption (Form 1023) is provided to the IRS within their timely filing guidelines; and

b. the copy of the Form 1023, and either the letter from the IRS confirming Form 1023 receipt or the return receipt confirmation or other evidence of delivery, is postmarked within 15 months after the day that is the last day of a calendar month and that is nearest to the entity's beginning date.

ENDNOTES

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2 See Tyree Collier, Recent Developments Applicable to Tax-Exempt Organizations, Tex. Tax Law. p. 22 (Oct. 2006).

3 Practitioners may expect a comparatively more focused IRS Exempt Organizations ("EO") Division, which has announced its goals of enhanced enforcement and improved customer service. See FY 2008 Implementing Guidelines, available at <http://www.irs.gov/pub/irs-tege/fy08_implementing_guidelines.pdf>.

4 Unless otherwise indicated, references to Sections contained herein are references to the Internal Revenue Code of 1986, as amended ("Code").

5 After the publication deadline of this article, the IRS posted on its web site a "Corporate Governance Update" which continues the theme of good governance and refines further the IRS "best practices" positions on governance of tax-exempt public charities. The update is available at <<http://www.irs.gov/pub/irs-tege/governance_practices.pdf>>.

6 Available at << http://www.irs.gov/pub/irs-tege/exec._comp._final.pdf>>

7 Available at <<]http://www.irs.gov/charities/charitable/article/0,,id=172267,00.html>>.

8 Available at <<http://www.irs.gov/pub/irs-tege/ehrdirective.pdf>>.

9 All forms and IRS discussion materials for the new Form 990 may be found at <<http://www.irs.gov/charities/article/0,,id=176613,00.html.>>.

10 Entities satisfying both a gross receipts test and assets tests in accordance with the following table may file Form 990-EZ:

May file 990-EZ for:	If gross receipts are:	and	If assets are:
2008 tax year (filed in 2009)	>$25,000 and < $1M		< $2.5M
2009 tax year (filed in 2010)	>$25,000 and <$500K		<$1.25M
2010 and later tax years	>$50,000 and <$200,000		<$500K

11 Available at <<http://www.irs.gov/pub/irs-tege/f990rcore.pdf>>.

12 Available at http://www.irs.gov/pub/irs-tege/f990rschh.pdf

13 Available at <<http://www.irs.gov/pub/irs-tege/f990rschj.pdf>>.

14 Available at <<http://www.irs.gov/pub/irs-tege/f990rscha.pdf>>.

15 Available at << http://www.irs.gov/pub/irs-tege/f990rschc.pdf>>.

16 Available at << http://www.irs.gov/pub/irs-tege/f990rschg.pdf>>.

17 Available at <<http://www.irs.gov/pub/irs-tege/f990rschr.pdf>>.

18 Temp. Reg. § 1.6033-6T (available at http://www.irs.gov/pub/irs-tege/epostcard_tregs111507.pdf).

19 More colloquially referred to as the Texas "margin" tax, although the Texas Comptroller continues to refer to it as a franchise tax.

20 Some taxpayers, of course, have had to file the returns early, whether for termination or fiscal year purposes.

SECTION OF TAXATION

State Bar of Texas

April 11, 2008

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VIA ELECTRONIC MAIL

CC:PA:LPD:PR (REG 136596-07)
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Washington, D.C. 20044

Re: Proposed Regulations -- RALs

Dear Commissioner Shulman:

On January 7, 2008, the Internal Revenue Service and Treasury issued an advance notice of proposed rulemaking (REG-136596-07) addressing guidance on the marketing of refund anticipation loans (RALs) and certain other products in with connection with the preparation of a tax return. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed set of 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.

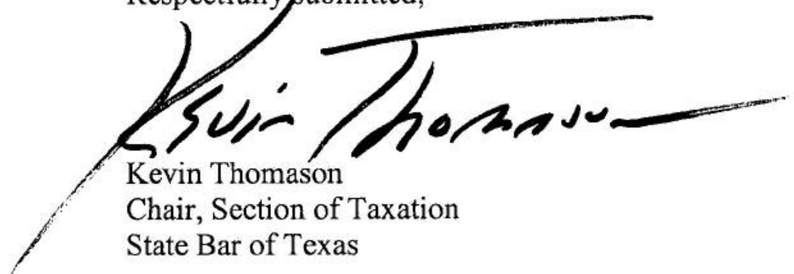
THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS

Page 2
April 11, 2008

SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Internal Revenue Service and the Department of the Treasury on their work in putting together a well-drafted comprehensive advanced notice of proposed rulemaking, particularly considering the importance of balancing the need to protect taxpayers from exploitation against the potential restriction of taxpayers' ability to control their tax return information. We also appreciate the opportunity to submit these comments.

Respectfully submitted,



Kevin Thomason
Chair, Section of Taxation
State Bar of Texas

cc: Eric Solomon, Assistant Secretary of the Treasury (Tax Policy)

COMMENTS CONCERNING GUIDANCE REGARDING MARKETING OF REFUND ANTICIPATION LOANS (RALs) AND CERTAIN OTHER PRODUCTS IN CONNECTION WITH THE PREPARATION OF A TAX RETURN.

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

These Comments were prepared by individual members of the Pro Bono Committee (the "Committee") of the Section. Principal responsibility was exercised by Seth Kaufman. The Comments were reviewed, and substantive contributions were made, by Dan Micciche and Elizabeth Copeland of the Section. They were also reviewed by Mary McNulty and Emily Parker of the Section's Committee on Governmental Submissions.

