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TAX SECTION
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Dear Fellow Tax Section Members:

With cooling temperatures and football season underway, I am honored to deliver the following report for our fall edition of the *Texas Tax Lawyer*. I would also like to thank our Editor, Michelle Spiegel, for her continued commitment and hard work in delivering an outstanding *Texas Tax Lawyer* publication four times a year.

Overview of Our Busy Summer

The new officers met on Wednesday June 8, 2016 to begin planning for the upcoming year. We started this process a little earlier than in previous years. This was followed up by our Council Retreat which was held in conjunction with the Annual meeting on Thursday, June 16, 2016. In addition, the Tax Section held its first meeting of the Chairs, Vice-Chairs and Council on Friday, August 26, 2016.

As a result of these meetings, below are a few documents that have been approved:

1. The Calendar for the 2016-2017 Fiscal Year : http://www.texastaxsection.org/uploads/2016-2017%20SBOT%20FINAL%20Tax%20Section%20Calendar%20Revised%20Sept%201.pdf
2. The List of Chairs and Vice Chairs for the various committees: http://www.texastaxsection.org/Uploads/2016-2017_FINAL_SBOT_Committee_Chairs_Vice-Chairs16-17.pdf
3. The 2016-2017 budget: http://www.texastaxsection.org/uploads/Budget%20-%20August%202016%20Handout%20-%20Gray.pdf
4. The Statement of Direction: http://www.texastaxsection.org/uploads/Statement%20of%20Direction.pdf

Leadership Academy

The third of our four installments of the Leadership Academy took place on September 22- 23, 2016 in Houston, Texas. We have 21 members in the class. The event began with a tour of the Menil Collection followed by dinner at the Link Lee Mansion. All day events were scheduled for the following day at the offices of Norton Rose Fulbright. We had a videographer on site both days to prepare an informative and promotional video that will be made available on our website for future applicants. The next and final installment of the Leadership Academy for the current class is scheduled for January 18, 2017 and will take place in Austin, Texas.

Committee on Governmental Submissions

The State and Local Tax Committee delivered a set of comments to the Texas Comptroller on Wednesday, September 28, 2016. The comments addressed Proposed Amendments to 34 Tex. Admin. Code § 3.292, Repair, Remodeling, Maintenance, and Restoration of Tangible Personal Property. A copy of those comments is included in this edition. Several other comment projects are underway, including comments on the long-awaited Proposed Regulations issued by the Internal Revenue Service under Section 2704 of the Internal Revenue Code**.** The Committee on Governmental Submissions meets with committee chairs every month to discuss potential and pending comment projects.

Pro Bono Dockets

The Pro Bono Committee assisted taxpayers at the Houston Small Tax Case docket on September 12, 2016 and at the Dallas Small Tax Case docket on September 26, 2017. Several other similar events are scheduled throughout the State of Texas for the remainder of the calendar year at various locations including Dallas, El Paso, Houston and Lubbock.

Meeting with the Texas Comptroller

Our annual meeting with the Texas Comptroller of Public Accounts occurred on Tuesday, October 4, 2016, in Austin, Texas. The presentation was provided by the Texas Comptroller's office for the Tax Section of the State Bar, the Texas Society of CPAs and Tax Executives Institute. The morning session included presentations by Texas Comptroller of Public Accounts Glenn Hegar, Tax Section members Stephen Long and Matt Hunsaker, and Texas Comptroller Tax Policy Research Analyst Sarah Pai. The afternoon session included updates on various topics provided by members of the Texas Comptroller of Public Accounts. Portions of this program should soon be available on the Tax Section's 24/7 library. Many thanks to the Texas Comptroller of Public Accounts Glenn Hegar, his staff and the State and Local Tax Committee for their hard work and efforts in making this program available to members of the Tax Section.

Law School Outreach Program/Law School Scholarship Applications

The Tax Section's efforts at reaching out to law school students is well underway. The Tax Section will be meeting with law students at the Southern Methodist University Dedman School of Law on October 19th and Texas Tech University School of Law on November 3, 2016. Other law school programs are in the process of being scheduled.

The application period for law school scholarships is scheduled to open on January 16, 2017. Applications will be available on our website. So law students and professors will want to be on the lookout for the applications at about that time.

The New and Improved 24/7 Free Online CLE Library

The Tax Section recently launched a newly updated 24/7 Free Online Library. It continues to be free to members of the Tax Section. It includes over 70 audio and video programs, along with PowerPoint presentations and outlines. And it continues to grow. The following are recent additions to the 24/7 library on the web site. The parenthetical information indicates where on the 24/7 Library the recording may be found.

1. Chief Appraiser's Panel (What's New)
2. Discovery Issues (What's New)

3. This is Jeopardy Ethics! (What's New)
4. Keeping it Weird-the City of Austin v. Travis CAD Case (What's New)
5. Recent Developments in International Tax (What's New)
6. IRS Enforcement Update (What's New)
7. The State of State Taxation-An Update from the Texas Comptroller's Office (What's New)
8. Understanding the New Partnership Audit Rules-Practical Tips! (What's New)
9. Issues Every Tax Lawyer Needs to Know (But May Have Lost Track Of) (What's New)
10. Property Tax 101: Understanding Ad Valorem Taxation in Texas (What's New)
11. Federal Transferee Liability Related to Estate and Gift Taxes (Real Estate & Gift Tax).
12. Tax Legends Interview with Stanley Blend at the 2016 Annual Meeting ("Texas Tax Legends").

Nominations Committee

As directed under the Bylaws, I have recently appointed members of the Nominations Committee. These members include:

Alyson Outenreath (Immediate Past Chair); Andrius Kontrimus (2014-2015 Chair); Elizabeth Copeland (2013-2014 Chair); and Dan Micciche (2008-2009 Chair).

As the current Chair, I will serve on the Nominations Committee as an Ex-Officio member.

I would like to extend a special thanks to our past chairs for their continued willingness to serve the Tax Section of the State Bar.

Deadline for the Winder Edition of the *Texas Tax Lawyer*

The deadline for submitting articles for the winter edition of the *Texas Tax Lawyer* is January 13, 2017. Any members interested in submitting articles should contact Michelle Spiegel at Michelle.spiegel88@gmail.com.

Join a Committee

We have an active set of committees, both substantive and procedural as in previous years. Our substantive committees include: Corporate Tax, Employee Benefits, Energy and Natural Resources, Estate and Gift Tax, General Tax Issues, International Tax, Partnership and Real Estate, Property Tax, Solo and Small Firm, State and Local Tax, Tax Controversy, Tax- Exempt Finance, and Tax-Exempt Organizations. In addition, our facilitator committees include: the Committee on Governmental Submissions, Annual Meeting Planning Committee, Continuing Legal Education Committee, Newsletter Committee, and Tax Law in a Day Committee.

Any members interested in joining a committee can do so by visiting our website at www.texastaxsection.org.

Contact Information

I look forward to future communications with our members! In the meantime, below is my contact information as well as the contact information for our Tax Section Administrator, Kelly Rorschach, if anyone would like additional information:

David E. Colmenero, Chair
Meadows, Collier, Reed, Cousins,
Crouch & Ungerman, L.L.P.
901 Main Street, Suite 3700
Dallas, Texas 75202
214-749-2462
dcolmenero@meadowscollier.com

Kelly Rorschach
Administrative Assistant
State Bar of Texas
Tax Section
3912 W.Main Street
Houston, Texas 77027
k.inkblot@icloud.com

The Battle of the Georges: Exports, Taxation, and the U.S. Constitution[1]

By Sam C. Webb[2]

I. Introduction

American international trade policy is a significant political issue in the 2016 presidential cycle. Donald Trump has spent countless speeches railing against the Trans-Pacific Partnership, the North American Free Trade Agreement, and trade imbalances between the United States and nearly every one of the country's trading partners. Former Secretary of State Hillary Clinton rails against the harmful effects of trade agreements on America's working class. International trade is of great interest to Texans because Texas consistently leads the nation in exports, with the Port of Houston exporting more tonnage than any other American port.

Most lawyers and exporters, however, are unaware of the tax and constitutional implications of international trade, particularly exports. This article offers a brief review of the history of the Export Taxation Clause, its relevant case law and analyzes the impact of the law on current potential legal landmines, like the Oil Spill Liability Tax. As such, the article serves as an introduction to the Clause and its applicability to current business and legal issues, particularly in light of the allowance of domestic crude exports in the United States.

II. The Export Taxation Clause During the Founding Era

The Export Taxation Clause of the United States Constitution reads: "No Tax or Duty shall be laid on Articles exported from any State." While obscure in the minds of attorneys, law professors, law students, and certainly the citizenry at large, the Clause formed the bulwark against the implosion of the Constitutional Convention.[3] The Clause served as one of many accommodations made to secure unity among the various factions of the early republic.[4] Taxes

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[1] This article was originally presented at the Southern Academy of Legal Studies in Business 2016 Annual Conference.

[2] Attorney & Advisor with Ryan, LLC, in Houston, Texas; Adjunct Business Law professor in the Texas A&M University System.

[3] 6 Fla. Tax Rev. 1, 1 (2003)

[4] The Heritage Guide to the Constitution

were a political impetus for the American Revolution and export taxes in particular proved to be a possible hurdle to the formation of the American constitutional republic.

The Convention factions broke primarily along ideological, rather than geographic, lines. True, many Southerners were concerned that any new national government controlled by a majority of Northerners might result in export taxes against cotton or tobacco, crippling the Southern economy.[5] The South led the new country in exports and feared it would bear a disproportionate share of the tax burden.[6] Such was the position of Virginian George Mason, who advanced the notion that an export tax would be a mechanism by which the Northern states could effectively control the South.[7] Mason, a Southerner, was joined, though, by Oliver Ellsworth, a Northerner, who argued that export taxes would stifle industry regardless of location.[8]

In defense of export taxation stood giants of the American Revolution, namely, George Washington and James Madison - both Southerners in their own right - and Alexander Hamilton, a Northerner.[9] The defense of export taxation centered on two primary (and expected) concerns: government revenue and trade regulation.[10] These men argued that the new central government would be in great need of revenues to pay for, among other things, the needed naval protection for the Southern trade routes. Further, as a unified country, the central government would need the power to regulate foreign commerce through the Congressional tax power to ensure the country's foreign policy objectives were met.

The debate between the delegates to the Constitutional Convention was contentious, at best, and provided early insight to the new American political system. James Madison, as an example to modern legislators, pursued a parliamentary strategy to block the absolute prohibition of export taxation by requiring a supermajority of delegates to pass the prohibition. That strategy

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[5] 6 Fla. Tax Rev 1, 2 (2003)
[6] The Heritage Guide to the Constitution.
[7] Id.
[8] Id.
[9] Heritage.
[10] Id.

failed by a 6 to 5 vote. The absolute prohibition on export taxation then passed the Convention in a 7 to 4 vote and was ratified by the respective states.

The Clause served as a protection against perceived economic attacks against the South in the founding era, and all future hindrance to export commerce in the future, but also served to promote the doctrine of judicial review in *Marbury v. Madison*. In that case, Chief Justice John Marshall used the Clause and its history to argue that judges should not "close their eyes on the constitution...only to see the law,"[11] but should render judgment as to whether a statute from Congress violated, in this case, the Export Taxation Clause of the United States Constitution. The Clause was "exhibit A" for the doctrine of judicial review, cementing its importance in the founding era of the new republic.

III. The Export Taxation Clause Before the Supreme Court of the United States

The Export Taxation Clause provided the backdrop for Constitutional Convention drama - as if any backdrop was needed - and functioned as an example in the argument for the doctrine of judicial review. However, despite the dramatic origin, the Clause sat rather dormant for long periods in the history of the United States. Few cases before the Supreme Court have implicated the Clause, but those cases that have raised questions of the Clause are fundamental to the question of congressional taxing power. Interesting, too, the Export Taxation Clause cases reveal the same two camps at play in the history of Clause interpretation as were active in the original debate at the Constitutional Convention. In other words, the history of interpretation is a battle of the Georges.

A. Tax, Duty, or Fee?

The first issue when interpreting the Export Taxation Clause is the definition of a "Tax or Duty." For our purposes, and keeping with the history of Court interpretation, we will treat a tax and duty as synonymous. As straightforward as the question may seem, a tax is by no means an

[11] *Marbury v. Madison*, 5 U.S. 137, 179 (1803).

all-encompassing phrase for any governmental charge as we see in the history of the Court's interpretation of the Clause.

1. Fees for Services Rendered in *Pace v. Burgess*, 92 U.S. 372 (1875)

The Court first reviewed a congressional tax in light of the Clause in the 1875 case *Pace v. Burgess*.[12] In a Washingtonian move to raise revenue, Congress enacted an excise tax on tobacco at thirty-two cents per pound, exempting tobacco intended for export. Congress, alternatively, levied a twenty-five cent stamp "tax" affixed to each package of exported tobacco.[13] The petitioners argued that the stamp tax was an unconstitutional tax laid on exported tobacco in violation of the Clause and sought refund for the stamp tax.

The Court distinguished between the thirty-two cent tax levied per pound of produced tobacco and "the stamp…[that] was intended for no other purpose than to separate and identify the tobacco which the manufacturer desired to export, and thereby, instead of taxing it, to relieve it from the taxation to which other tobacco was subjected."[14] The stamp was a "means devised to prevent fraud" and acted as "compensation for services properly rendered" by the federal government, namely certifying each tobacco package as intended for export.[15]

The Court in *Pace* did consider that - at least during this era - "stamps [are] seldom used, except for the purpose of levying a duty or tax."[16] In fact, the levy was called a "stamp tax." Justice Bradley, however, made the famous quip that the Court "must regard things rather than names."[17] Later in the opinion, Justice Bradley offers more "clarity" when he writes: "The sense and reason of the thing will generally determine the character of every case that can arise."[18] As such, the Court found that rather than using a stamp to levy a tax on exported tobacco, the "sense and reason of the thing" acted as a means to secure exemption from the tobacco tax.[19] Therefore,

[12] 92 U.S. 372 (1875).
[13] Id. at 374.
[14] Id. at 375.
[15] Id.
[16] Id. at 376.
[17] Id.
[18] Id.
[19] Id.

since the stamp's purpose was to secure exemption from the tobacco tax and acted as compensation for such service, the stamp tax was a fee for purposes of the Clause.

Pace serves as the foundational case setting forth the difference between a tax and a user fee under the Clause, a distinction that carried forward over 100 years in the Court's jurisprudence. In this case[20], the Court propounded the important interpretational notion that a tax under this Clause is not "compensation for services properly rendered." Rather, whether called a tax or not, any such levy on exports is a permissible fee under the Clause.

B. The Relationship Between a Tax or Duty and "Articles Exported"

It is well-established by *Pace* and *U.S. Shoe* the distinction between a tax and a user fee for purposes of the Export Taxation Clause. The natural question arises, then, what is the relationship between the tax and the "Articles exported?" Put another way - how attenuated must the relationship be between the tax and export to satisfy the Clause?