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

Contact Person:

Seth Kaufman
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Date: April 11, 2008

These Comments are submitted in response to REG-136596-07 published by the Department of the Treasury ("Treasury") on January 7, 2008. In REG-136596-07 the Treasury proposed an exception to the general consent requirement in Treas. Reg. § 301.7216-3 for Refund Anticipation Loans ("RALs"), Refund Anticipation Checks ("RACs"), audit insurance and similar products. This exception would effectively separate the act of return preparation from the act of marketing by prohibiting the use of information obtained during the return preparation process for a non-tax administration purpose, including the marketing of a RAL or a substantially similar product.

We agree with the proposed exception to the general consent requirement in Treas. Reg. § 301.7216-3. Businesses that provide tax return preparation services should not be permitted to use information obtained during the preparation process in their marketing efforts. While this may place a slight limit on taxpayers' ability to control their own tax return information, the benefit of protecting taxpayers by segregating tax return preparation services from marketing appears to us to be significant.

As several commentators have mentioned in previous submissions, RALs are primarily marketed to low-income taxpayers. These are the taxpayers who need the most protection because, for the most part, they often do not understand the ramifications of obtaining a RAL. Several members of the Committee have served as volunteers in the Volunteer Income Tax Assistance (VITA) program. The VITA program's sole purpose is to provide low- and moderate-income taxpayers free tax return preparation service. While participating in the VITA program, we have noticed that these taxpayers generally trust the tax return preparer with unwavering, unquestioning and sometimes unjustified deference due to the complexity of the tax returns and the taxpayers' lack of experience. Indeed, our observations lead us to believe that these taxpayers often will sign almost any document that the tax return preparer presents to them as part of the normal return and refund process.

Our concern is that the RALs are not always clearly presented as one of several options. Instead, many taxpayers may believe that obtaining a RAL is part of the regular, mandated tax return preparation process as opposed to something that is completely optional and unnecessary. As such, some low-income taxpayers may unknowingly consent to disclosing their tax information for marketing purposes. By instituting a ban on the use of information obtained during the tax return preparation process for non-tax administration purposes, including the marketing of a RAL, the IRS would be protecting taxpayers who need protection.

Our experiences with the VITA program are not unique. The National Taxpayer Advocate has noted that taxpayers who obtain RALs often are not fully informed, need immediate access to cash, and need protection. Volume II of the National Taxpayer Advocate's 2007 Objectives Report to Congress (the "Report") further supports these points by stating that taxpayers obtain RALs for one or more of the following reasons: (i) need for immediate cash; (ii) lack of information about the products; (ii) immediate access to a large sum of money; (iv) inability to pay preparation and filing fees out of pocket; and (v) experience of friends and family. Despite the written disclosures that paid preparers provide to taxpayers, the Report

questions whether taxpayers who purchase RALs truly understand that a RAL is in fact a loan and not a means of receiving a faster refund. If taxpayers do not understand that they are obtaining a loan, they likely also do not understand that they are giving preparers the permission to use their personal information for marketing purposes. Therefore, taxpayers need additional protection.

We believe that a regulation prohibiting the use of information obtained during the tax return preparation process for the purposes of marketing a RAL is necessary because it further enhances the IRS's efforts to protect taxpayers. Even if the proposed restriction is adopted, taxpayers who really want or need a RAL will still be able to obtain one through other avenues. On the other hand, taxpayers who do not want or need a RAL will no longer unintentionally obtain them simply due to the complexity or misuse of the tax return preparation process.

B. Mom and Pop Partnerships

Proposed Section 710 may also provide particular challenges for "Mom and Pop" and other small partnerships. As described above, the current draft of Proposed Section 710 applies to any person who provides a substantial quantity of certain delineated services in the course of a trade or business to a partnership with respect to "specified assets." This treatment may apply regardless of whether the partnership's underlying business predominantly involves such specified assets. Partners in small partnerships often provide a broad range of services to their partnership, simply because the partnership's size does not permit the specialization of functions found in larger organizations. For example, both partners in a two-person partnership operating a retail store are likely to engage in all facets of the business, including purchasing, sales, employee relations, and managing the store's real estate. Since real estate is a specified asset, depending on its significance the real estate activity may be sufficient to cause the partnership interests of both partners to be characterized as "investment services partnership interests," and the exception for capital interests provided in Proposed Section 710(c)(2) may or may not apply if the allocations differ at all between the two partners. By contrast, in a larger partnership, with greater specialization of job functions, the effect of Proposed Section 710 would likely impact fewer of the partnership's partners. Thus, the partners of small partnerships could be disproportionately affected by the literal application of Proposed Section 710.

Moreover, the financing constraints that small partnerships often face make Proposed Section 710 particularly likely to impact small partnerships disproportionately. While large, well-financed partnerships may be able to afford to pay cash for various advisory and management services, small partnerships that are short of cash may find it particularly useful to compensate such service providers with a share of the partnership's profits. In some circumstances, compensating a service provider with equity will not create an issue under Proposed Section 710, since the nature of the services will not cause the issued partnership interest to be an investment services partnership interest. However, given the expansive reach of Proposed Section 710, many partnership interests issued by small partnerships which happen to own their own real estate or invest excess cash in securities will be affected.

Proposed Section 710 may also present planning and compliance challenges for small businesses. Proposed Section 710 provides an exception to investment services partnership interest treatment to the extent a portion of a partnership interest is acquired on account of invested capital. Where the contributed capital consists of property, this exception will require the valuation

of the contributed property in order to determine the extent to which the interest is acquired on account of the property. In this regard, an appraisal of the property may be necessary to determine the value of the property. The costs of obtaining an appraisal may be particularly significant for small partnerships and for partners making relatively modest capital contributions.

Furthermore, small partnerships may be less able to take advantage of planning opportunities presented by Proposed Section 710. For example, if Proposed Section 710 is enacted, it may be more beneficial to simply compensate a would-be partner with cash or other consideration, provided the amount paid to such would-be partner would be an ordinary deduction for the partnership.

Consider the case of a partnership with three partners, John, Steve and Mary. Each has an equal share of partnership profits, and John's interest is considered to be an "investment services partnership interest" under Proposed Section 710. Further assume that for a taxable year, the partnership has $150 of capital gain income and $150 of ordinary income. If the partnership treats John as a partner, the partners will recognize $200 of ordinary income in the aggregate because John's $50 share of the partnership's capital gain will be recharacterized as ordinary income

	John	Steve	Mary
Ordinary Income	$100	$50	$50
Capital Gain	--	$50	$50

If the partnership simply pays John a $100 salary, the two partners, Steve and Mary, and service-provider John, will recognize $150 of ordinary income in the aggregate.

	John	Steve	Mary
Ordinary Income	$100	$25*	$25*
Capital Gain	--	$75	$75

* The partnership's ordinary income is offset by a $100 deduction for the amount paid to John.

Small partnerships with less expansive budgets for tax planning will be less able to take advantage of such planning opportunities. Again, Proposed Section 710 may disproportionately impact small partnerships and their partners.

C. Oil and Gas Partnerships

An industry of particular concern to Texas which may be greatly impacted by Proposed Section 710 is the oil and gas industry. In the past few decades, there has been a shift in oil and gas exploration, development and production (E&P) within the United States from large scale producers, such as Exxon, to smaller independent oil and gas producers. While some independent producers are well capitalized and able to carry on their own E&P operations, many are not. In fact, a significant part of the current United States E&P activity is carried on by independent producers who must attract capital to conduct their E&P operations.

At the outset of the oil and gas industry, joint ventures among those seeking to engage in E&P operations arose in two ways. The first involved arrangements between owners of adjoining or shared mineral interests whereby such owners would agree to undertake joint operations with respect to the production of the underlying minerals and would share in the proceeds of such operations. The second involved the holder of a mineral interest selling interests in the wells it proposed to drill, with its industry "partners" paying the costs of such drilling operations. The promoter, in recognition of its efforts, would retain an interest in the well. This arrangement took several forms, but it was most commonly referred to as "a third for a quarter," reflecting arrangements whereby purchasers would receive a quarter interest in a well by paying one-third of the drilling costs. As the participants in such deals were often themselves involved in the oil and gas industry, the vast majority of such arrangements contained a specific election not to be treated as a partnership for federal tax purposes. Thus, the trend toward using the partnership form did not gain traction until the oil industry price collapse in the mid-1980s.

The result of such price collapse was that many independent producers became insolvent, and many of the large producers sought to divest themselves of their domestic properties. That in turn led to a surplus of untapped, low-priced oil and gas properties in the market, and a financing vacuum within the E&P industry. To rejuvenate the industry, capital from non-industry investors was sought, and it was the partnership form that best met the needs and requirements of such investors, specifically their desire for flowthrough tax treatment and limited liability.

The attractiveness of the partnership structure in the oil patch is due in part to its ability to replicate the oil and gas joint sharing arrangement that existed for decades, while simultaneously protecting investor partners from the large risks and other drawbacks associated with direct ownership of oil and gas working interests. As a result, over the past decade there has been a dramatic increase in the number of oil and gas partnerships funded by non-industry investors seeking the benefits of an investment in natural resources. Realistically, it is now unlikely that many non-industry investors, even those accustomed to E&P financings, would invest in oil and gas interests outside the partnership form.

Under the current language of Proposed Section 710, persons who form oil and gas partnerships to attract non-industry investors and who receive an interest in such resulting entity would arguably be considered to have an "investment services partnership interest" because such persons would be providing the type of "investment services" described in Proposed Section 710 and because oil and gas is indirectly included within the definition of a "specified asset" in Proposed Section 710. That definition lists as "specified assets," among other things, "commodities," as defined in section 475(e)(2) of the Code. That Code section includes within the definition of the term "commodity," as here relevant, "any commodity which is actively traded (within the meaning of section 1092(d)(1))." Because of the specific reference in section 475(e)(2)(A) to section 1092(d)(1) which simply defines "personal property" as "personal property of a type which is actively traded," one would presumably conclude that for these purposes property that falls within the definition of personal property under section 1092(d)(1) of the Code will be considered a commodity for purposes of section 475(e)(2), and therefore a "specified asset" for purposes of Proposed Section 710. Under the Treasury regulations promulgated pursuant to section 1092, "[a]ctively traded personal property includes any personal property for which there is an established financial market." Because oil and gas constitutes personal property and is actively traded within established financial markets, such as the New York Mercantile Exchange, oil and gas would be treated as a commodity, and therefore as a "specified asset," as defined in Proposed Section 710. Consider the following examples.

(a) *Example 1*. A is a geologist. B owns options to acquire certain mineral rights. B desires to retain A's services to determine which of such mineral rights B should acquire for development. B plans to sell his rights to the productive mineral properties once the sites are proven. A and B enter into an agreement whereby B grants a 20% working interest in the mineral properties to A in exchange for a reduced fee for A's services. A

advises B regarding which mineral properties are the most likely to produce oil and gas and where the drill sites should be placed on those tracts. At the end of year 1, one property has started to produce meaningful quantities of oil and gas. A and B sell the oil and gas produced from that property to E. Soon thereafter, A and B agree to sell their respective interests in the producing property to E.

On audit, the Service determines that A's working interest in the parcels of land constitutes an interest in a partnership for U.S. federal income tax purposes. Moreover, A's interest in the tax partnership may be determined to be an "investment services partnership interest" under Proposed Section 710 because he will provide a substantial quantity of the following types of services specified therein as part of A's trade or business of providing those services: (i) advising as to the advisability of investing in, purchasing, or selling specified assets (including which options B should exercise); and (ii) providing activities in support of investing in, purchasing, or selling specified assets. As discussed above, oil and gas would be treated as commodities, a "specified asset" under the current language of Proposed Section 710. Therefore, the tax partnership's gain on the sale to E of its oil and gas that is allocated to A could be treated as ordinary income for the performance of services, including any amounts that would otherwise be long term capital gain, such as the gain recognized by A on the sale of his working interest in the parcels of land.