1. Stamp Tax on Export Surrogates in *Fairbank v. United States*, 181 U.S. 283 (1901) and *Thames & Mersey Marine Insurance Co. v. United States*, 237 U.S. 19 (1915)

For guidance on this question, like *Pace*, stamp taxes provide the initial case law to determine what counts as "Articles exported" for purpose of the Clause prohibition. In 1898, Congress enacted a stamp tax on foreign bills of lading. In 1900, an agent for Northern Pacific Railway Company failed to stamp an export bill of lading for exported wheat and was fined an amount of $25.[21] The question before the Court was whether the stamp tax on the export bill of lading was an unconstitutional tax on articles exported from the United States or whether the tax was within the congressional plenary power to tax documents and instruments in the normal course of business transactions.[22]

[20] The Court took up the same issue in *Turpin v. Burgess*, 117 U.S. 504 (1886) drawing the same conclusion, that the export stamp was "really the objects of favorable treatment on the part of the government." 117 U.S. at 508.
[21] 181 U.S. at 283-284
[22] Id. at 289

Aside from the lengthy discussion by the Court on matters of judicial review, the Court also went to great lengths in its analysis of the effect of bills of lading in the shipping process. The Court declared boldly that "The requirement of the Constitution is that exports should be free from any governmental burden"[23] and "the power to tax is the power to destroy."[24] The Court found that destructive power can even be exercised indirectly on bills of lading evidencing the export as an unconstitutional governmental burden in violation of the Export Taxation Clause.[25]

The Court opined that "a tax or duty on a bill of lading, although differing in form from a duty on the article shipped, is in substance the same thing; for a bill of lading, or some written instrument of the same import, is necessarily always associated with every shipment of articles of commerce from the ports of one country to those of another."[26] In fact, the Court understood that the "necessities of commerce require it." [27] Therefore, according to the Court, a tax upon export bills of lading "is, in substance and effect, a [tax] on the article exported."[28] *Fairbank* established the principle that an export surrogate - in this case, a bill of lading - was sufficiently connected to the underlying export as to be indistinguishable from the export for purposes of the Export Taxation Clause.

This *Fairbank* principle was again affirmed by the Court in 1915 in *Thames & Mersey Marine Insurance Co. v. United States*. Thames & Mersey was an insurance company engaged in the business of underwriting marine insurance.[29] As such, Thames & Mersey periodically insured exported goods from certain marine risks.[30] By an act of Congress, the company had to pay a stamp tax on such marine insurance policies for exported goods and the company brought suit for refund of the tax paid arguing, as in *Fairbank*, that the connection between the insurance

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[23] Id. At 290.
[24] Id. At 291.
[25] Id. At 312.
[26] 181 U.S. at 293-294
[27] Id. at 294.
[28] Id.
[29] 237 U.S. 19, 22 (1915)
[30] Id.

policy and the exported goods was close as to make indistinguishable the policy from the exported articles.

The Court found that "the business of exporting requires not only the contract of carriage [i.e. bills of lading], but appropriate provision for indemnity against marine risks during the voyage. The policy of insurance is universally recognized as one of the 'ordinary shipping documents'"[31] Again, the Court looked to the "demands of commerce"[32] for justification in tying the insurance policy and "ordinary shipping documents" to the export itself. Therefore, the Court held that that stamp tax on marine export insurance policies was in violation of the constitutional prohibition.[33]

2. Pre-Export Tax in *Cornell v. Coyne*, 192 U.S. 418 (1904)

The Court may seem to give deference to the demands of commerce in the preceding cases by finding that ordinary shipping documents are indistinguishable from exported articles under the Clause, but the Court's rationale is closely tied to its decisions of the nature of exports. When does an export become, well, an export? This was a core question in the *Cornell v. Coyne* case before the Court in 1904.

The Cornell brothers manufactured and exported filled cheese[34] in and from Illinois.[35] Congress imposed a 1 cent per pound tax on every pound of domestically manufactured filled cheese. The Cornell brothers manufactured the majority of its filled cheese under export contacts and filed suit for a refund of such taxes. The Cornell brothers relied on the previous stamp tax cases as justification for its suit.

The Court, in light of its previous stamp tax cases, now was faced with the question of whether a tax on to-be-exported goods violated the Clause. The Court previously held that an

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[31] 237 U.S. at 26.
[32] Id.
[33] Id. at 27.
[34] The author was unfamiliar with "filled cheese." According to Merriam-Webster Online, filled cheese is a product made from whole or skim milk enriched by the addition of foreign fatty material.
[35] 192 U.S. at 425

export is an export only after it "is in the actual process of exportation, and which has begun its voyage or preparation for its voyage."[36] So, in this case, was the filled cheese manufactured under an export contract improperly levied with a 1 cent per pound tax?

The Court affirmed that nature of an export and held that the tax was not in violation of the Export Taxation Clause. The Court declared that the Clause "does not mean that articles exported are relieved from the prior ordinary burdens of taxation which rest upon all property similarly situated."[37] In other words, as in *Coe*, the Court in *Cornell* acknowledged that goods manufactured for export are not legally exports at the time of manufacture. Therefore, if a tax is levied on manufactured goods *at the time of manufacture*, regardless of export intent, those goods are subject to the same tax as all other property similarly situated. If the tax had been bifurcated between manufactured filled cheese for domestic use and for export, like the tobacco in *Pace*, with a tax explicitly on filled cheese for export, then it is likely the Court would have reached a different conclusion. However, those are not the facts and the Court found that the 1 cent stamp tax on manufactured filled cheese was not levied on "articles exported," but rather all property similarly situated.

C. Same Song and Dance: *IBM* & *U.S. Shoe*[38]

The Court decided a flurry of cases related to the Clause in the late 19th and early 20th centuries. Those cases set the framework for Congress for most of the 20th century. And given the implementation of the federal income tax, issues of stamp taxes largely fell by the wayside as means of revenue. However, a flurry of Clause activity rained down on the Court again in the 1990's with two cases directly related to the issues addressed nearly one hundred years before: tax versus fees and the relationship between a tax and articles exported.

In 1996, the Court revisited the issue of the relationship between an export and export insurance in light of *Thames & Mersey*. IBM paid a tax on insurance premiums remitted to

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[36] *Coe v. Town of Errol*, 116 U.S. 517, 528-529 (1886)
[37] *Cornell*, 192 U.S. at 427.
[38] The author recognizes these two cases are worthy of separate and detailed attention, but unfortunately such analysis is outside the breadth intended by this brief overview article.

foreign insurers to cover shipment of goods to its foreign insurers.[39] IBM filed a refund claim for the tax and was denied by Internal Revenue Service and subsequently filed suit.

Writing for the majority, Justice Clarence Thomas reiterated that the Court has "broadly exempted from federal taxation not only export goods, but also services and activities closely related to the export process."[40] The parties to the case admitted that the insurance policy issue here mirrored the facts in *Thames & Mersey*. But, the petitioner in *IBM,* the federal government, argued that the Court should overrule *Thames & Mersey* in light of the Court's developed dormant Commerce Clause jurisprudence.[41] However, the Court rejected the government's argument due to the express, textual prohibition of any tax on articles exported under the Clause. Justice Thomas wrote for the majority:

> "At one time, the Court may have thought that the dormant Commerce Clause required a strict ban on state taxation of interstate commerce, but the text did not require that view. The text of the Export Clause, on the other hand, expressly prohibits Congress from laying any tax or duty on exports. These textual disparities strongly suggest that shifts in the Court's view of the scope of the dormant Commerce Clause should not, and indeed cannot, govern our interpretation of the Export Clause."[42]

The Court affirmed *Thames & Mersey* in *IBM*, holding "We conclude that the Export Clause does not permit assessment of nondiscriminatory federal taxes on goods in export transit."[43]

Interestingly, just as the dissenting justices in *Fairbank*, Justices Kennedy and Ginsburg dissented in this case referencing the 1797 congressional Act "laying Duties on stamped Vellum, Parchment, and Paper" as evidence that one of the earliest Congresses had intentionally levied a stamp tax on legal documents rather than direct exports in order to avoid violation of the Clause.[44] The Court has historically acknowledged this historical fact, but has declined to allow such action to sway the clear textual prohibition. As in *IBM*, the Court has chosen to apply the

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[39] *United States v. International Business Machines Corp.*, 517 U.S. 843 (1996)
[40] Id. at 846.
[41] Id at 850.
[42] Id. at 850-851.
[43] Id. at 863.
[44] 6 Fla. Tax Rev. 1, 22 (2003).

strict letter of the Clause to the facts presented. As such, the doctrine that the Clause prohibits even export surrogates, like bills of lading and insurance policies, is well established.

Two years later, the Court took up the "tax versus fee" question again. In *United States v. United States Shoe Corporation*,[45] the Court was faced with the question of whether the Harbor Maintenance Tax was prohibited by the Clause. The Harbor Maintenance Tax ("HMT") is an ad valorem tax levied against the value of imported goods. At the time of the case, the HMT was also levied against the value of exports. U.S. Shoe Corp., as an exporter, filed a refund of HMT under the auspice that HMT was unconstitutionally a tax against exports. The Court was faced again with whether this revenue stream was a tax or a fee, like *Pace v. Burgess*.

The government found itself in the awkward, though not uncommon, situation of arguing that the "tax" was actually a user fee collected for the maintenance of public utility ports of entry.[46] The Court reiterated the developed case law that the Clause provides a categorical ban on all taxation levied against exports, but allows for fees, "provided that the fee lacks the attributes of a generally applicable tax or duty and is, instead, a charge designed as compensation for Government-supplied services, facilities, or benefits."[47] Ultimately, the Court held "that the tax, which is imposed on an ad valorem basis, is not a fair approximation of services, facilities, or benefits furnished to the exporters, and therefore does not qualify as a permissible user fee."

U.S. Shoe is important because it reiterated the criteria that a fee must be proportionate compensation for a rendered service. Otherwise, a generally-applicable tax on the export or its surrogate is a violation of the Clause. In this case, a carrier could dock at the Port of Houston with $1 billion worth of goods on board for export. The carrier next to it could dock with $100 million of goods valued and pay much less in HMT, yet receive the same service at the docking station. Unlike the stamp tax-turned-fee in *Pace*, the disparity in amount paid relative to service received was the primary factor for the Court to overturn the HMT for exports.

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[45] 523 U.S. 360 (1998).
[46] Id. at 360.
[47] Id. at 363.

This brief survey of the leading cases interpreting and applying the Export Taxation Clause offers several clear doctrines. First, the Court recognizes the Clause as a unique, clear, categorical prohibition of Congressional taxing power on "exported articles." Second, the categorical ban on taxation of exports extends to export surrogates, such as export documentation and insurance policies. Third, however, that does not preclude Congress from levying fees related to exportation or exports when such fees are proportionate compensation for governmentally-rendered services. And, fourth, pre-exported goods are subject to taxation like all similarly situated property.

IV. The Export Taxation Clause Today

Given the relative clarity of interpretation of the Export Taxation Clause in the history of the Court, one might conclude the likelihood of other cases arising to the appellate level, much less the Supreme level, of the court system is rather low. However, the Clause is sure to see even more flurries in the coming years as storm clouds have formed due to changing policy dynamics.

A. *Consolidation Coal Co. v. United States*[48]

In this case, a consolidation of coal producers sued the federal government for refund of revenue collected under the Surface Mining Control and Reclamation Act ("SMCRA"), which provides that a reclamation fee is levied on each ton of coal produced for sales, transfer, or use.[49] The coal industry group argued that since the fee is collected at first sale or use, that effectively the fee is a tax levied against export sales.[50] After several years of litigation, the Federal Circuit held that the production of coal does not include the sale of coal, but only the extraction of coal.[51] Therefore, the fee falls within the purview of *Cornell* that held pre-exported goods are subject to generally applicable taxes as all similarly situated property, even despite the reality

[48] 615 F.3d 1378 (Fed. Cir. 2010; writ den'd 2011)
[49] Id. at 1381.
[50] Id.
[51] Id.

that the reclamation fee is collected at time of first sale. The taxable event is the extraction of the coal, rather than the export sale of the coal.[52]

The significance of *Consolidation Coal* is twofold. First, the Federal Circuit applied the logic of *Cornell* without citing the case that the timing of the tax or fee on pre-exports is not prohibited under the Clause. Second, the Supreme Court of the United States denied the petition for writ of certiorari. Therefore, the *Consolidation Coal* case stands as a Federal Circuit case that adds more color to the question of at what point does a tax, or in this case fee, attach to an export. This question will undoubtedly continue to be raised of taxes and fees that exist for environmental protection and reclamation, as is the case with the Oil Spill Liability Tax.

B. Oil Spill Liability Tax[53]

Congress imposed a tax on "any domestic crude oil…exported from the United States" so long as "no tax was imposed on such crude oil" previously under subsection (a) of the same statute.[54] The rate of the tax is 8 cents per barrel.[55] Even more, Congress makes "the person…exporting the crude oil" liable for payment of the tax.[56] This statute has never been tested in Court, to my knowledge, because of the historical ban on exporting domestic crude oil. However, in light of the recent allowance of domestic crude exports, the constitutionality of this statute will almost surely be called into question.

The case law surrounding the Clause is instructive of how a court might understand the Oil Spill Liability Tax. First, the Oil Spill Liability Tax is a tax for purposes of the Clause, rather than a "user fee" designed as compensation for government-supplied benefits. The Oil Spill Liability Tax set forth in Section 4611(b) of Title 26 of the United States Code is a <u>tax</u>, rather than a fee, imposed on "domestic crude oil…exported from the United States."[57] This may seem obvious given that the statute refers explicitly to "a tax at the rate specified in subsection (c)

[52] Id. at 1382.
[53] 26 U.S.C. § 4611
[54] 26 U.S.C. § 4611(b)(1)
[55] 26 U.S.C. § 4611(c)(2)(B)(i)
[56] 26 U.S.C. § 4611(d)(3)
[57] 26 U.S.C. § 4611(b).

[that] is hereby imposed on such crude oil."[58] But, "'we must regard things rather than names' in determining whether an imposition on exports ranks as a tax."[59]

The United States Supreme Court has found a categorical ban of any tax on exports under the Export Taxation Clause of the United States Constitution.[60] Specifically, the prohibition is against a generally applicable tax levied against exports, rather than "a 'user fee'…designed as compensation for government-supplied services, facilities, or benefits."[61] A permissible user fee must bear "connection between a service the Government renders and the compensation it receives for that service."[62] The permissible user fee must not be proportional to the quantity or value of a given product.[63] On the contrary, if the disputed fee is generally applicable, bears no direct connection between a service rendered by the Government and compensation for that service, and is proportional to the quantity or value of a given product, the "fee" is a tax.[64]

The Oil Spill Liability Tax is a generally applicable tax levied against all exportation of domestic crude oil so long as no tax was imposed under § 4611(a).[65] Further, the Oil Spill Liability Tax bears little direct connection between a service rendered by the Government and compensation for that service. The Oil Spill Liability Tax funds the Oil Spill Liability Trust Fund.[66] The Oil Spill Liability Trust Fund is authorized to make certain expenditures, subject to subsequent appropriation Acts,[67] like payment of liabilities and clean-up costs related to oil pollution, but those expenditures are only indirectly related to the immediate collection of the tax.

The Trust Fund is analogous to the collection of the Harbor Maintenance Tax (HMT) in the *U.S. Shoe Corp.* case, where HMT monies were deposited into a fund from which Congress could appropriate amounts to pay for harbor maintenance, development, and related projects. In that case, the Court held that such collection of HMT was in violation of the Clause because the

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[58] 26 U.S.C § 4611(b)(1)(B).
[59] *U.S. Shoe Corp.*, 523 U.S. at 367 (quoting *Pace v. Burgess*, 92 U.S. 372, 376 (1875)).
[60] *U.S. Const. art. I, § 9, cl. 5; U.S. Shoe Corp.*, 523 U.S. at 363; *IBM*, 517 U.S. at 846.
[61] *U.S. Shoe Corp.*, 523 U.S. at 363.
[62] *U.S. Shoe Corp.*, 523 U.S. at 369.
[63] *Id.; See, e.g., Pace*, 92 U.S.at 375.
[64] *See, e.g., U.S. Shoe Corp.*, 523 U.S. 360 (1998) and *IBM*, 517 U.S. 843 (1996).
[65] 26 U.S.C § 4611(b)(1)(A)-(B).
[66] 26 U.S.C. § 9509(b)(1).
[67] 26 U.S.C. § 9509(c).