(b) *Example 2*. PS is an independent oil and gas exploration and development limited liability company taxed as a partnership for U.S. federal income tax purposes. D is an individual with experience in developing oil and gas properties, including identifying suitable projects, locating investors and managing projects. D agrees to work for PS to develop properties, but wants an interest in PS in exchange for his services. PS agrees to grant D a profits interest in PS. D makes all decisions regarding the activities of PS, including which projects to develop, when to allow investment by third parties and when the projects are to be sold. After several years, PS winds down, selling all of its remaining assets and liquidates.

D's interest in PS may be an "investment services partnership interest" under Proposed Section 710 because he will provide a substantial quantity of the following type of services specified in Proposed Section 710 as part of D's trade or business of providing those services as an oil

and gas developer: (i) advising as to the advisability of investing in, purchasing, or selling commodities and mineral rights which are considered real estate; (ii) managing, acquiring, or disposing of commodities (oil and gas) and mineral rights which are real estate; (iii) arranging financing to acquire commodities (and potentially mineral rights which are real estate for development); and (iv) activities in support of the previously listed services. Under Proposed Section 710, the amount D receives upon the liquidation of PS could be treated as ordinary income from the performance of services, including the amounts that would otherwise be taxed as long-term capital gain from the deemed sale of D's interest in the mineral rights and other capital gain property of PS.

We are concerned that Proposed Section 710 as drafted could have a possibly unintended and negative effect on the oil and gas industry, undermining decades of concerted efforts by Congress to induce more activity in the E&P business. Although Proposed Section 710 should not directly affect the landowner or the driller, it could affect those who bring such parties together. A possible consequence of the "idea" people becoming subject to a higher level of taxation with respect to their partnership interests is that they will simply cease to do business through the partnership form. If that occurs, non-industry investors may shy away from investing in oil and gas operations due to the drawbacks and inherent risks appurtenant to direct ownership of working interests. While it is not clear that Proposed Section 710 was intended to apply to the oil and gas industry, the broad language of the current draft of Proposed Section 710 would seem to include partnerships operating in this area. As such, we urge Congress to carefully consider the impact of Proposed Section 710 on the oil and gas industry and to clarify its intent with respect thereto.

D. Farming and Ranching Partnerships

Another industry in Texas which could be greatly impacted by Proposed Section 710 is the agricultural industry. Consider the following examples:

(a) *Example 1*. A is a landowner. B is a person experienced in farming/livestock operations, but with no capital. A and B enter into a partnership agreement. That agreement states that A will contribute the land to the partnership, B will contribute B's full-time services to the partnership, and A and B will split profits from the farming/livestock operations equally. They will also split equally any appreciation in the land occurring after the formation of their partnership. B makes all decisions regarding the activities of the partnership and arranges for the

partnership to obtain financing for its operations, mortgaging the land and crops/livestock as security. The partnership exists for ten years. At the end of the ten years, B decides he wants to use his equity in the partnership to start his own agricultural operation. The partnership sells the land and all of its other assets and distributes the proceeds according to the partnership agreement.

B's interest in the partnership will likely be an "investment services partnership interest" under Proposed Section 710 because he will provide a substantial quantity of the following type of services specified in Proposed Section 710 as part of B's trade or business of providing those services: (i) advising as to the advisability of investing in, purchasing, or selling commodities (and potentially real estate); (ii) managing, acquiring, or disposing of commodities and real estate; (iii) arranging financing to acquire commodities (and potentially real estate for expansion); and (iv) activities in support of the previously listed services.

Commodities for purposes of Proposed Section 710 are defined as commodities described in section 475(e)(2) of the Code. That Code section includes within the definition of the term "commodity," as here relevant, "any commodity which is actively traded (within the meaning of section 1092(d)(1)). Because of the specific reference in section 475(e)(2)(A) to section 1092(d)(1) which simply defines "personal property" as "personal property of a type which is actively traded," one would presumably conclude that for these purposes property that falls within the definition of personal property under section 1092(d)(1) of the Code will be considered a commodity for purposes of section 475(e)(2), and therefore a "specified asset" for purposes of Proposed Section 710. Thus, since agricultural commodities, such as grain, corn, cattle, pork, etc., are actively traded personal property, they will be deemed commodities, and therefore "specified assets," within the meaning of Proposed Section 710. Therefore, the partnership's gain on the sale of its assets that is allocated to B will be treated as ordinary income for the performance of services, including any allocated amounts that would otherwise be long-term capital gain, such as the gain recognized on the sale of the land.

(b) *Example 2*. LLC is a limited liability company taxed as a partnership for U.S. federal income tax purposes that owns and operates a cattle feedyard. D is an individual with experience in operating a cattle feedyard. LLC desires to hire D as feedyard manager. D desires to be employed by LLC, but wants to have a "piece of the action." LLC agrees

to grant D a "profits interest" in LLC. D works for LLC for 20 years. On retirement, LLC redeems D's interest in LLC for $200x. LLC's assets include the land on which the feedyard sits, land surrounding the feedyard, and improvements to the land. B makes all decisions regarding the activities of LLC, including the purchase and sale of cattle and feed and arranging for LLC to obtain financing for its operations.

D's interest in LLC will likely be an "investment services partnership interest" under Proposed Section 710 because he will provide a substantial quantity of the following type of services specified in Proposed Section 710 as part of D's trade or business of providing those services as a feedyard manager: (i) advising as to the advisability of investing in, purchasing, or selling commodities (and potentially real estate for expansion or contraction or to satisfy environmental regulations); (ii) managing, acquiring, or disposing of commodities and real estate; (iii) arranging financing to acquire commodities (and potentially real estate for expansion); and (iv) activities in support of the previously listed services.