HMT paid by an exporter did not correlate reliably with the federal harbor services used by the exporter.[68] The same is true of each crude oil exporter who pays 8 cents per exported barrel into the Trust Fund without any direct service, supply, or benefit from such extracted money.

The tax is also proportional to quantity of the given product. As opposed to paying a given amount for each exported product regardless the quantity or value of the product, the tax in this case is 8 cents per barrel of exported crude.[69] In the *Pace* case, the Court held that a flat rate stamp fee for the inspection of an export shipment, regardless the quantity or value of the export shipment, did not violate the Clause because the fee was not levied on the value or quantity of the shipment in the way a tax is imposed. In this case, however, the tax is imposed upon a certain quantity – specifically, a barrel, which is defined as 42 United States gallons.[70] Therefore, a court would likely find the Oil Spill Liability Tax is a tax of the nature contemplated by the Export Taxation Clause.

Second, a court would likely find the Oil Spill Liability Tax is a tax laid against "Articles exported" as contemplated by the Export Taxation Clause, rather than pre-exported product. The Clause prohibits "taxes levied on goods in the course of exportation and taxes directed specifically at exports."[71] However, the Clause "does not mean that articles exported are relieved from the prior ordinary burdens of taxation which rest upon all property similarly situated."[72] In other words, "nondiscriminatory pre-exportation assessments do not violate the Clause, even if the goods are eventually exported."[73]

The Oil Spill Liability Tax, however, is imposed directly upon "any domestic crude oil…exported from the United States."[74] Specifically, the tax is imposed against each barrel, or 42 United States gallons, of exported crude.[75] Further, the "tax imposed by subsection (b) shall

[68] *U.S. Shoe Corp.*, 523 U.S. at 369.
[69] 26 U.S.C. § 4611(c)(2)(B)(i).
[70] 26 U.S.C. § 4612(a)(8).
[71] *IBM*, 517 U.S. at 847 (citing *Turpin v. Burgess*, 117 U.S. 504 (1886)).
[72] *Cornell v. Coyne*, 192 U.S. 418, 427 (1904).
[73] *IBM*, 517 U.S. at 848.
[74] § 4611(b)(1)(A).
[75] 26 U.S.C. § 4612(8).

be paid by the person…exporting the crude oil."[76] The Oil Spill Liability Tax is not a pre-exportation assessment imposed upon eventually exported crude oil, like a business personal property or severance tax, but rather a tax directed specifically at exports of crude oil. Therefore, the Oil Spill Liability Tax is a tax imposed upon "Articles exported" and is therefore in violation of the Export Taxation Clause.

This brief analysis of the Oil Spill Liability Tax makes clear that it will be a soon challenged tax levied on exports. The author's view is that this tax is a tax on exports in violation of the Clause. The primary question, however, is to what extent will the Court characterize the tax as a fee. If the Court views the tax as a generally proportionate compensation for services rendered in the event of an oil spill accident, then arguably the Court will find the tax to be a user fee, essentially a privilege fee for oil production.

V. Conclusion

The Export Taxation Clause in the United States Constitution was propounded in controversy, but has served as a stalwart defense against the plenary taxing authority of Congress. It has not seen much case action at the highest court, but the rare times it is implicated in a decision it has offered relatively clear and thorough legal rules. The Clause may be a rather silent clause in the history of constitutional interpretation, but it is relevant more so today than since the turn of the 19th century.

[76] § 4611(d)(3).

THE WILSON FIRM
TAX LAWYERS
2002 TIMBERLOCH PLACE, SUITE 550A
THE WOODLANDS, TEXAS 77380
PHONE: (281) 210-0140
FAX: (832) 553-7869
www.thewilsonfirmpllc.com

Are they employees or independent contractors? How they may actually be BOTH...and the IRS might agree...sort of.

By: Lee Wilson, JD, LL.M.

For business owners, the decision on how to classify those who work for them is very important. It's been known for a while that worker classification matters are one of the key target areas for the IRS, and in an era of constant cutbacks and budget shortfalls, it's an area that will continue to have their attention. As recently as the summer of 2014, the IRS announced that it was stepping up its audits of S Corporations, largely due to what has been perceived as abuses in this area. Combined with a joint information-sharing initiative between the IRS and the U.S. Department of Labor to ensure that such misclassifications are minimized, it's clear that this is an area of focus among multiple government agencies and demands attention from business owners and their advisors.

But what about instances where it makes sense to have employees do additional work after hours that a company would have normally hired outside help to do? For example, what if Jane from Accounting who happens to have a penchant for graphic design is hired to design the new logos to be put on the company's delivery trucks? Or what if Tom from Operations is tabbed to make deliveries after work of critical items for the freight delivery company he works for that the company would have otherwise hired an independent delivery company to handle? Clearly, these examples offer up situations where the roles Jane and Tom are being paid to fill are completely different. Might that thus allow the companies that employ them for the former role to treat them differently for withholding tax purposes while performing the latter duties?

The Office of Chief Counsel - which represents the IRS in disputes before the United States Tax Court in worker classification matters - has recognized that such a dichotomy can exist. In late 2012, the Office of Chief Counsel issued an information letter addressing this topic. *See* Office of Chief Counsel Information Letter 2012-0069, released December 28, 2012. Importantly, the information letter was provided to a member of Congress on behalf of a constituent, was for informational purposes only, and did not constitute a ruling. The inquiry centered around whether or not the same individual can be both an employee and an independent contractor simultaneously for the same company. While the inquiry posed this question in the context of the individual working as a consultant on two separate consulting projects, those specifics weren't central to the analysis put forth in the information letter. Rather, the letter focused on analyzing the same factors used to evaluate whether an individual falls into the "employee" or "independent contractor" classification that's used in those types of cases. Those factors focus on the relationship between the worker and the business, and the facts and circumstances of each case are generally categorized and reviewed within a construct of: 1) behavioral controls; 2) financial controls; and 3) the relationship of the parties. When one analyzes these factors while evaluating individual workers, you can quickly begin to see that in cases where one individual occupies these "dual roles" within the same company, some factors both favor AND disfavor one status simultaneously. For example, when looking at the financial control factor in relation to Jane up above, it would likely be clear that when it comes to her performing her function as an accountant, she'd probably fail in all respects to qualify as an independent contractor assuming the situation isn't very unusual. Jane's risk of making a profit or a loss, her making her accounting services available to the market at large (unlikely to be allowed by her company), and her incurring a bunch of unreimbursed expenses while performing the accounting function (unless she forgets to turn in her receipts) are likely going to tip heavily toward "employee" status. However, when it comes to her graphic design work, a look at those same factors may yield a very different outcome. Jane may have purchased the design software she uses on her own and it may be on her home computer, which is where she's usually fiddled around with graphic design in the past. Perhaps she's taken graphic design classes on her own dime as well, and purchased other related supplies needed to produce the designs. Maybe she even has her own website where she markets her talents to other businesses or individuals that she also pays for. Clearly, the scale has tipped considerably the other way when looking at Jane's situation from this angle. The information letter makes it clear that a role-based approach is necessary in these "dual role" situations, and provides that "[i]n instances where an individual provides services in two separate roles to the same business, the IRS examines separately the relationship between the worker and the business for each performance of service . . . [i]f an employer-employee relationship is found with regard to the performance of services for only one role of the worker, remuneration with regard to only those specific services is subject to all FICA and income tax withholding requirements under the Code." *See* Chief Counsel Information Letter 2012-0069.

Interestingly, in our practice, we've seen an increased number of instances where the IRS has attempted to "recharacterize" the amounts paid to employees for their second role (where they'd been paid as independent contractors). In doing so, the agents have taken the position that the reduced penalty regime that normally applies under I.R.C. § 3509 when an employer mistakenly fails to withhold income and employment taxes does not apply in these cases to the portion of compensation paid from which no withholding took place (i.e., for the second role). In essence, their reasoning seems to be that § 3509 only applies in "reclassification" cases – where workers are treated as simply falling into the incorrect classification - not cases where they are simply "recharacterizing" the portion of compensation paid to a worker for their second role.

I.R.C. § 3509 was originally enacted to provide a bit of a break from paying the full amount of past withholding taxes to employers who accidentally misclassified workers as independent contractors (its application is excepted in cases where such failure was intentional). While the legislative history is sparse, the Joint Committee on Taxation's report underlying the enactment of the statute clearly indicates that the rule is intended to provide relief against the "significant retroactive tax burden" that can apply to employers in situations where workers are reclassified as employees. However, the statute itself nor the legislative history address any exceptions for situations where this "dual role" issue comes into play. The relevant statutory language is somewhat vague and leaves room for interpretation, stating that "[i]f any employer fails to deduct and withhold any tax under chapter 24 (these are income taxes) or subchapter A of chapter 21 (more commonly known as "FICA" taxes) with respect to any employee by reason of treating such employee as not being an employee for purposes of such chapter or subchapter, the amount of the employer's liability for . . ."

There is no case law that we can find that specifically deals with these "dual role" situations, so we really don't have any instances where a court has interpreted how this language might apply in these types of cases. There are also no interpretive regulations issued by the Treasury Department for I.R.C. § 3509, so we're left with a little room here to argue how it SHOULD apply (that's always nice, isn't it?). It seems clear that in cases like this, an employer's failure to withhold these taxes on the compensation paid to Jane or Tom for their secondary, unrelated role was due to "treating such employee as not being an employee," but what does "any" mean? "Any" as in NO tax was withheld AT ALL with regard to that employee, period? Or is "any" here to be interpreted within the context of each separate, distinct role? The Office of Chief Counsel recognizes that such dual role situations can exist, and made it clear in the information letter issued that each role should be looked at on its own when determining whether FICA and withholding taxes should apply. Doesn't that cut toward the argument, then, that the penalty relief statutorily afforded in normal cases where an employer simply accidentally misclassifies its workers should also apply in cases where those workers just have more than one role? In light of the statutory language's lack of such an exclusion, it seems inequitable for the IRS to take the opposite approach. Of course, it goes without saying that it's also an option when representing clients in these dual role cases to contest whether such "recharacterization" should apply at all. After all and as discussed, the Office of Chief Counsel has already recognized that such situations can exist, and if so, perhaps the facts support the lack of withholding as to that second role and thus, no penalties - reduced or otherwise - should apply. But as we all know, there's a financial balance that has to be struck between accepting what the examining agent is proposing at the end of the audit, and the cost (and risk) of fighting that down to zero at Appeals and/or in court. But it sure would be nice if the proposed penalties at that initial stage were in line with what we believe is statutorily required.

Finally, it’s worth noting that with regard to the distinction between "reclassification" and "recharacterization" being put forth by the IRS in these cases, neither word - nor any derivative thereof - appear in the statute.

New Tax Rules Relating to Healthcare Management Contracts

By: **Joy R. Ellis, Norton Rose Fulbright**
Patrick L. O'Daniel, Norton Rose Fulbright
George W. Scofield, Norton Rose Fulbright
Peter D. Smith, Norton Rose Fulbright

On August 22, 2016, the Internal Revenue Service (the "IRS") released Revenue Procedure 2016-44,[1] further modified on September 2, 2016 ("Rev. Proc. 2016-44"), which provides guidance with respect to management contracts[2] related to property financed with certain types of tax-exempt debt. Rev. Proc. 2016-44 modifies and supersedes prior guidance contained in Revenue Procedures 97-13 and 2001-39[3] and section 3.02 of Notice 2014-67[4]. Rev. Proc. 2016-44 provides new safe harbor conditions for management contracts which, if satisfied, will assure that the contract does not create private business use under sections 141 and 145 of the Internal Revenue Code of 1986 (the "Code").[5] Having more than a de minimis amount of private business use may disqualify bonds from being tax-exempt. This article discusses Rev. Proc. 2016-44 specifically in the context of healthcare financings.

Certain types of tax-exempt bonds (including qualified 501(c)(3) bonds which are issued for many nonprofit healthcare systems) are subject to a limitation on the amount of private business use of financed facilities. Private business use may result from certain types of management contracts relating to bond-financed facilities. Until now, issuers of tax-exempt bonds and conduit borrowers such as healthcare systems have relied on the safe harbor conditions established under Revenue Procedures 97-13 and 2001-39 and, more recently, Notice 2014-67 (collectively, the "Original Safe Harbors") to ensure that management contracts entered into with respect to financed property do not result in private business use. Revenue Procedure 97-13, however, was somewhat constraining, resulting in significant efforts to conform the normal commercial practices of the nongovernmental service provider to noncommercial

[1] 2016-36 I.R.B. 1.

[2] Management contracts generally include service contracts and incentive payment contracts. Management contracts that are properly treated as leases for federal income tax purposes are not subject to this guidance.

[3] Revenue Procedure 97-13, 1997-1 C.B. 632, as originally issued, specified various permitted terms of contracts that depend on the nature of the compensation, including the extent to which the compensation is a periodic fixed fee. The greater the percentage of fixed compensation, the longer the permitted term of the management contract. Revenue Procedure 2001-39, 2001-2 C.B. 38, made only a minor amendment to Revenue Procedure 97-13 allowing for automatic increases in set fees according to specified, objective, external standards.

[4] Section 3.02 of Notice 2014-67, 2014-46 I.R.B. 822, expanded the Revenue Procedure 97-13 safe harbors to address certain developments involving accountable care organizations after the enactment of the Patient Protection and Affordable Care Act, Pub. L. 111-148, 124 Stat. 119, and also to allow a broader range of variable compensation arrangements for shorter-term management contracts of up to five years. The remainder of Notice 2014-67, which sets forth circumstances under which participation in the Medicare Shared Savings Program through an accountable care organization will not in itself result in private business use of the healthcare organization's tax-exempt bond-financed facilities, is not modified or superseded by Rev. Proc. 2016-44 and remains in effect.

[5] The new revenue procedure also creates a category of contracts called eligible expense reimbursement arrangements. If the conditions for this category are satisfied, the arrangement will not give rise to private business use.

constraints regarding compensation, reimbursement of nongovernmental expenses and term of the service arrangement. Healthcare organizations have typically utilized relatively short-term contracts, particularly with respect to contracts with physicians and medical practices. Such short duration has typically allowed for maximum flexibility in compensation under Revenue Procedure 97-13. Even with the shortest term contracts there were difficulties meeting the requirements of Revenue Procedure 97-13. For example, requirements under Revenue Procedure 97-13 to include set fee schedules for per unit fee contracts presented commercial difficulties with physician group contracts, which were often structured as separate billing arrangements without specific fees enumerated in the contract. Notice 2014-67 removed some of Revenue Procedure 97-13's constraints by allowing contracts with any combination of compensation with a term of up to five years so long as there was no sharing of the net profits of the bond-financed facility. Five years, however, was thought not to be long enough by governmental issuers that desired long-term arrangements with respect to long-lived infrastructure projects. In response, the IRS issued Rev. Proc. 2016-44, which, as described below, provides for a longer maximum contract term, but with certain additional requirements.

Under the new framework set forth in Rev. Proc. 2016-44, all management contracts, no matter the term, must satisfy a uniform set of requirements in order to qualify for the safe harbor. This new framework provides much needed relief for activities that need very long-term management contracts such as the construction and operation of toll roads. However, there are now additional conditions that must be taken into account and some of these new requirements, discussed in more detail below, may require changes to the traditional forms of management contracts used by healthcare organizations.

The new management contract safe harbor provided under Rev. Proc. 2016-44 generally allows for fixed or variable compensation that is determined to be reasonable for services rendered under the contracts. As under the Original Safe Harbors and applicable regulations, the sharing of net profits is still not permitted. Rev. Proc. 2016-44 applies a principles-based approach focusing on (i) the extent of governmental control over the financed property; (ii) the extent to which the service provider does (or does not) bear risk of loss with respect to the financed property; (iii) the term of the arrangement in comparison to the economic life of the financed property; and (iv) consistency of tax positions taken by the service provider.

Rev. Proc. 2016-44 generally applies to any management contract that is entered into on or after August 22, 2016. However, an issuer may continue to rely upon the Original Safe Harbors in evaluating any agreement entered into prior to August 18, 2017, that is not materially modified or extended after that date (other than pursuant to a renewal option under which a party to the contract has a legally enforceable right to renew the contract). In addition, an issuer may apply the new Rev. Proc. 2016-44 safe harbor conditions to any management contract that was entered into before August 22, 2016. As noted above, given that many management contracts with healthcare service providers are short-term in nature and were structured to qualify for favorable treatment under the Original Safe Harbors (and may not currently be structured to satisfy the additional requirements of the new safe harbor), it may be advantageous to keep these contracts grandfathered and not elect to have the new guidance apply to them. All contracts, however, should be reviewed on a case-by-case basis before making such a blanket determination. Any contracts entered into, materially modified or extended (other than pursuant to a legally enforceable renewal right) after August 18, 2017 must satisfy the requirements of

Rev. Proc. 2016-44 in order to qualify for the safe harbor; as such, healthcare systems should review and update any management contract templates to conform to the new safe harbor.

Eight Safe Harbor Conditions under Rev. Proc. 2016-44

Under Rev. Proc. 2016-44, a management contract must satisfy certain conditions in order to qualify for the safe harbor and ensure that such contract does not result in private business use under sections 141 or 145 of the Code.[6] Below is a discussion of the eight conditions along with commentary specific to healthcare-related contracts.

1. **Compensation must be reasonable for services rendered during the term of the contract**. Reasonable compensation has always been required under the Original Safe Harbors. However, compensation for such purposes is now defined to include payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider. *Nonprofit healthcare systems that are exempt from taxation under Section 501(c)(3) of the Code are generally already subject to such restrictions, as unreasonable compensation may result in impermissible private inurement or private benefit. This requirement raises the concern as to what type of evidence will need to be established to support a finding of reasonableness with respect to physician and practice group contracts. For example, in determining fees for specific physician services should such fees be based on schedules provided by unrelated third parties and any increases in such fees be tied to a specified, objective, external standard such as the Consumer Price Index?*

2. **Contract must not provide the service provider a share of the net profits from the operation of the managed property**. As a safe harbor, a compensation arrangement will not be treated as a sharing of net profits if no element of the compensation for services takes into account or is contingent upon either the managed property's net profits or both the managed property's revenues and expenses for any fiscal period. For such purposes, the "elements" of compensation are: (i) eligibility for compensation; (ii) amount of compensation; and (iii) timing of compensation. Solely for the purpose of evaluating whether the amount of compensation (element (ii)) "takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses for any fiscal period," any reimbursement of actual and direct expenses paid by the service provider to "unrelated parties" is disregarded as compensation.[7] As an example of application of this safe harbor, a compensation

[6] For purposes of Rev. Proc. 2016-44, a "management contract" means a management, service or incentive payment contract between a qualified user and a service provider under which the service provider provides services for a "managed property." A "service provider" means any person (other than another qualified user) that provides services to, or for the benefit of, a qualified user under a management contract. The term "qualified user" means, for projects financed with governmental bonds, any government person or, for projects financed with qualified 501(c)(3) bonds, any governmental person or 501(c)(3) organization with respect to its activities that do not constitute an unrelated trade or business, determined by applying section 513(a) of the Code.

[7] For purposes of Rev. Proc. 2016-44, the term "unrelated party" means a person other than a related party (as defined in Treas. Regs. § 1.150-1(b)) or a service provider's employee. Thus, for example, an arrangement under which the amount of reimbursement of a service provider for its employee expenses (or those of a related party) is contingent on both the revenues and expenses of operation of the managed property would fail this second condition.

arrangement that provides for incentive bonuses for reaching targeted quality, performance or productivity goals in the service provider's operation of the managed property will not (in and of itself) be treated as providing the service provider a share of the net profits from the operation of the managed property. *It is important to remember that although the new safe harbor allows for more flexibility with respect to terms of contracts and variable compensation, an arrangement (such as a patient food services contract or a physician contract) with compensation based both on revenues and expenses of the financed facility may result in private business use.*

3. **Contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property**. As in the case of net profits, above, as a safe harbor, an arrangement will not be treated as shifting the burden of bearing a share of net losses if (i) the amount of compensation and unreimbursed expenses of the service provider does not take into account either the net losses of the managed property or both the revenues and expenses of the managed property for any fiscal year, and (ii) the timing of payment of compensation is not contingent upon the net losses of the managed property. As an example of application of this safe harbor, a compensation arrangement that provides for reductions by stated dollar amounts for failure to cause the operation of the managed property to satisfy targeted expense limitations will not (in and of itself) be treated as imposing the burden of a share of net losses from operation of the managed property on the service provider.

4. **Term of contract (including all legally enforceable renewal options) must not exceed the lesser of 30 years or 80% of the weighted average reasonably expected economic life of property**. For this purpose, "economic life" is determined in the same manner as under section 147(b) of the Code. Under existing law, as a safe harbor with respect to the economic life of acquired or improved property, its midpoint life under the asset depreciation range system in effect in 1984 may be applied.[8] *As noted above, although this expansion of time periods is of great benefit to certain industries, it may have limited effect on healthcare-related management contracts, which for commercial reasons are generally of much shorter duration. However, the short-term nature of such contracts suggests more frequent testing dates for satisfying this requirement; care should be taken toward the end of the economic life of financed property to ensure that the term of any newly entered into management contract meets the requirement of the safe harbor.*

5. **Qualified user must exercise a significant degree of control over managed property**. This requirement will be met if the contract requires that the qualified user approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for the use of the managed property[9] and the general nature and type of use of the

[8] *See* Rev. Proc. 83-35, 1983-1 CB 745. For buildings, the asset guideline lives under Rev. Proc. 62-21 may be used. As an alternative, economic life may be established under section 147(b) through the expert opinion of a licensed engineer or other professional, and usually is based upon industry experience with the particular type of property and familiarity with the maintenance practices of the owner of the property. Additional guidance will be required to fully interpret this requirement, *e.g.,* the proper treatment of financed land.

[9] Rev. Proc. 2016-44 provides that a qualified user may show approval of capital expenditures for a managed property by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts, and that it may show approval of dispositions of property in a similar manner. Rev. Proc. 2016-

managed property. For example, this safe harbor may be met through approval of an annual budget that includes the operating budget, a capital expenditure budget (by functional purpose and specified maximum amounts), an authorization of dispositions of property and a methodology for the setting of rates (or requiring that rates be reasonable and customary as specifically determined by an independent third party) for the use of the managed property. *This is a new requirement that did not exist under the Original Safe Harbors. Management contracts that are entered into, extended or materially modified after the effective date should be closely examined to ensure compliance with this requirement. For example, under separate billing arrangements with physicians and under patient food services contracts, healthcare organizations often cede control over rates charged for the use of managed property to the service provider. Under the new safe harbor, either the healthcare organization must expressly approve such rates or the methodology for setting such rates, or the contract must include a requirement that the service provider charge customary and reasonable rates as specifically determined by an independent third party. This requirement is a prime example of how the new framework, while seemingly more flexible than the Original Safe Harbors, may in some ways prove more restrictive for healthcare organizations.*

6. **Qualified user must bear the risk of loss upon damage or destruction of the property.** This requirement may be satisfied notwithstanding that the qualified user insures the property through a third party or, under the contract, imposes upon the service provider a penalty for failure to operate managed property in accordance with standards set forth in the contract.

7. **Service provider must agree that it is not entitled to and will not take any tax position inconsistent with being a service provider to the qualified user.** The contract must include an express written undertaking by the service provider not to take depreciation or amortization, investment tax credits, or deduction for any payment as "rent" with respect to the managed property. While as a practical matter a service provider under a management contract satisfying the Original Safe Harbors likely would not have been able to take a return position that it had an adequate ownership interest to support credits, depreciation or rental deductions, an express contractual covenant is one of the conditions to the Rev. Proc. 2016-44 safe harbor. *Many healthcare management contracts likely do not currently contain such explicit language. In order to continue qualifying for the safe harbor, such language will need to be added to these contracts at the time they are otherwise extended or materially modified.*

8. **Service provider must not have any role or relationship with the qualified user that would restrict the exercise by the qualified user of its rights under the contract**. As a safe harbor, this condition will not be violated if: (i) no more than 20% of the voting power of the qualified user is vested in directors, officers, shareholders, partners, members, or employees of the service provider (or of any person related to the service provider); (ii) neither the service provider's chief executive officer (or person with

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44 further provides that a qualified user may show approval of rates charged for the use of the managed property either by expressly approving such rates or the methodology for setting such rates, or by including in the contract a requirement that the service provider charge rates that are reasonable and customary as specifically determined by an independent third party.

similar management responsibilities) (the "CEO") nor the chairperson of the service provider's governing board is a member of the governing board of the qualified user; and (iii) the CEO of the service provider (or of any person related to the service provider) is not also the CEO of the qualified user or any person related to the qualified user. *As under Revenue Procedure 97-13, this requirement may prove difficult to meet in certain situations in which the service provider is a joint venture involving the exempt health care provider, such as a hospital/physician joint venture.*

Furthermore, a service provider's use of a project that is functionally related and subordinate to its performance under a management contract meeting all of the conditions above does not result in private business use.

Eligible Expense Reimbursement Arrangement

If a management contract is an "eligible expense reimbursement arrangement," such management contract does not result in private business use under Sections 141 and 145 of the Code. An "eligible expense reimbursement arrangement" is a management contract under which the compensation consists only of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider.[10]

[10] Under the Original Safe Harbors, contracts that provided only for reimbursement of actual and direct expenses paid by the service provider to unrelated parties did not result in private business use, but contracts (other than those related to public utility property) that provided for reimbursement of administrative overhead expenses were subject to the general rules of the Original Safe Harbors and could result in private business use.

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GRAY REED & MCGRAW, P.C.

IRS LAUNCHES RENEWED ATTACK ON VALUATION OF FAMILY BUSINESSES - A SEISMIC SHIFT FOR ESTATE AND GIFT TAX VALUATIONS

by Norm Lofgren, Gray Reed & McGraw *August 2016*

Taxation by Executive Fiat

IRS Launches Renewed Attack on Valuation of Family Businesses A Seismic Shift for Estate and Gift Taxations

The proposed rules signal a seismic shift in valuation rules for estate, gift and GST tax purposes, making the stakes high for impacted taxpayers.

Unable to accomplish its long-standing legislative objective of eliminating valuation discounts involving family-controlled business entities, the Obama administration issued new proposed Treasury Regulations on August 2, 2016 designed to eliminate those valuation adjustments, which have long been available to decrease the value of family-controlled business entities for federal estate tax, gift tax and generation skipping transfer (GST) tax purposes. If made final, the rules, commonly referred to as the "Section 2704 Regulations," accomplish their work by precluding the consideration of restrictions built into entity agreements as well as those imposed by state law in valuing transfers of family-controlled entities for estate, gift and GST taxes. It is not a surprise that the proposed Section 2704 Regulations were published. However, the scope of the proposed rules and how they accomplish their desired result does have the professional planning community taking stock. One thing is for sure, if finalized the proposed rules signal a seismic shift in valuation rules for estate, gift and GST tax purposes, making the stakes high for impacted taxpayers.

Repeated efforts by both the Bill Clinton and Barack Obama administrations to eliminate valuation discounts of family-controlled businesses through legislative proposals consistently failed.

Efforts to accomplish the same result through the judicial process have similarly failed. In the landmark 2000 *Estate of Strangi* case, Gray Reed attorneys Norm Lofgren and Tom Rhodus successfully defeated a judicial attempt by the IRS (Tax Court and Fifth Circuit) to deny valuation adjustments to a family-controlled limited partnership. The IRS sought to (i) expand the breadth of Section 2703 (a companion to Section 2704) in an effort to disregard the existence of the limited partnership and (ii) disregard that entity for lack of economic substance. Shortly before trial in *Strangi*, the IRS abandoned its attack under Section 2704. *[An historical perspective of Section 2704 follows at the end of this alert.]*

The Tax Implications – Setting the Stage

Consider the following example: Texas Cabinet Company, a private Texas limited liability company, manufactures kitchen cabinets for sale to big-box retailers. It was founded by John Austin, and upon his death in 1997 he left it equally to his three adult children: Mary, Joe and Henry. Mary is the president. The Company Agreement of Texas Cabinet requires unanimous consent of the owners to (i) transfer his / her member interest outside of the family, (ii) force the company to redeem a member's interest or (iii) liquidate the company. Assume that Joe (unmarried with no children and no other assets) dies on December 31, 2016 leaving his member interest equally to his brother and sister. Assume that as of Joe's death on December 31, 2016, Texas Cabinet has a fair market value of $27 million. Under current law, regulations and court rulings, the approximate value for estate, gift and GST tax purposes of Joe's 33 1/3 percent member interest in Texas Cabinet (a minority interest) would be approximately $5.4 million (assuming a combined 40 percent adjustment for lack of control and lack of marketability are applicable to the interest), that valuation adjustment mirroring the "real-world" economic realities of a 33 1/3 percent interest in a private business which likely would be hard to sell. Current federal law exempts the first $5.45 million of a decedent's estate from estate tax. As a result, Joe's estate would pay no federal estate tax on his interest in Texas Cabinet under these facts.

Now, assume that the Section 2704 Regulations are published as final regulations on December 2, 2016, and made effective for transfers starting 30 days later (on January 1, 2017 and thereafter). If Joe were to die on January 3, 2017, under the 2704 Regulations, Joe's estate would be required to report the value of his 33 1/3 percent interest without regard to the restrictions on liquidation of either the company OR Joe's minority interest as an interest in a "family-controlled" corporation. The impact of the changed valuation rules would artificially increase the economic value of Joe's estate for federal estate tax purposes to $9 million (33 1/3 percent of $27 million), thereby increasing the estate tax his estate must pay the IRS on Joe's interest in Texas Cabinet by over $1.4 million. Needless to say, Joe's estate and its heirs would experience a substantially different outcome than under current law.

Overview of the 2704 Regulations

To achieve its intended result, the Section 2704 Regulations are designed to fundamentally alter the rules for valuation of "family-controlled" entities. By way of history, in establishing the federal estate, gift and GST tax system, Congress specified those taxes would be based upon the "value" of the asset being transferred. To that end, Treasury Regulation Section 20.2031-1(b), enacted decades ago, defines "value" for estate tax purposes as "fair market value." Fair market value is measured as the price at which property would change hands between hypothetical unrelated parties in a "willing buyer / willing seller" analysis.