As described above, since cattle and feed for cattle, such as grain and corn, are actively traded personal property, they will be deemed commodities, and therefore as "specified assets," within the meaning of Proposed Section 710. Therefore, the entire $200x that D receives in redemption of D's LLC interest in LLC will be treated as ordinary income for the performance of services, including the amounts that would otherwise be taxed as long term capital gain from the deemed sale of D's interest in the land and other capital gain property of LLC.

II. POTENTIAL ALTERNATIVE

Given the potential broad reach of Proposed Section 710 and the myriad of difficult questions that it will likely generate, perhaps an alternative means of achieving the objectives of Proposed Section 710 should be considered. One such alternative is already contained in the Code. Specifically, section 707(a)(2)(A) of the Code calls for the promulgation of regulations that would characterize payments to a partner for services as payments made to a non-partner rather than as an allocation of partnership income. While no such regulations have yet been issued, there would appear to be significant overlap between the approach taken by Proposed Section 710 and the existing language of section 707(a)(2)(A) of the Code. In general, a payment to a partner that is subject to section 707(a)(2)(A) of

the Code would be treated as ordinary income to the partner (and would either be available as a deduction to, or subject to capitalization by, the partnership.)

Admittedly, the purposes of section 707(a)(2)(A) of the Code and Proposed Section 710 may not be co-extensive. The legislative history to section 707(a)(2)(A) of the Code provides five relevant factors in determining whether characterization of a payment to a partner as a non-partner payment is appropriate, to wit: (1) whether the payment is subject to an appreciable risk as to amount; (2) whether the partner status of the recipient is transitory; (3) whether the allocation and distribution made to the partner are close in time to the partner's performance of services; (4) whether the recipient became a partner primarily to obtain tax benefits; and(5) whether the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question. Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84, pp. 226-233 (December 31, 1984). Many profits interests will not fall within the reach of section 707(a)(2)(A) of the Code if evaluated under these factors. Nevertheless, section 707(a)(2)(A) of the Code may provide sufficient regulatory authority to address the concerns that spawned Proposed Section 710. Moreover, Proposed Section 710 should address the coordination issues presented by section 707(a)(2)(A) of the Code. For example, Proposed Section 710 should address which of section 707(a)(2)(A) of the Code and Proposed Section 710 will prevail where both provisions appear to apply.

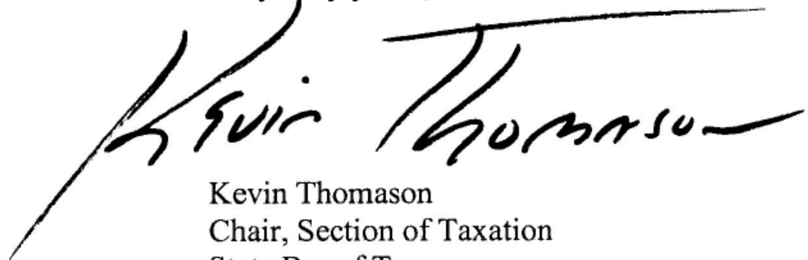
III. CONCLUSION

Proposed Section 710, if enacted, will have a significant impact on all entities operating as partnerships for U.S. federal income tax purposes. It will potentially apply to every partnership and limited liability company taxed as a partnership which owns real estate or otherwise invests in securities and/or commodities, regardless of the purpose or size of any such holdings and regardless of the size of the partnership or limited liability company. Given the broad range of partnerships and limited liability companies which will be impacted by Proposed Section 710, it could easily have unintended and potentially severe tax consequences and could further prove to be difficult to implement and enforce. It could particularly impact several industries that make up a large part of the economic base of the State of Texas. Therefore, we urge you to carefully consider the effect of the approach taken by Proposed Section 710 on all taxpayers. It is not our intention to advocate for or against the current proposal. Instead, we seek only to identify issues that we believe should be considered as you go forward in this process.

Hon. Max Baucus
Hon. Jim McCrery
Hon. Charles Grassley
April 10, 2008
Page 19

Thank you for the opportunity to provide comments on this important matter.

Very truly yours,



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Chair, Section of Taxation
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BNA - Daily Tax Report

SECTION OF TAXATION
State Bar of Texas

June 10, 2008

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Re: Comments on Treasury Regulations Under Section 401(a)(9)

Dear Messrs. Solomon and Korb:

On November 2, 2007, James E. Holland, Jr., A.S.A, E.A., of the Internal Revenue Service (the *"Service"*) orally requested that the Section of Taxation of the State Bar of Texas submit written comments to the Service and the Department of Treasury regarding the potential conflict between section 1.401(a)(9)-7 of the Treasury Regulations regarding merged employee benefit plans with divergent required beginning dates and section 411(d)(6) of the Internal Revenue Code. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed set of 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.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT

Eric Solomon, Assistant Secretary for Tax Policy
Donald L. Korb, Chief Counsel
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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.

Respectfully submitted,

Kevin Thomason
Chair, Section of Taxation
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Comments On Treasury Regulations Under Section 401(a)(9)

These comments are presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafters of these comments were Stephanie Schroepfer and David C. D'Alessandro. Felicia A. Finston, Gary G. Short, Shane M. Tucker and Jose J. Valcarce provided helpful guidance in preparing and reviewing these comments. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Mary McNulty is Chair of COGS, and Emily Parker reviewed these comments on behalf of COGS.

Although many of the people who participated in preparing, reviewing and approving these comments have clients who will be affected by the federal tax principles addressed by these comments and frequently advise clients on the application of such principles, none of the participants (or the firms or organizations to which such participants belong) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the subject matter of these comments.