The Section 2704 Regulations fundamentally impact these long-existing rules in the following manner:

1. **New "Disregarded Restrictions" Category Created**. The 2704 Regulations create a new category of "Disregarded Restrictions" which must be ignored in establishing the value of interests in "family-controlled" entities for estate, gift and GST tax purposes. Note that interests held directly by specified family members, as well as interests held indirectly such as through partnerships, corporations and trusts, are all considered to be held by the family for the purposes of these rules. The Section 2704 Regulations specifically provide that the following four restrictions are to be ignored in valuing an interest for estate, gift and GST tax purposes:
    - A restriction on an owner's right to compel liquidation or redemption of his or her interest;
    - A restriction which limits the liquidation proceeds to an amount that is less than "minimum value," ultimately described as the interest's share of the fair market value of the entity's property minus obligations of the entity;
    - A restriction which defers or permits the deferral of payment of liquidation proceeds for more than six months; and
    - A restriction which permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain types of notes.

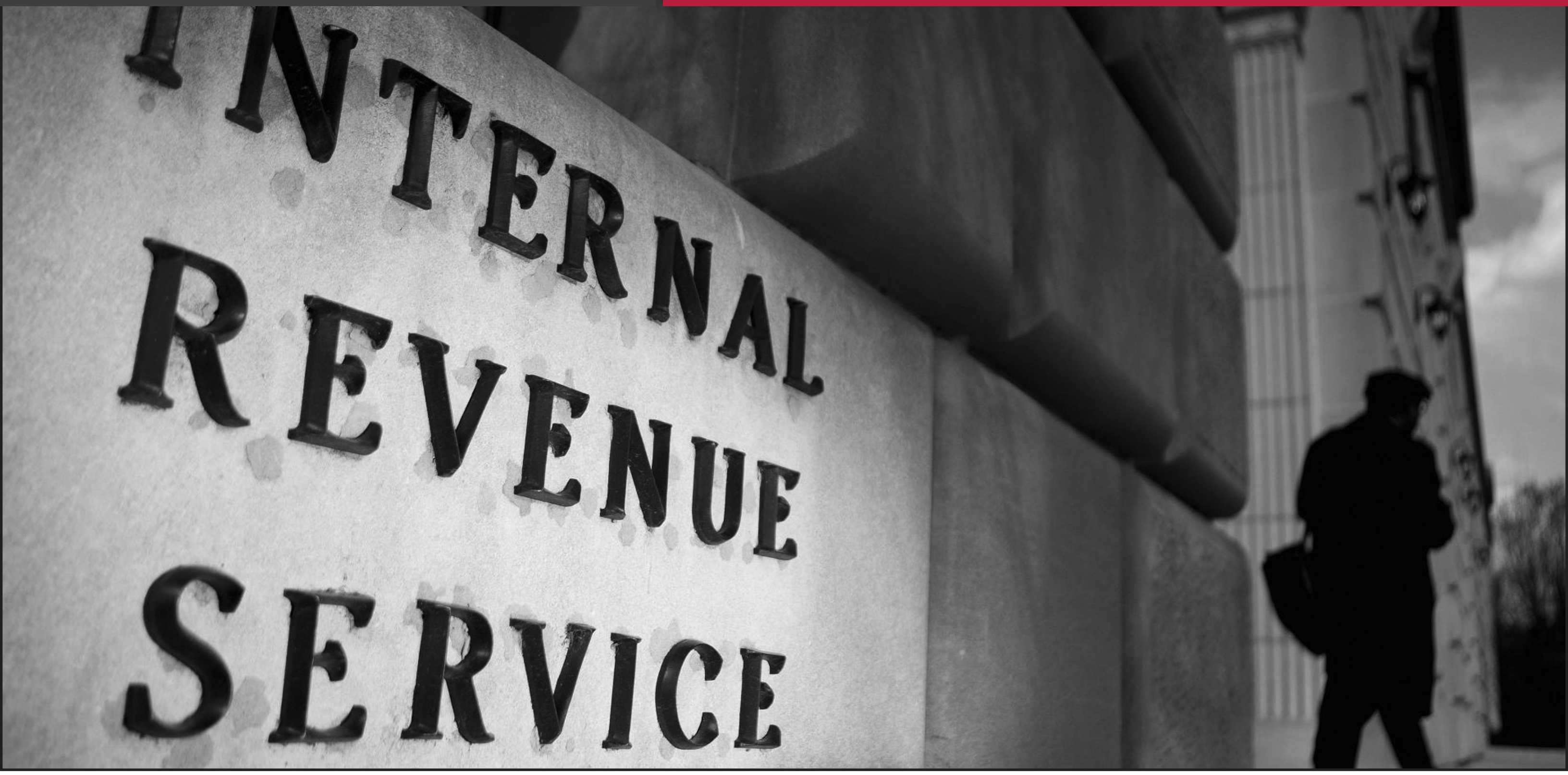
These rules are at the heart of the changes in the 2704 Regulations which result in a disallowance of valuation adjustments for transfers of an interest in a family-controlled entity.

2. **Non-Family Members Generally Disregarded**. In determining whether an entity is "family-controlled" and therefore subject to the Section 2704 Regulations, if the transferor's family has the power to remove a restriction, any interest held by a non-family member is disregarded for valuation purposes unless **all** of the following are satisfied with respect to any non-family interest:

    - The non-family interest has been held for at least three years;
    - The non-family interest is at least a 10% equity interest in the entity;
    - Non-family members hold at least 20% equity in the entity; AND
    - Each non-family member has a put right to have their interest redeemed with a maximum of six month's notice at the "minimum value."

Not surprisingly, the specificity of these rules prevent most non-family interests from counting when determining whether there is family control over an entity and are also critical to the impact of the proposed new rules.

3. **Lapses Within Three Years of Death**. The Section 2704 Regulations, taking apparent inspiration from Section 2035 of the Internal Revenue Code, provides that transfers made within the three years preceding the transferor's death will trigger estate tax consequences to the transferor's estate regardless of whether any liquidation right with respect to the interest continues to apply to the interest. This "bright-line" rule would result in an increase in what is taxable in the transferor's estate any time a de-controlling transfer is made closer than three years before the transferor's death. Specifically, the proposed rules provide that the value of such a lapsed right within three years of death must be reported on the decedent's federal estate tax return as an asset (effectively a "**phantom asset**" in that it results in additional value being taxed for estate tax purposes for which there is no "real" asset out of which the tax can be paid). The value of the phantom asset would seem to equate to any valuation adjustments associated with the transferred interest. The practical impact of these proposed rules would preempt de-controlling transfers within three years of death.



It is important to note that the additional value being added to the transferor's gross estate as a result of this proposed rule would not be eligible for either the charitable or marital deductions.

4. Modifications Concerning Applicable Restrictions.

- State Law Restrictions. Current regulatory provisions recognize restrictions on liquidation and withdrawal contained in an entity's governing documents if those restrictions are no more restrictive than restrictions imposed under applicable state law. The 2704 Regulations eviscerate the existing rules on that point. Of note, Texas law is expressly cited in the Section 2704 Regulations as an example of where the Treasury Department believes that state law changes facilitated the circumvention of Section 2704. The provisions of Revised Limited Partnership Act §6.03 were amended after the enactment of Internal Revenue Code Section 2704 to permit withdrawal of a limited partner only as provided in the partnership agreement. According to the Treasury Department's explanation of the Section 2704 Regulations, the Internal Revenue Service will respect a state law restriction only if the "restriction (i) cannot be removed or overridden and it is mandated by the applicable law, (ii) is required to be included in the governing documents, or (iii) otherwise is made mandatory."

- Assignee Interests. Transfers of an "assignee interest" (which do not have voting or liquidation rights) are interests treated as an applicable restriction and subject Section 2704 such that the restrictions are disregarded.

5. **Covered Entities Expanded**. The Section 2704 Regulations make clear that all entities are covered by the special valuation rules of Section 2704 despite the fact that current Internal Revenue Code and Treasury Regulations only expressly deal with corporations, general and limited partnerships. The Section 2704 Regulations would add rules whereby any business entity arrangement, foreign or domestic, (other than corporations, general and limited partnerships that have their own express rules) in which the taxpayer owns at least 50 percent of the capital or profits or in which there is the ability to force a partial or full liquidation of such entity are covered by the valuation restrictions.

Where This Leaves Us

The Section 2704 Regulations are set to be discussed in a public hearing in the auditorium of the Internal Revenue Service Building in Washington, D.C. on December 1, 2016. It is not unreasonable to expect that numerous comments will be made in that hearing. If the Internal Revenue Service elects to make changes to the Section 2704 Regulations in light of comments received, that would obviously delay in the publication of final Treasury Regulations for some time. Even if the Internal Revenue Service chooses not to make any changes in light of comments received (or has determined it will not make any changes), the Section 2704 Regulations state that the final Treasury Regulations **will NOT become effective until 30 days after they are published as final in the Federal Register**. Thus, assuming the Internal Revenue Service elects to make no changes in light of comments received, it is hard to imagine that the rules would be applicable to transfers prior to January 1, 2017. Once the Section 2704 Regulations are in place, it is reasonable to expect that a round of legal challenges from impacted taxpayers will ensue. Challenges to the Section 2704 Regulations include: (i) arguments that the rules exceed the scope of what the enacting legislation envisioned them to be, and (ii) do they constitute a violation of the Constitutional separation of the executive and legislative branches of government. However, most taxpayers will likely not want to "sign up" to test the new valuation rules for a variety of reasons. That being the case, **persons considering transferring interests in family-controlled entities or freezing the value of such interests should consider acting quickly – i.e., before the end of 2016, if they wish to avoid the impact of these Section 2704 Regulations, assuming they are finalized as proposed.**

As a reminder, persons considering transferring interests in family-controlled entities or freezing the value of such interests should consider acting quickly. If you have any questions regarding this subject or if we may be of assistance to you or your clients in any way, please call: Norm Lofgren at 469.320.6075, Greg Sampson at 469.320.6097, or Glen Eichelberger at 713.986.7154.

See the following pages for a historical perspective on this issue.

DALLAS
1601 Elm Street, Suite 4600
Dallas, TX 75201
T: 214.954.4135 F: 214.953.1332

HOUSTON
1300 Post Oak Blvd., Suite 2000
Houston, TX 77056
T: 713.986.7000 F: 713.986.7100

www.grayreed.com

More Comments – An Historical Perspective

Article 1, Section 8 of the United States Constitution grants Congress the "power to lay and collect taxes." That power is not granted to the executive branch of our government.

In establishing the federal estate tax, gift tax and generation skipping transfer tax (GSTT), Congress specified that these taxes would be based upon the "value" of the asset being transferred (Internal Revenue Code Section 2031). Treasury Regulation Section 20.2031-1(b), enacted decades ago, defines "value" as "fair market value." Fair market value is basically the price at which property would change hands between hypothetical unrelated parties.

In the context of transfers of interests in business entities such as corporations, partnerships and limited liability companies, the fair market value of an interest in the entity is, in an economic sense, not equal to the underlying fair market value of the enterprise times the percentage ownership interest. Rather, in valuing non-publicly traded business interests, expert appraisals take into account such impairments to value as "lack of control" and "lack of marketability." In very round numbers, these valuation impairments are often in the 30 percent to 40 percent range AND the IRS and the Courts have routinely accepted these valuation discounts. Accordingly, if you own 30 percent of the stock of a private corporation worth $10 million, the value of your 30 precent interest is likely in the range of $1.8 million to $2.1 million – not $3 million (30 percent of $10 million value of the whole enterprise).

In the fall of 1990, the Democratic Party held a majority of both houses of Congress. Effective October 9, 1990, new Sections 2701 – 2704 ("Chapter 14") were added to the Internal Revenue Code. These provisions are titled "Special Valuation Rules." Chapter 14 created a set of <u>artificial valuation rules</u> for estate, gift and GST taxes – a departure from the general rule of utilizing fair market value.

Section 2704

Internal Revenue Code § 2704 specifically deals with (a) "lapsing" voting and liquidation rights restrictions and (b) intra-family transfers (e.g., death or gift) of corporation or partnership ownership interests where the family controls the entity and the ownership interest is subject to liquidation restrictions (an "Applicable Restriction"). An Applicable Restriction is one which limits the ability of an owner to liquidate the entity (in whole or in part) which the transferor or his family has the power to remove. However, an Applicable Restriction does not include a restriction "imposed, or required to be imposed" by state or federal law. On January 28, 1992, the Treasury Department issued regulations under Section 2704 (Treas. Reg. §25.2704-2(b)) which provide in relevant part an Applicable Restrictions is one "that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." The exception under the regulations is phrased differently from the statute. By ignoring Applicable Restrictions, the value reportable for federal estate, gift and GST taxes is increased above true economic fair market value.

In one of the landmark estate tax cases, *Estate of Strangi*, decided in 2000 and tried by Gray Reed attorneys Norm Lofgren and Tom Rhodus, the Chief Judge of the Tax Court observed:

> "The new special valuation rules in Chapter 14 departed substantially from the hypothetical willing buyer-willing seller standard."

GRAY REED
GRAY REED & MCGRAW, P.C.

IRS LAUNCHES RENEWED ATTACK ON VALUATION OF FAMILY BUSINESSES - A SEISMIC SHIFT FOR ESTATE AND GIFT TAX VALUATIONS

by Norm Lofgren, Gray Reed & McGraw

In *Estate of Strangi*, the IRS was unsuccessful in its attempt to convince the courts (Tax Court and Fifth Circuit) to expand the breadth of Section 2703 (a companion to Section 2704) in an effort to disregard the existence of a family limited partnership and also unsuccessful in its attempt to disregard that entity for lack of economic substance. Shortly before trial, the IRS abandoned its attack under Section 2704. A properly constructed partnership had successfully navigated the problems of Chapter 14.

Immediately following enactment of Section 2704, many owners of family-owned businesses, which routinely required unanimous consent of the owners to liquidate, gifted small interests in their business to public charities. This tactic conceptually destroyed the IRS' ability to classify liquidation restriction as an Applicable Restriction since the family no longer had the power to remove the liquidation restriction. The IRS unsuccessfully attacked this tactic in *Kerr v. Commissioner*. In 1997, the Texas legislature amended the law governing the ability of a limited partner to withdraw from a limited partnership (TRLPA § 6.03) and in 2003 amended the law governing withdrawal of a member of a limited liability company (TBOC § 101.107). Generally, a limited partner or limited liability company member can withdraw only as provided for in the governing documents of the entity. Other states enacted similar legislation. Kerr and the changes in state law provided a safe path to avoid the pitfalls of Section 2704. When coupled with the *Estate of Strangi* decision, taxpayers had a road map to avoid Chapter 14.

In light of the proliferation of family limited partnerships and their valuation discounts, President Bill Clinton attempted to curtail discounts, requesting legislation to curb these discounts. Congress was not receptive. On January 9, 2009, Congressman Earl Pomeroy (Democrat – ND) introduced HR 436, to curb discounts. This Bill died in committee. In his first several budgets, President Obama requested legislation to eliminate valuation discounts of family entities and close down the perceived Section 2704 avoidance. Congress was not receptive to these requests. Similarly, the Courts repeatedly upheld well-planned taxpayer strategies following *Estate of Strangi, Kerr* and the new state laws.

Starting with his FY 2014 budget, President Obama abandoned pursuit of a legislative change to the tax law and the Treasury Department began work on what has now been issued as the proposed Section 2704 regulations. If the proposed regulations are finalized, this unilateral action by the Executive Branch, which greatly expands the reach of Section 2704 and seemingly departs from the statutory provisions of Section 2704, will likely be challenged by taxpayers in court as an unconstitutional usurpation of the power of the legislative branch of government. The "disregarded restrictions" portion of the proposed regulations, i.e., the look-through to underlying entity value is in essence an attempt to disregard the separate existence of the entity for valuation purposes, a tactic already rejected by the courts in *Estate of Strangi* and other cases in the context of IRS attacks under Section 2703 and "the lack of economic substance theory."