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I. EXECUTIVE SUMMARY

The following comments are submitted regarding section 401(a)(9)[1] of the Internal Revenue Code of 1986, as amended.

We respectfully recommend that Regulations section 1.401(a)(9)-7 be amended to permit merged plans with divergent required beginning dates to be permitted to comply with section 401(a)(9) in the same manner as if the plans had never been merged. The Regulations as drafted could require the elimination of optional forms of benefits that are protected under section 411(d)(6).

We also respectfully recommend that the Treasury and the IRS, whether through an amendment of Regulations section 1.401(a)(9)-7 or otherwise, expressly state that compliance with the existing provisions of Regulations section 1.401(a)(9)-7 will not result in a violation of section 411(d)(6). We respectfully request that the Treasury and the IRS consult with the Department of Labor (the *"DOL"*) concerning this matter and expressly state in revised Regulations or in the preamble thereto that the Treasury and the IRS has consulted with the DOL and understands that the DOL takes the position that compliance with the existing provisions of Regulations section 1.401(a)(9)-7 will not result in a violation of section 204(g)(1) of the Employee Retirement Income Security Act of 1974, as amended (*"ERISA"*).

Following a discussion of these issues, on November 2, 2007, James E. Holland, Jr., A.S.A, E.A., of the Service orally requested that the Section of Taxation of the State Bar of Texas submit written comments to the Service and the Treasury regarding the potential conflict between Regulations section 1.401(a)(9)-7 and section 411(d)(6).

We appreciate the opportunity to comment on Regulations section 1.401(a)(9)-7 and hope that our comments prove helpful.

1. Summary of Recommendation.

We respectfully recommend that the Service and the Treasury amend Regulations section 1.401(a)(9)-7 to provide that in the event defined benefit plans or defined contribution plans are merged, the successor plan may comply with section 401(a)(9) by making distributions at the same times and in the same amounts as if the plans had never been merged. We respectfully request that the Service and the Treasury consider amending the Regulations to permit merged defined benefit or defined contribution plans to implement an approach similar to the separate account approach contemplated in Regulations section 1.401(a)(9)-8, A-3 (involving different beneficiaries). Under the proposal, if benefits under a merged plan are separated into separate identifiable components they may be separately distributed in the same manner as if the merger had never occurred.

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[1] All references to sections herein are references to sections of the Internal Revenue Code of 1986, as amended (the *"Code"*), unless otherwise expressly stated herein, and references to "Regulations" are to the regulations promulgated under the Code by the Department of Treasury (the *"Treasury"*) and the Internal Revenue Service (the *"IRS"* or the *"Service"*).

In addition, we respectfully recommend that the Treasury and the IRS issue relief from section 411(d)(6) for those employers who operate in compliance with the existing provisions of Regulations section 1.401(a)(9)-7.

2. Explanation.

There is legal uncertainty regarding the manner in which merged plans with divergent required beginning dates are required to be operated under section 401(a)(9) dealing with required minimum distributions.

In the context of a merger of defined benefit plans or defined contribution plans with divergent required beginning dates, there is an apparent conflict between Regulations section 1.401(a)(9)-7 and section 411(d)(6) which prohibits the elimination of certain protected benefits such as required beginning dates.

One of the plans involved in a merger may specify that the required beginning date for section 401(a)(9) purposes is April 1 of the calendar year following the calendar year in which the employee attains age 70½. Another plan involved in the merger may specify that the required beginning date for purposes of section 401(a)(9) is April 1 of the calendar year following the later of the calendar year in which the employee retirees or the calendar year in which the employee attains age 70½.

Section 411(d)(6) and a parallel provision in the Employee Retirement Income Security Act of 1974, as amended (*"ERISA"*), *i.e.*, section 204(g)(1) of ERISA, provide that a plan amendment may not eliminate an optional form of benefit. Regulations section 1.411(d)-4, Q-2(a)(3) specifies that the prohibition against the reduction or elimination of section 411(d)(6) protected benefits already accrued applies to plan mergers. Regulations section 1.411(d)-3(g)(6) provides that the term "optional form of benefit" means a distribution alternative available under the plan. Different optional forms of benefit exist if a distribution alternative is not payable on substantially the same terms as another distribution alternative. The relevant terms include all terms affecting the value of the optional form, such as differences in terms relating to timing and commencement of the benefit.

Regulations section 1.401(a)(9)-7, A-4 provides that if an employee's benefit is transferred from one plan (a transferor plan) to another plan (a transferee plan), the benefit of the employee under the transferee plan is increased by the amount transferred for purposes of determining future required minimum distributions under the transferee plan. The required beginning date of the transferee plan will evidently govern the combined benefit. There is no exception for transferor plans and transferee plans that may have divergent required beginning dates. A literal application of the foregoing Regulations could result in mandatory distributions of portions of transferor plan benefits earlier than such benefits would have been distributed prior to the merger. Such accelerated mandatory distributions would appear to violate section 411(d)(6) of the Code.

In our view the existing Regulations promulgated under section 401(a)(9) do not provide clear guidance concerning plan mergers involving plans with divergent required beginning dates. Those existing Regulations appear to contemplate that all plans will have the same required

beginning dates. The ability to change required beginning dates may be limited by section 411(d)(6). The Regulations do not presently deal with the potential conflict with section 411(d)(6).

Some employers have complied with existing Regulations section 1.401(a)(9)-7 erroneously assuming that the Treasury and the IRS have granted relief from any attendant violations of section 411(d)(6). Other employers that were cognizant of the potential for violating section 411(d)(6) and section 204(g)(1) of ERISA have operated their merged plans in a manner that is consistent with the approach outlined below in the new Q&A-6 that we propose be added to Regulations section 1.401(a)(9)-7. We urge the Treasury and the IRS to expressly authorize both of these approaches taken by employers.

II. BACKGROUND AND CURRENT LAW

Divergent Required Beginning Dates Permitted

Retirement plans are permitted to have divergent required beginning dates for purposes of section 401(a)(9).

Under section 401(a)(9)(C), required minimum distributions must commence not later than the required beginning date. In general, the required beginning date is (1) in the case of a person who is a 5-percent owner[2], April 1 of the calendar year following the calendar year in which the employee attains age 70½ and (2) in the case of a person who is not a 5-percent owner, April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires from employment with the employer maintaining the plan.[3] However, a plan is permitted to provide that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which an employee attains age 70½ regardless of whether the employee is a 5-percent owner.[4]

Section 401(a)(9) Regulations Require Merged Plans to Use Required Beginning Date of Transferee Plan

Regulations section 1.401(a)(9)-7 requires that merged plans use the same required beginning date for purposes of section 401(a)(9). The required beginning date to be used is the required beginning date of the transferee plan.

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[2] For purposes of section 401(a)(9), a 5-percent owner is an employee who is a 5-percent owner (as defined in section 416) with respect to the plan year ending in the calendar year in which the employee attains age 70½. Regulations section 1.401(a)(9)-2, Q-2(c).

[3] Regulations section 1.401(a)(9)-2, A-1(a) and (b).

[4] Regulations section 1.401(a)(9), A-2(e); and Internal Revenue Service Notice 97-75, Q-10. Prior to the enactment of the Small Business Job Protection Act of 1996, retirement plans qualified under section 401(a) were generally required to provide for a uniform section 401(a)(9) required beginning date for all participants - April 1 of the calendar year following the calendar year in which the participant attained age 70½.

Regulations section 1.401(a)(9)-7, A-5 provides in relevant part as follows:

> For purposes of determining an employee's benefit and required minimum distribution under section 401(a)(9), a spinoff, a merger, or a consolidation (as defined in § 1.414(1)-1) will be treated as a transfer of the benefits of the employees involved. Consequently, the benefit and required minimum distribution of each employee involved under the transferor and transferee plans will be determined in accordance with A-3[5] and A-4 of this section.

Regulations section 1.401(a)(9)-7, A-4 provides in relevant part as follows:

> In the case of a transfer from one plan (transferor plan) to another (transferee plan), the benefit of the employee under the transferee plan is increased by the amount transferred in the same manner as if it were a plan receiving a rollover contribution under A-2 of this section.

Regulations section 1.401(a)(9)-7, A-2 provides in relevant part as follows:

> If an amount is distributed by one plan (distributing plan) and is rolled over to another plan (receiving plan), the benefit of the employee under the receiving plan is increased by the amount rolled over for purposes of determining the required minimum distribution for the calendar year immediately following the calendar year in which the amount rolled over is distributed. If the amount rolled over is received after the last valuation date in the calendar year under the receiving plan, the benefit of the employee as of such valuation date, adjusted in accordance with A-3 of § 1.401(a)(9)-5, will be increased by the rollover amount valued as of the date of receipt. In addition, if the amount rolled over is received in a different calendar year from the calendar year in which it is distributed, the amount rolled over is deemed to have been received by the receiving plan in the calendar year in which it was distributed.

Elimination of Required Beginning Date Prohibited

Section 401(a)(9) required beginning dates may not be eliminated retroactively (with respect to benefits already accrued) in the context of a plan merger without violating section 411(d)(6).

Section 411(d)(6) and a parallel provision in section 204(g)(1) of ERISA prohibit a plan amendment that has the effect of eliminating an optional form of benefit.[6] For this purpose, an

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[5] Regulations section 1.401(a)(9)-7, Q-3 addresses the situation where the employee's benefit is transferred in the first or second distribution calendar year under section 401(a)(9) and describes the obligations of the transferor plan in satisfying the section 401(a)(9) distribution requirements with respect to such employee.

[6] The Secretary of the Treasury has the ultimate authority to interpret these overlapping anti-cutback provisions. Reorganization Plan No. 4 of 1978, § 101, 43 Fed. Reg. 47713 (1978), 92 Stat. 3790; and *Central Laborers' Pension Fund v. Heinz,* 124 S. Ct. 2230 (2004).

agreement to transfer assets or to merge plans is treated as a plan amendment. Regulations section 1.411(d)-4, A-2(a)(3)(i) provides in relevant part as follows:

> The prohibition against the reduction or elimination of section 411(d)(6) protected benefits already accrued applies to plan mergers, spinoffs, transfers, and transactions amending or having the effect of amending a plan or plans to transfer plan benefits. Thus, for example, if Plan A, a profit-sharing plan that provides for distribution of plan benefits in annual installments over ten or twenty years, is merged with Plan B, a profit-sharing plan that provides for distribution of plan benefits in annual installments over life expectancy at time of retirement, the merged plan must retain the ten or twenty year installment option for participants with respect to benefits already accrued under Plan A as of the merger and the installments over life expectancy for participants with benefits already accrued under Plan B.

Optional forms of benefits are section 411(d)(6) protected benefits that may not be eliminated unless an express exception applies. For purposes of section 411(d)(6) the term optional form of benefit means a distribution alternative that is available under the plan with respect to an accrued benefit.[7] Different optional forms of benefit exist if a distribution alternative is not payable on substantially the same terms as another distribution alternative.[8] Different optional forms of benefit may result from differences in terms relating to payment schedule, timing or commencement.[9]

Section 401(a)(9) required minimum distributions with different section 401(a)(9) required beginning dates are different optional forms of benefits for purposes of section 411(d)(6). The Service has recognized that express exemptions from section 411(d)(6) are required in order for a plan sponsor to change section 401(a)(9) required beginning dates with respect to benefits already accrued.[10] Thus far, it appears that the Service has not yet expressly stated that a required beginning date providing for payments following retirement is a section 411(d)(6) protected benefit. However, just as the right to a required beginning date providing for payments prior to retirement is a protected section 411(d)(6) benefit, the right to a required beginning date that provides for payment following retirement should also be a protected section 411(d)(6) benefit that may not be eliminated with respect to benefits already accrued.