Query – Is this proposed unilateral action by the Executive Branch taxation by executive fiat? If the proposed regulations are finalized in their current form, litigation by impacted taxpayers will likely ensue.

DALLAS
1601 Elm Street, Suite 4600
Dallas, TX 75201
T: 214.954.4135 F: 214.953.1332

HOUSTON
1300 Post Oak Blvd., Suite 2000
Houston, TX 77056
T: 713.986.7000 F: 713.986.7100

ELECTING INTO NEW PARTNERSHIP AUDIT RULES

KELLY, HART & HALLMAN LLP
CHESTER GRUDZINSKI, JASON HENDRIX

1. General Effect Of New Partnership Audit Rules

Under Temporary Regulation §301.9100-22T, released on August 4, 2016, partnerships can elect to begin applying the new partnership audit rules prior to January 1, 2018[1]. The primary effect of the new rules was a shift of the IRS focus from each individual partner to the partnership entity itself[2], which puts all partnerships, especially large partnerships, at a heightened risk of audit. Additionally, partnerships have limited options in the event of an IRS adjustment. If an underpayment adjustment is proposed, the new rules require the partnership (rather than the partners) to make non-deductible[3] payments *in the adjustment year*[4]. In cases where a partnership's interest structure has changed, this can result in an economic misallocation of the adjustment liabilities.[5] Partnerships can avoid this misallocation in one of two ways. First, the adjustment will be reduced by the amount of tax paid by any reviewed year[6] partners who file an amended return[7]. However, these amended returns must be filed, and tax paid, within 270 days of the proposed adjustment[8], which limits a partnership's ability to challenge it. Second, the partnership can elect to instead apply the adjustment directly to the reviewed year partners[9], but this election will cost those partners an additional 2% in underpayment interest[10], and effectively prevents any court petition of the IRS final partnership adjustment[11].

2. Benefits To Electing In

In almost all cases, partnerships would be better served not to elect into the new audit rules. However, despite the overwhelmingly negative effects for taxpayers as a result of the streamlined audit process, there do exist two possible, but narrow, situations in which a partnership could benefit from early application of the rules. First, some partnerships may find the new system easier to manage. By narrowing its focus to the partnership entity and requiring a partnership representative, the IRS has simplified the new audit process for most partners.

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1 Treas. Reg. § 301.9100-22T(a).

2 IRC § 6225(a). All references herein to sections of the Internal Revenue Code (the "IRC") apply to the language of those sections as amended by the Bipartisan Budget Act of 2015 (the "BBA").

3 IRC § 6241(4).

4 IRC § 6225(a)(1). "Adjustment Year" means, with respect to underpayment assessments, the year in which either (i) a court proceeding renders a final decision or (ii) the IRS mails a final partnership adjustment (IRC § 6225(d)(2)).

5 "Comments in Response to Notice 2016-23", Texas State Bar (Tax Section), April 26, 2016, at 12-13.

6 IRC § 6225(d)(1). "Reviewed Year" means the partnership taxable year to which the adjustment item relates.

7 IRC § 6225(c)(2). The Tax Section notes that because the BBA does not amend IRC § 6511 (providing the period of limitations for filing an amended return), it is possible that the partner's ability to file an amended return under IRC § 6225(c)(2) may be impaired (See Comments, *supra* note 5, at 15).

8 IRC § 6225(c)(7).

9 *See* IRC § 6226(a).

10 IRC § 6226(c)(2)(C).

11 IRC § 6226(a)(1). This provision provides that the election must be made within 45 days of a final partnership adjustment, effectively preventing the partnership from filing a Tax Court petition.

However, the partnerships that would benefit most from simplicity are larger partnerships and, as discussed above, electing into the new rules makes these partnerships easier to audit. Additionally, the regulations provide that partnerships may elect into the new rules within 30 days after notice of IRS examination, providing an incentive for partnerships to wait before making an election. Therefore, a benefit of this type likely requires an incredibly specific partnership situation.

Second, partnerships that either (a) overstated income items or (b) understated deduction or loss items on a prior return may benefit from the new administrative adjustment request rules. The new rules provide that in the event of an adjustment relating to overpayment, the partnership shall account for the adjustment by either reducing income or increasing losses *in the adjustment year*[12]. This seems to create an incentive to elect in for partnerships who would benefit from such deferral. However, because the language of the election out described above seems to indicate that it only applies to adjustments caused by *underpayments*[13], any overpayment benefit can only be allocated to the current partners[14]. This means the only way to properly allocate overpayment under the new rules is with the filing of amended returns. Finally, partnerships are further limited by the timing of such an election. The temporary regulation states that partnerships will not be eligible to elect in for the purpose of making an administrative adjustment request until January 1, 2018[15]. Therefore, the only partnerships that will benefit from election in are those with very specific fact situations.

3. How To Elect In

Temporary Regulation 301.9100-22T provides the time, form, and manner required for early election into the new partnership rules[16]. Generally, an election is not valid if it would "frustrate the purposes of section 1101 of the [Bipartisan Budget Act of 2015]."[17] The IRS has not issued regulations expanding on this, but it is possible that this language was included to prevent partnerships from making the election for the purpose of shifting partnership tax liability to bankrupt entities.[18] If a partnership makes this election, all of the new rules will apply to any return of the partnership filed for a taxable year beginning after November 2, 2015[19] and before

[12] IRC § 6225. "Adjustment Year" means, with respect to a partnership adjustment request, the year in which the adjustment request is made (IRC § 6225(d)(2)(B)).
[13] See Comments, *supra* note 5, at 20. The Tax Section notes that the language of IRC § 6227(b)(2) (providing that an adjustment request resulting in an overpayment is taken into account by the reviewed year partners under IRC §6226) conflicts with the language of § 6226, which limits its application to adjustments resulting in underpayment.
[14] *See* IRC § 6226(a).
[15] Treas. Reg. § 301.9100-22T(f).
[16] *See* Treas. Reg. § 301.9100-22T(b).
[17] Treas. Reg. § 301.9100-22T(a).
[18] *See* KMPG, *Regulations: Early Elections Into New Partnership Audit Regime*, KPMG TaxNewsFlash, August 4, 2016, at 3, https://assets.kpmg.com/content/dam/kpmg/pdf/2016/08/tnf-16354-aug4-2016.pdf.
[19] IRC § 6241(g)(4). For calendar year taxpayers, this means that an election can be made with respect to the 2016 and 2017 taxable years only.

January 1, 2018[20]. The rules for an election in vary depending on whether the partnership has received an IRS notification of selection for examination[21].

a. Election In Response to Notice of Examination

If notice of examination has been received, partnerships have 30 days in which to elect into the new rules[22]. Each election must be made on a written statement including the words "Election under Section 1101(g)(4)" written at the top[23]. Additionally, elections must be in writing and be dated and signed by the tax matters partner or any individual with authority to sign the partnership return[24]. The election must include several other items[25] including: (a) the taxpayer information of the partnership and signer; (b) language indicating the election; (c) identification of the partnership's representative as required by the new rules; (d) a statement that the signer is authorized to make the election; and (e) a series of representations regarding the partnership's solvency and bankruptcy status. The requirement of these representations may be related to the above-mentioned possibility that the IRS is seeking to prevent the shifting of partnership tax liability to bankrupt entities using the early election[26].

b. Election For Purpose of Adjustment Request

Alternatively, if the partnership seeks to elect into the rules for the purpose of making an administrative adjustment request, the election cannot be made until January 1, 2018. Because of the 3 year statute of limitations on administrative adjustment requests under the new rules[27], this will not affect the years for which an adjustment request can be made, but the partnership will not be able to use 2016 or 2017 as the adjustment year for purposes of claiming a loss item[28]. Additionally, if the partnership has already filed an amended return for the year in question, the election is invalid[29]. However, other than these caveats, the form and manner required for electing into the new partnership rules is the same regardless of IRS examination notification[30].

Therefore, because partnerships have 30 days after notification of IRS examination to make an election, and cannot make an election for the purpose of an administrative adjustment request until 2018, almost no partnership will benefit from early election into the new audit rules. It should be noted that the temporary regulation allowing for election into the new partnership audit rules for years prior to 2018 will expire on August 5, 2019[31]. While this will have no effect

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[20] There is an exception for one provision that provides an election out of partnership audit rules for qualifying partnerships of fewer than 100 partners. It should be noted that to qualify for this provision, none of the partners of a partnership may be partnerships. *See* IRC § 6221(b).

[21] *See* Treas. Reg. § 301.9100-22T(b) & (c).

[22] Treas. Reg. § 301.9100-22T(b)(1).

[23] Treas. Reg. § 301.9100-22T(b)(2)(i).

[24] Treas. Reg. § 301.9100-22T(b)(2)(ii).

[25] *Id*.

[26] KPMG, *supra* note 15.

[27] IRC § 6235(a).

[28] *See* IRC § 6225(a)(2); IRC § 6225(d)(2)(B).

[29] Treas. Reg. § 301.9100-22T(d)(2).

[30] Treas. Reg. § 301.9100-22T(c)(4).

[31] Treas. Reg. § 301.9100-22T(f).

on partnership taxable years beginning after January 1, 2018, any election to apply these rules to a partnership taxable year between November 2, 2015 and January 1, 2018 must be made before the expiration date[32].

[32] *Id*.

Preparing for a Partial Plan Termination- Considerations and Consequences

By Jessica Stricklin, Baker Botts L.L.P.

Overview

The economic downturn in the energy sector in 2015 forced many companies in the oil and gas industry to dramatically reduce costs, often by reducing payroll or closing a division of business. With oil prices projected to remain low for the foreseeable future, new rounds of layoffs are expected to occur throughout 2016. As companies continue to downsize, it is important for employers to understand the impact layoffs can have on company-sponsored qualified retirement plans under Section 401(a) of the Internal Revenue Code of 1986, as amended (the "Code"). When a significant number of employees who participate in a retirement plan are terminated, an employer may have unintentionally and unknowingly triggered a "partial plan termination" under Section 411(d)(3) of the Code, requiring full-vesting of benefits for all affected participants.

A partial plan termination occurs when a group of employees previously covered by a retirement plan are involuntarily removed from participation in the plan and the resulting reduction in the participant group is significant. Partial plan terminations can occur indirectly, such as through the adoption of an amendment that has the effect of adversely affecting the ability to participants to ultimately vest in their benefits under the plan. More commonly, however, partial plan terminations occur as the result of employer-initiated severances from employment relating to plant or facility shutdowns, layoffs, downsizing or restructuring.

In a difficult economic environment, partial plan terminations occur more frequently and often without any warning. To avoid administrative problems and potential plan disqualification or penalties, it is important for employers to understand the circumstances that may lead to a partial plan termination and to identify whether a partial plan termination has occurred as soon as practicable. In practice, however, this may be easier said than done. This article will review the background and guidance issued by the Internal Revenue Service ("IRS") on determining whether a partial plan termination has occurred as well as identify unresolved questions that still remain in this analysis in practice.

Background and IRS Guidance on Partial Plan Terminations

Section 411(d)(3) of the Code provides that upon a partial termination of a qualified plan, the rights of all affected employees to benefits accrued to the date of such partial termination become nonforfeitable. Neither the Code nor the IRS Treasury Regulations (the "Regulations") explicitly define "partial plan termination" or "affected employee." The Regulations provide that the IRS will determine whether a partial plan termination based on all the applicable facts and circumstances[1]. Prior to 2007, employers had to rely on limited guidance and insight from the IRS and various court holdings to determine whether a partial plan termination may have occurred under a particular fact pattern.

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[1] Treas. Reg. §1.411(d)-2(b)(1).

In 2007, the IRS issued Revenue Ruling 2007-43, 2007-28 I.R.B. 45 ("Revenue Ruling 2007-43"), which provided clearer standards and considerations for determining whether a partial plan termination has occurred with respect to a defined contribution plan. In its ruling, the IRS held that a turnover rate of at least 20% of participants creates a rebuttable presumption that a partial plan termination has occurred (the "20% presumption test"), a position previously adopted by several courts.[2]

In applying the 20% presumption test, the turnover rate is determined by dividing (i) the number of participating employees who had an employer-initiated severance from employment during the applicable period by (ii) the sum of all of the participating employees as of the start of the applicable period and the employees who became participants during the applicable period. The turnover rate includes both vested and nonvested participants.

Although the focus of Revenue Ruling 2007-43 is on the 20% presumption test, the ruling notes that determination of whether or not a partial plan termination occurred still remains dependent on the facts and circumstances of the particular case. Moreover, the 20% presumption test does not preclude a finding by the IRS that a partial plan termination occurred if the turnover rate is less than 20%. As a result, an employer must consider many different factors in calculating the turnover rate to determine whether or not the turnover rate has exceeded 20%.

1. Employer-Initiated Severances

Revenue Ruling 2007-43 defines employer-initiated severance broadly as any involuntary termination other than death, disability, or retirement on or after normal retirement age, even if it is caused by reasons outside of the employer's control (e.g., depressed economic conditions). Voluntary terminations by employees are disregarded in calculating the turnover rate if the employer can support a determination that such terminations were in fact voluntary. The employer can support a claim that a termination was voluntary through such items as information from personnel files, employee statements and other corporate records.[3] Thus, it is very important for employers to keep detailed records documenting the circumstances of each employee's termination.

Under Revenue Ruling 2007-43 the IRS takes the expansive position that the 20% presumption test should apply to those who were active participants in the plan in question, rather than all qualified plan participants.

2. Routine Turnover

Facts and circumstances that suggest that turnover for an applicable period was "routine" favors a finding that there is no partial plan termination for the applicable period. This can be especially important for small employers, who can reach the 20% presumption when very few employees

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[2] See, e.g., Matz v. Household International Tax Reduction Investment Plan, 388 F.3d 570 (7th Cir. 2004); Halliburton Co. v. C.I.R., 100 T.C. 216 (1993).

[3] Note, however, that in some cases employees who appear to terminate employment voluntarily have been found to have terminated involuntarily under a constructive discharge theory. The employer's intent, working conditions and reasonably foreseeable impact of the employer's conduct on the employees are factors considered in evaluating whether a constructive discharge has occurred.

are terminated. An employer can support this by presenting information on: (i) turnover rates in other periods; (ii) the extent to which terminated employees were replaced; and/or (iii) whether new employees performed the same job functions, had the same title or job classification or title and received comparable compensation.

3. Total Number of Participants

The total number of participants for purposes of calculating the turnover percentage is equal to the number of active participants at the beginning of the applicable period plus the number of new participants added during the period. Active participants for 401(k) plans include employees who are eligible to participate, regardless of whether they elect to make deferrals. This is consistent with counting this class of eligible employees as 401(k) participants for other testing purposes under the Code, such as minimum coverage and anti-discrimination testing.

4. Applicable Period

Prior to Revenue Ruling 2007-43, it was unclear whether a partial plan termination could occur over multiple plan years. Although several courts addressed the issue,[4] most previous IRS rulings and court decisions addressing partial plan terminations analyzed turnover on a plan-year basis. In Revenue Ruling 2007-43, the IRS clarified that the applicable period is generally the plan year, but recognized that this period can be longer if there are a series of related severances from employment.

For employers conducting layoffs in waves, determining the applicable period may be more difficult to ascertain. If the employer has a series of related layoffs over the course of the plan year, it is likely that all the layoffs are considered in the 20% presumption test for that year. However, for employers making a series of related layoffs that extend beyond the plan year, and/or are further apart in time, it can be less clear on what dates the applicable period should begin and end. There is some case law support that the applicable period should run from the first date of the event causing the employer-initiated severance through the date of its completion.[5] Because the 20% presumption test is a facts and circumstances analysis, employers will need to carefully review all instances of employer-initiated severance and subsequent events to determine whether they are in the same series of related events for purposes of determining the applicable period.

Consequences of a Partial Plan Termination

1. Vesting Requirement for Affected Participants

Section 411(d)(3) of the Code provides that when a plan experiences a partial plan termination, all employees "affected" by a partial plan termination have to be fully vested in their benefits to

[4] For example, in In Re Gulf Pension Litigation, the court found that a series of layoffs resulting from the merger of Gulf and Chevron were related even though they occurred over multiple years. 764 F.Supp. 1149, 1167-1168 (S.D. Tex. 1991). In Matz v. Household International Tax Reduction Investment Plan, the court determined that terminations that occurred over three plan years were the result of sales of subsidiaries and assets that were closely related in time and "had the same motives" (i.e. the company underwent a multi-year reorganization after it was acquired). 227 F.3d 971, 977 (7th Cir. 2004).

[5] See cases cited in note 4 above.

the extent they are funded as of the date of the partial plan termination. For defined contribution plans, this generally means that the affected employee's account balance must be 100% vested. For defined benefit plans, each affected employee's accrued benefits must be fully vested to the extent that the plan has sufficient assets to fund such benefits. This determination requires an actuarial calculation of the present value of vested benefits in the plan and a hypothetical application of the plan termination distribution rules.

Accelerated vesting can be more complicated and more costly for defined contribution plans when affected employees previously received a distribution of their vested balance and forfeited the unvested portion. These affected employees incurring an improper forfeiture of their account balance would be due additional plan benefits to be made whole. If the plan has already reallocated these forfeitures to other participants or otherwise used them for future employer contributions or plan expenses, it is still on the hook to make participants whole.

There is some uncertainty in the guidance surrounding who is considered "affected" by a partial plan termination. In Revenue Ruling 2007-43, the IRS interprets the statute to mean that "all" participants who had a severance from employment during the applicable period must be fully vested. Under the IRS' position, employees who voluntarily terminated their employment during the applicable period would be fully vested, even though voluntary terminations are not considered in determining whether the 20% presumption test has been met.

Many practitioners disagree with the IRS' interpretation of who is "affected" and take a position that the statute does not require vesting of the accounts of employees who are terminated for reasons unrelated to the employer-initiated actions. Several courts have also taken this position.[6] However, although the IRS' position is arguably contrary to the intent of the partial plan termination rules to date, we are unaware that is has been challenged before a court. Moreover, we understand that, on audit, the IRS has taken the position that affected employees includes all participants with a severance from employment during the applicable period.

2. PBGC Reporting

In addition to partial plan terminations, employer-initiated severances from employment may cause a "reportable event" to occur in a defined benefit plan insured by the Pension Benefit Guaranty Corporation ("PBGC"). A reportable event occurs when the number of active plan participants falls to less than 80% of the number of active participants at the beginning of the plan year or less than 75% of the number of active plan participants at the beginning of the prior plan year. If a reportable event occurs, notice must be filed with the PBGC within 30 days of such event unless a waiver or extension applies.

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[6] See, e.g., Borst v. Chevron Corp., 36 F.3d 1308, 1314, n. 9 (5th Cir. 1994)("Affected employees are those who ceased participation in the Gulf Plan, by termination of employment, during that period, other than those employees whose termination was not the result of the merger and those employees who were transferred to another company."); Borda v. Hardy, Lewis, Pollard & Page, P.C., 138 F.3d 1062, 1068-69 (6th Cir. 1998)(holding that an employee was not affected by the termination of a profit sharing plan because he had voluntarily terminated his employment and his employment was not linked, even indirectly, to the termination of the plan); Artz v. Fairbanks Co., 112 F.R.D. 59 , 61-62 (N.D.N.Y. 1986)(stating that employees terminated at or about the time of a partial plan termination for reasons totally unrelated to the event giving rise to the termination may not be entitled to vesting).

Under Section 4062(e) of the Employee Retirement Income Security Act of 1974 ("ERISA"), employers who shut down or reduce workforce at a specific facility or plant may also have a "cessation of operations" which occurs when participation in a defined benefit plan declines by 20% or more. In addition to being subject to the potential consequences for a partial plan termination and a reportable event, under ERISA such employers would be subject to an additional notice requirement and funding liability to the PBGC. Due to these additional notice requirements and potential liabilities, it is especially crucial for employers with a defined benefit plan to be aware of a partial plan termination and/or reportable event as soon as it occurs.

3. Plan Disqualification and Penalties

If a partial plan termination occurs and the plan sponsor fails to accelerate vesting for all affected plan participants, the plan faces the threat of disqualification. The tax consequences of plan disqualification include: (i) for open tax years, the employer will lose its deduction for nonvested contributions made to the plan for such years; (ii) for open tax years, plan participants must recognize income with respect to their vested accrued benefits; (iii) for open tax years, the plan's trust will recognize income on its earnings; and (iv) distributions from the plan will not be eligible for rollover into another tax-qualified vehicle. Additionally, the plan sponsor and fiduciaries responsible for maintaining the plan's qualified status are at risk of lawsuits by participants. Fortunately, the failure to accelerate vesting on account of a partial plan termination should be considered an operational error that is eligible for correction pursuant to the IRS Employee Plans Compliance Resolution Procedure ("EPCRS"), assuming the sponsor and plan are otherwise eligible for EPCRS.[7]

In addition, prior to vesting affected employees, a plan sponsor can request a determination letter on the issue of whether a partial plan termination has occurred by filing a Form 5300. If the IRS determines that a partial plan termination has occurred, the plan will retain its qualified status if the employer retroactively vests affected participants as of the date of the partial plan termination. The benefit of seeking a determination letter is that the plan sponsor protects the plan from later challenge by the IRS. The disadvantage is that the process can be lengthy and it precludes the employer's ability to take a good faith position that a partial plan termination has not occurred. However, the IRS is currently in the process of eliminating the determination letter program for individually designed plans and until the final rules are issued, it is unclear whether employers will still be allowed to seek a determination letter on the issue of partial plan terminations.[8]

Remaining Practical Considerations

Revenue Ruling 2007-43 provides important considerations and guidance for employers determining whether or not their plan has experienced a partial plan termination. Most importantly, by providing the 20% presumption test, employers have a discernible standard to

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[7] See Rev. Proc. 2015-28.

[8] As announced in Rev. Rul. 2015-19, the IRS will no longer accept determination letter applications based on the 5-year remedial amendment cycle, but will accept applications for initial plan qualification, plan termination and in "certain other limited circumstances" determined by the Treasury and the IRS. There has been no guidance on whether a partial plan termination determination could be a "limited circumstance" for purposes of requesting a determination letter.

guide them in their partial plan termination analysis. However, as this article has noted, practical uncertainties remain, especially in the context of a series of layoffs.

First, Revenue Ruling 2007-43 and most other IRS rulings and court decisions addressing partial plan terminations have analyzed the question in the context of a single event, such as a plant closing. Although Revenue Ruling 2007-43 acknowledges that the applicable period could be longer than a plan year if there are a series of related severances from employment, it does not address how this determination would be made. As a result, employers conducting multiple rounds of layoffs, or expecting to have future rounds of layoffs, must be diligent in keeping detailed records of the terminations and considering whether the layoffs are part of a related series or are separate corporate events.

Second, upon determining that a partial plan termination has occurred or is likely to occur, employers must identify which employees were "affected," requiring accelerated vesting. Although in Revenue Ruling 2007-43 the IRS indicates that it interprets "affected employees" to mean all participating employees with a severance from employment, many practitioners and courts have taken a narrower position. Employers will need to review the circumstances of their partial plan termination to determine which employees were affected. This analysis can be more difficult and more costly in the context of a series of employer-initiated layoffs, which requires the employer to review the circumstances surrounding each employee termination that occurred during that period of layoffs as well as calculate any additional contributions that may be owed to nonvested participants who forfeited account balances.

Conclusion

The current economic climate in the energy sector has forced many companies to downsize and reduce costs through workforce layoffs, which can result in a partial plan termination of the employer's tax-qualified plan(s). It is important for employers to identify a partial plan termination as soon as possible because failure to do so can cause disqualification of the plan and substantial tax consequences for both the employer and employees. Where a significant number of employees are laid off at one time, employers can more easily identify that a partial plan termination has occurred and accelerate vesting for affected employees without too much administrative difficulty. However, as this article has noted, identification and vesting are often more difficult when employers implement layoffs in several tranches or over several years.

Although Revenue Ruling 2007-43 provides important guidance for employers on determining whether a partial plan termination has occurred, uncertainties remain in practice. Employers who have recently reduced their work force or foresee future layoffs should perform a careful analysis of whether their plan has experienced a partial plan termination and, to the extent they can, estimate plan costs in advance. These costs include calculating the fully vested benefits of all affected employees, paying out balances from the plan and amending the plan, if necessary. By preparing and making a timely determination that a partial plan termination has occurred, an employer greatly minimizes its administrative burden and avoids time-consuming and costly consequences.

Estate of Clara M. Morrissette - a Taxpayer Victory in the Valuation of Intergenerational Split-Dollar Life Insurance Arrangements*

By Laurel Stephenson
Davis Stephenson, PLLC, Dallas, Texas

In an opinion issued by the full Court, the Tax Court in *Estate of Morrissette* approved an intergenerational split-dollar life insurance arrangement entered into by the Decedent with trusts she created for her sons as being properly valued under the "economic benefit regime" described in Treas. Reg. § 1.61-22, as opposed to the typically less preferable "loan regime" described in Treas. Reg. § 1.7872-15.[1] The Court concluded that the Decedent was the deemed owner of the policies for purposes of determining the applicable regime despite the trusts being the actual owners of the policies (for purposes of IRC § 2042, the preferred arrangement).[2]

The Decedent through her court appointed conservator created dynastic trusts for her three sons. The trustee of each son's trust purchased universal life insurance policies on the lives of his brothers, with the intention that the proceeds be used to facilitate a buyout of a deceased brother's stock in the family company upon his death. Via her revocable trust, the Decedent entered into a split-dollar agreement with each of the three trusts pursuant to which she agreed to pay the premiums on the policies owned by it. Her revocable trust correspondingly contributed funds to each trust in an amount designed to facilitate the trust's payment of a lump sum premium for each of its policies designed to maintain that policy for the insured sibling's actuarial life expectancy.

The Decedent retained the right to receive from each child's trust upon another child's death (or an earlier termination of the subject split-dollar life insurance arrangement) a portion of the proceeds equal to the greater of the cash surrender value of the policy held by the trust on the deceased child's life or the total associated premium payments previously made by the Decedent. The trusts executed collateral assignments of the policies to the Decedent's revocable trust to secure payment of those amounts.

In the years following her contributions to the trusts, the Decedent accordingly reported gifts to the trusts based upon an application of the economic benefit regime. The IRS took issue with the gift reporting and determined that the Decedent instead owed a total of $13,800,179 in gift tax (seemingly indicating that the IRS intended to preserve the argument that neither regime applies) and a penalty of $2,760,036.

The Decedent's estate moved for summary judgment on the issue of whether the economic benefit regime or the loan regime applied to the split-dollar agreements. Application of the economic benefit regime hinged on whether the children's trusts received any economic benefit under the split-dollar agreements beyond the current life insurance protection provided by the

*This article was first published in Volume 54:4 REPTL Reporter.

[1] *Estate of Clara M. Morrissette, et al. v. Commissioner*, 146 T.C. No. 11 (April 13, 2016).
[2] All references to "IRC" in this outline are references to the Internal Revenue Code of 1986 (as amended).

policies each owned, specifically whether the trusts had current access to the cash surrender values of the policies.

Despite the split-dollar agreements' clear and unconditional guarantee of the Decedent's receipt of the cash surrender values of the policies in all events, the IRS argued that the Decedent's bequest to each child's trust of the payments she would accordingly receive from it under the subject split-dollar agreement provided it with a direct or indirect right to the cash surrender values of the policies it owned. The Tax Court rejected the IRS' arguments and noted that (i) only the Decedent had the legal right to the policies' cash surrender values under the agreements and (ii) the Decedent's bequest to each child's trust of the amount she was entitled to receive from it upon another child's death pursuant to the subject split-dollar agreement was revocable by her at any time, not required of her under the split-dollar agreement, and correspondingly did not provide any trust with a legally enforceable right to its policies' cash values.

The IRS also argued that pursuant to the reasoning of Notice 2002-59 (issued to address reverse split-dollar life insurance arrangements), the use of the economic benefit regime was prohibited.[3] The Court dismissed the argument, noting that the agreements between the Decedent's revocable trust and her children's trusts "bear no resemblance to the transactions Notice 2002-59, supra, is prohibiting."

The IRS also argued that the Decedent's prepayment of the premiums via her lump sum gifts provided the trusts with a benefit beyond the current life insurance protection, precluding application of the economic benefit regime. In rejecting that argument, the Court noted that the argument again relied incorrectly upon application of Notice 2002-59 for the proposition that prepayment of premiums provides policy benefits beyond the current life insurance protection. In rejecting that argument, the Court again noted that it was the Decedent, and not the trusts, who was solely obligated under the agreements to pay all premiums. In making the large upfront contributions to facilitate the prepayment of premiums, she was simply exercising her discretion to prepay the future years' premiums she was obligated under the agreements to pay and did not in the process relieve the trusts of any legal obligations.

While the Tax Court's granting of summary judgment in favor of the estate provided welcome guidance regarding how to structure an intergenerational split-dollar life insurance arrangement to secure a valuation of the deemed owner's rights under the economic benefit regime, the Court specifically reserved the actual valuation of the receivables due to the Decedent from her children's trusts for later consideration.

Ideally, the Court will ultimately address whether those receivables may be properly discounted in the Decedent's estate in order to take into consideration not only the delay in receipt of the payments due to the Decedent under the agreements but also any restrictions incorporated in the agreements that might further affect the date of death value of those payments. While the Court did not address any specifics regarding the subject split-dollar agreements, restrictions typically incorporated that arguably impact the value of the rights retained by an individual occupying the role filled by the Decedent include a requirement that he/she (as did the Decedent)

[3] Notice 2002-59, 2002-2 CB 481 (August 16, 2002).

pay some or all of the premiums and be prohibited from unilaterally terminating the split-dollar agreement or accessing a policy’s cash value (it is unclear from the opinion whether the Decedent was prohibited in either respect).

The Statute of Limitations for Assessment: The Taxpayer's Ultimate Defense to the IRS' Assessment of Additional Tax

By Joel N. Crouch

One of the questions taxpayers regularly ask is: How long does the IRS have to propose and assess additional tax? Or as some taxpayers put it, “How long before I can be sure I am safe from the IRS”? In this article, I will discuss the general rules relating to the statute of limitations (SOL) on assessment and the exceptions to the general rule.

As a general rule, the IRS must assess additional tax and propose penalties no later than 3 years after either a tax return is filed or the return’s due date, whichever is later. IRC Section 6501. An assessment is the recording of the tax debt on the books of the IRS. If a taxpayer files a return before the filing date, for example a Form 1040 filed on April 12th, for purposes of the assessment SOL the return is deemed to have been filed on the due date, i.e., April 15th. If a taxpayer files an extension to file a return, for purposes of the SOL, the return is considered filed on the date of IRS receipt or the extended due date (if mailed before the due date but received later). Subject to the exceptions discussed below, if the IRS fails to assess additional tax and penalties within this 3-year period, it is timed barred from doing so.