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[7] Regulations section 1.411(d)-3(g)(6)(ii).

[8] *Id.*

[9] *Id.*

[10] See, for example, Regulations section 1.411(d)-4, Q-10 containing a section 411(d)(6) transitional rule in which, during a limited period of time that generally expired with the end of the remedial amendment period applicable for changes under the Small Business Job Protection Act of 1996, the Service permitted plans to be amended to eliminate distribution options that provide for age 70½ distributions commencing prior to retirement from employment. For this purpose, an age 70½ distribution was a distribution commencing at any time during the period that begins on or after January 1 of the calendar year in which an employee attains age 70½ and ends April 1 of the immediately following calendar year. See also Internal Revenue Service Announcement 97-24 in which the Service recognized that an amendment that eliminates the right to receive a distribution prior to retirement after age 70½ is precluded by section 411(d)(6).

III. COMMENTS

We respectfully recommend that the Service and the Treasury amend Regulations section 1.401(a)(9)-7 to permit transferor plans and transferee plans to implement an approach similar to the separate account approach contemplated in Regulations section 1.401(a)(9)-8, A-2 (involving different beneficiaries).[11] Under the proposal, if benefits under a transferee plan are separated into separate identifiable components they may be separately distributed in the same manner as if the transfer had never occurred.[12]

Specifically, we recommend that the Service and the Treasury consider amending the Regulations section 1.401(a)(9)-7 by adding thereto the following new Q-6:

> Q-6. May an employer elect to apply special distribution rules in the case of a transfer of benefits where the transferor plan and the transferee plan provide for different section 401(a)(9) required beginning dates?
>
> A-6. In the case of a spinoff, merger or consolidation (as defined in § 1.414(1)-1) or other trust to trust transfer of assets (within the meaning of section 414(1)) involving a transferor plan and a transferee plan with different definitions of

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[11] Regulations section 1.401(a)(9)-8, A-2(a)(2) provides in relevant part as follows:

> If the employee's benefit in a defined contribution plan is divided into separate accounts and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts of the employee under the plan, for years subsequent to the calendar year containing the date as of which the separate accounts were established, or the date of death if later, such separate account under the plan is not aggregated with the other separate accounts under the plan in order to determine whether the distributions from such separate account under the plan satisfy section 401(a)(9). Instead, the rules in section 401(a)(9) separately apply to such separate account under the plan.

Regulations section 1.401(a)(9)-8, A-3 provides in relevant part as follows:

> For purposes of section 401(a)(9), separate accounts in an employee's account are separate portions of an employee's benefit reflecting the separate interests of an employee's beneficiaries under the plan as of the date of the employee's death for which separate accounting is maintained.

Regulations section 1.401(a)(9)-8, A-2(b) provides in relevant part as follows:

> The rules of paragraph (a)(2) . . . of this A-2 [of Regulations section 1.401(a)(9)-8, Q-2] also apply to benefits under a defined benefit plan where the benefits under the plan are separated into separate identifiable components which are separately distributed.

[12] This approach is consistent with the provisions of Regulations section 1.401(a)(9)-8, Q-14 which allow a transferee plan to distribute a benefit transferred from a transferor plan (including earnings thereon in the case of a defined contribution plan) pursuant to a Tax Equity and Fiscal Responsibility Act of 1982 (*"TEFRA"*) section 242(b)(2) election made under the transferor plan so long as the transferred amount is separately accounted for. Similarly, in the case of a TEFRA section 242(b)(2) election made under the transferee plan, Regulations section 1.401(a)(9)-8, Q-14 precludes the distribution of the transferred benefit (plus earnings thereon in the case of a defined contribution plan) from being distributed pursuant to such TEFRA section 242(b)(2) election and requires separate accounting of amounts from the transferee and transferor plans.

required beginning dates, if the benefits under the transferor plan and the transferee plan are separately accounted for in the case of defined contribution plans (including separate accounting for earnings and losses) or are separated into separate identifiable components in the case of defined benefit plans, the rules in section 401(a)(9) may be applied separately to such separate accounts (or separate identifiable components) just as if the transfer had never occurred. This treatment is available if the transferor plan and the transferee plan have different definitions of section 401(a)(9) required beginning dates even if the plan participant elects to commence distribution at a time that is not later than the section 401(a)(9) required beginning dates under both the transferor plan and the transferee plan. In the case of a transfer of assets involving a transferor plan and a transferee plan with potentially divergent section 401(a)(9) required beginning dates, if the special distribution rules of this A-6 are to apply the transferee plan must specify that the benefits under the transferor plan and the transferee plan will be separately accounted for (or separated into separate identifiable components in the case of defined benefit plans) and separately distributed for purposes of section 401(a)(9) in the same manner as if the transfer had never occurred.

For purposes of simplifying the administration of plans we respectfully recommend that merged plans with different definitions of required beginning dates be permitted to comply with section 401(a)(9) in the same manner as if the merger had never occurred, even if the date benefits actually commence under the transferee plan for a given participant is not later than the required beginning dates of both the transferor plan and the transferee plan.

We also respectfully recommend that the Treasury and the IRS, whether through an amendment of Regulations section 1.401(a)(9)-7 or otherwise, expressly state that compliance with the existing provisions of Regulations section 1.401(a)(9)-7 will not result in a violation of section 411(d)(6).

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2007-2008 CALENDAR

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

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

2007-2008
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