The 3-year SOL can be suspended by a number of different things. The three most common are (1) bankruptcy by taxpayer, (2) issuance of a Notice of Deficiency by the IRS, and (3) taxpayer involvement in a third party summons enforcement action. If a taxpayer files for bankruptcy protection, the IRS cannot assess a tax debt during the automatic stay period. As a result, the SOL is suspended for the period of the automatic stay plus 60 days. Where the IRS assesses additional tax after bankruptcy, the taxpayer should confirm that the assessment was not made during a period for which the IRS was stayed from doing so. Failure by the IRS to properly and timely assess a tax debt after bankruptcy can invalidate the assessment. When the IRS issues a Notice of Deficiency to the taxpayer, the SOL is suspended until either (1) the 90 days for filing a tax court petition have passed and no petition was filed, or (2) the taxpayer timely filed a petition with the tax court and the decision of the court is final. In addition, the IRS is given an additional 60 days after expiration of the applicable time period to make an assessment. Finally, if the IRS summons records from a third-party and the taxpayer institutes a proceeding challenging the summons or intervenes in a proceeding to enforce the summons, the SOL is suspended during the period of any proceeding and appeal.

The 3-year SOL may be extended by agreement where, prior to the expiration of the 3 years, the taxpayer executes a Form 872 agreement to extend the SOL to a specific date or a Form 872-A which extends the SOL indefinitely. When the IRS asks for the extension, the taxpayer is not required to agree, and whether or not to extend the SOL depends on the particular facts and circumstances. In *Kunkel v. Commissioner,* the 7th Circuit Court Appeals addressed the issue of a Form 872-A, drafted by the IRS and signed by the taxpayer, that had the wrong tax period. In Kunkel, the taxpayer's representative was asked by the IRS to execute an extension of the statute of limitations for one of the years under examination, 2008. The representative executed the Form 872-A as drafted by the IRS agent, which said "the amount of any Federal Income tax due on any returns made by or for the above taxpayer for the period ended February 15, 2012 may be assessed at any time on or before December 31, 2012." Thereafter, the IRS continued the examination, the results of which the taxpayer did not agree. The IRS issued a Notice of Deficiency for the year of examination beyond the general 3 year SOL. In response, the taxpayer filed a petition with the Tax Court challenging the timeliness of the Notice of Deficiency, because the Form 872-A had the wrong tax period, the period ending February 15, 2012, instead of November 30, 2008. Although neither party introduced testimony as to what the parties to the Form 872-A intended, the Tax Court concluded that there was a mutual mistake of facts and that the court had the power to reform the Form 872-A to reflect the parties' true intent, as manifested by "clear and convincing evidence. The 7th Circuit agreed with the Tax Court and upheld the ruling but on a different basis.

Where an original tax return omits items of income in an amount exceeding 25% of the gross income that was shown on the return, the SOL for assessment is 6 years instead of 3 years. IRC 6501(e). The 6-year SOL applies because the government is at a disadvantage in discovering an omitted item of income. A taxpayer can overcome the application of the 6-year SOL by establishing that the item of omitted income was disclosed in the return – or in a statement attached to the return – in a manner adequate to put the IRS on notice as to the nature and amount of such item. In *United States v. Home Concrete*, the US Supreme Court ruled that under the statute in effect at that time, the 6-year SOL did not apply when the 25% underreporting of income was due to the overstatement of basis in an item. After the *Home Concrete* decision, Section 6501(e)(1)(B) was amended to provide that "[a]n understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income," subject to a six-year statute of limitations. This change was effective for all tax years still open under the 3-year SOL at the time of enactment – July 31, 2015.

When an original tax return was filed fraudulently with the intent to evade tax, there is an unlimited SOL. IRC 6501(c). The IRS bears the burden of proof with respect to the application of the fraud exception to the statute of limitations. When the IRS meets this burden, it has automatically met its burden of proof for the application of the civil fraud penalty. A number of recently-decided cases address the application of the unlimited SOL, where the fraudulent return at issue was due to conduct by a third party and not the taxpayer. In *Allen v. Commissioner*, the Tax Court ruled that the unlimited SOL applied in a case where the tax return preparer's conduct, unbeknownst to the taxpayer, resulted in a fraudulent return. However, in *BASR Partnership v. United States*, the Federal Circuit held that 6501(c)'s suspension of the three year period of limitations for assessment for fraud or false return applies only when the taxpayer acts with the requisite intent to evade tax. As the judicial conflict deepens, this may be an issue that the U.S. Supreme Court is eventually asked to address.

Where the taxpayer does not file a tax return, there is also an unlimited SOL unless and until the taxpayer files a return. If the taxpayer eventually files a late return, the 3 year SOL would apply, subject to the exceptions discussed above, and starts on the return filing date. Failure to file a return or filing a late return can have adverse consequences in bankruptcy. There are a number of recent bankruptcy and appeals court decisions holding that where a return is not timely filed, by even one day, under Bankruptcy Code Section 523(a) any taxes due for that year cannot be discharged in bankruptcy. see *In re Fahey*, 779 F.3d 1 (1st Cir. 2015); In *re McCoy*, 666 F.3d 924 (5th Cir. 2012); and In *re Mallo*, 774 F.3d 1313 (10th Cir. 2014).

Statute of Limitations: The Taxpayer's Ultimate Defense in a Criminal Tax Case

By: Joel N. Crouch

In a previous article, I discussed the civil statute of limitations (SOL) the IRS has for assessing additional tax, penalties and interest against a taxpayer. In this post, I will briefly discuss the SOL for criminal tax cases and a recent case where the defendant effectively used the SOL as a defense.

The SOL for criminal tax cases can vary from three years to six years depending on the particular crime. The most commonly charged tax crimes, filing a false tax return (Section 7206(1)), tax evasion (IRC Section 7201) and failure to file a tax return (Section 7203) are subject to a 6 year SOL. The SOL begins on the date the criminal offense is completed. In false tax return cases, the crime is completed the day the tax return at issue is deemed filed. In tax evasion cases, the SOL begins to run on the later of the date of the last affirmative act in furtherance the evasion or the filing due date of the tax return. In failure to file cases, the SOL starts on the day the tax return was due. If the taxpayer files an extension to file the return, the SOL for failure to file a tax return does not start until the extension date. Pursuant to Section 6531, the running of the SOL is tolled during any time the taxpayer is "outside the United States or is a fugitive from justice."

In *United States v. Johnson* on April 16, 2013 the defendant was charged with filing a false 2006 Form 1040, which he filed in February 2007. Pursuant to Section 6501(b)(1), "a return…filed before the last day prescribed by law...shall be considered as filed on such last day." Therefore, Mr. Johnson's return was deemed filed on April 15, 2007, and it would appear that the government's indictment is one day beyond the applicable 6 year statute of limitations. Mr. Johnson raised the SOL defense prior to trial but the trial court denied his motion to dismiss the indictment. The government convinced the court that the indictment was timely because April 15, 2007 was a Sunday and April 16, 2007 was a holiday, pursuant to Section 7503 the last date for filing the 2006 tax return was April 17, 2007. Section 7503 provides, "When the last day prescribed…for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if is performed on the next succeeding day which is not a Saturday, Sunday or a legal holiday." After the jury convicted him, Mr. Johnson appealed his case to the 6th Circuit Court of Appeals. In its brief to the 6th Circuit, the government reconsidered its position and agreed that its indictment was untimely. In conceding the case, the government agreed that Section 7503 provides only that a return "shall be considered timely" if due on a Saturday, Sunday or legal holiday and filed on the next business day. Section 7503 does not change the "last day prescribed for the filing” of a tax return within the meaning of Section 6513(a). Mr. Johnson’s subsequent motion for recovery of attorney's fees and litigation expenses under the Hyde Amendment for a “vexatious, frivolous or bad faith” prosecution was recently denied by the district court and the 6th Circuit.

As the *Johnson* case illustrates, the calculation of the SOL in a criminal tax case can be complicated and confusing for both the defendant and the government.

PLANNING FOR CAPITAL GAINS, LOSSES AND DEPRECIATION

August 25, 2016

Presented by Chris M. Goodrich

Prepared by Anthony A. Garcia, Chris M. Goodrich, John R. Strohmeyer &

Werner R. Holtmeier

Crady, Jewett & McCulley, LLP
2727 Allen Parkway, Suite 1700
Houston, Texas 77019
Telephone: (713) 739-7007
Facsimile: (713) 739-8403
Email: cgoodrich@cjmlaw.com

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PLANNING FOR CAPITAL GAINS, LOSSES AND DEPRECIATION

The purpose of this outline is to provide planning strategies for capital gains, capital and ordinary losses and depreciation.

I. LIMITS ON FAVORABLE CAPITAL GAINS RATES FOR CORPORATIONS.

A. **No Capital Gains Rates for C Corporations**. Unlike individual taxpayers who receive preferential capital gains tax rates under Code § 1(h)[1], C corporations do not have a reduced capital gains tax rate. Thus, planning to take advantage of favor long term capital gains rates does not apply to assets held inside of a C corporation.

B. **Beware S Corporations With Built-In Gains Under Code § 1374**. S corporations and their shareholders typically do not have the same two levels of tax which apply to a regular C corporation. On an S corporation's sale of assets or allocation of operating profits (losses), the gains from the sale of the assets or allocation of operating profits (losses) passes through to the corporate shareholders and increases (or decreases) the basis in their respective corporate stock. When the corporation distributes the cash proceeds or profits to the shareholders, the shareholder generally recognizes no gain (to the extent of their increased stock basis).

1. Upon Conversion to S-Corp. "Built-in gain" is the difference between the fair market value of the corporation's assets (both tangible and intangible) as of the effective date of the S corporation election less the tax basis in the assets on such date. Stated differently, built-in gain is the gain which would have been taxed had the C corporation sold its assets on the date its Subchapter S election become effective. This built-in-gain may be subject to challenge by the IRS at a later date. An IRS review is generally more likely if the corporation's assets are sold for a gain substantially in excess of the appraised value shortly after the effective date of the election. If the S corporation has never been a C corporation nor acquired assets from a C corporation, the "built-in-gains" tax does not apply. The fair market value of corporation's assets should be determined by an independent appraisal retained for the corporation's tax records and future reference.

a. *Built-In-Gain Tax*. Generally, if any of the corporation's assets are sold within five years of the effective date of the S Corporation election,[2] then the corporation will be liable for a built-in-gain tax.[3]

(1) *Rate*. The statute provides that the tax rate applied to the built-in-gain is the highest rate of tax specified in Code § 11(b), i.e., 35%. The tax is assessed on the *lesser* of the corporation's (i) net recognized built-in-gain or (ii) taxable income.[4]

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[1] All references herein to the "Code" mean the Internal Revenue Code of 1986, as amended, and all references herein to a "Section" or "§"means a section of the Code, except as the context otherwise suggests.
[2] Code § 1374(d)(7).
[3] Code § 1374(a).
[4] Code § 1374(d)(2)(A).

(2) *Assets*. Generally, any asset carried over from the C corporation upon its conversion to an S corporation is subject to the built-in-gains tax. This includes hard assets such as buildings, equipment and inventory, as well as intangibles, including goodwill.

(3) *Subsequent Appreciation*. All appreciation in the corporation's assets after the S corporation election effective date will not be subject to tax under Code § 1374. Thus, there will only be one level of tax on such post-election appreciation—a shareholder-level tax.

(4) *Shareholder Tax Rate*. The §1374 tax imposed on the corporation is in addition to, and not in lieu of, the tax regime (i.e., other rules) imposed on S shareholders under Subchapter S of the Code. To mirror the effects of C corporation taxation, the S shareholders are subject to tax on the corporate-level gain, net of the corporate-level tax. This result is achieved by permitting the shareholder to treat the corporate-level tax as a loss that has the same character as the gain that gives rise to the tax.[5] For example, if the S corporation recognizes a $100 long-term capital gain, all of which is treated as recognized built-in gain, the corporation generally incurs a $35 built-in gains tax.[6] The shareholders recognize their allocable share of a net $65 long-term capital gain for the same tax year. The rate of tax imposed on the shareholder will vary depending on the nature of the assets sold. Generally, depreciation recapture will be subject to ordinary income tax rates. Capital gains will be subject to a 15% to 23.8% (including the Net Investment Income Tax) capital gain tax rate at the individual level.

(5) *Common Issues*.

- How to treat sales of inventories during the recognition period;
- How to apply the tax to cash method accounting corporations;
- How to most efficiently use losses and C corporation attributes to reduce or eliminate the built-in-gain tax.

C. **Determining the Built-In-Gain.** Following the S corporation election (whether timely filed or not), the corporation should have an appraisal of its assets in order to determine the built-in-gain as of effective date of the S election. The appraisals may be subject to later IRS review, therefore it is important to obtain professional and thoughtful appraisals.

1. Calculation. First, a C corporation must calculate unrealized built-in-gain when the corporation elects to be taxed under Subchapter S. This is done by subtracting the corporation's adjusted basis in a particular asset (on an asset by asset basis) from the fair market value of the asset at that time of the election.

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[5] Code §1366(f)(2).

[6] This example is greatly simplified and ignores other factors which could affect how the recognized built-in gain may be calculated.

However, the total amount of gain subject to the built-in gains tax cannot exceed the corporation's "net unrealized built-in gain" ("NUBIG"), which is the amount by which the fair market value of all assets of the S corporation (determined on the first day of its first tax year as an S corporation) exceeds the aggregate adjusted bases of all such assets at that time.[7]

A corporation's NUBIG is equal to:

a. The amount which would be realized by a converting corporation on a hypothetical sale of all of its assets on the first day of the recognition period to an unrelated party which assumed all of the corporation's liabilities, decreased by

b. Any liability that would otherwise be included in the amount realized as calculated in (1) above that is deductible for tax purposes when paid, (e.g., accounts payable, salaries payable, etc., of a cash basis taxpayer), decreased by

c. The aggregate adjusted bases of the corporation's assets on the first day of the recognition period, increased or decreased by

d. Any Code § 481 adjustments of the corporation on the first day of the recognition period, and increased by

e. Any recognized built-in loss that would not be allowed under Code §§ 382, 383 or 384.[8]

D. **NUBIG Example[9].** X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	Basis	FMV
Factory	$900,000	$500,000
Accounts Receivable	0	300,000
Goodwill	0	250,000
Total	900,000	1,050,000

Liabilities	Amount
Mortgage	$200,000

[7] Code § 1374(d)(1).

[8] Treas. Reg. §§ 1.1374-3(a)(1)-(5).

[9] Treas. Reg. § 1.1374-3(c), Example 1.

Accounts Payable	100,000
Total	300,000

Further, X must include a total of $60,000 in taxable income in 1996, 1997 and 1998 under Code § 481(a).

If, on December 31, 1995, X sold all its assets to a third party who assumed all X's liabilities, X's amount realized would be $1,050,000 ($750,000 cash received plus $300,000 liabilities assumed = $1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

Amount realized	$1,050,000
Deduction allowed (A/P)	-100,000
Basis of X's assets	-900,000
Code § 481 adjustments	60,000
Net unrealized built-in gain	110,000

1. Built-In-Gain Tax on S Corporation Election. Before the S Corporation election is made, an analysis should be made to determine whether any gain is triggered upon the election. The built-in-gain tax may be triggered upon an S Corporation election with respect to cash accounts receivable, certain inventory and other items. For example, if the corporation has an overall foreign loss or uses the last-in, first-out ("LIFO") method of accounting for its inventories, then there may be immediate tax consequences following the S election.

a. A LIFO recapture tax is imposed in the last year of its C corporation status, and the resulting tax is paid in equal installments over a period of four tax years beginning immediately after the final C corporation year.[10]

b. An overall foreign loss generally must be recaptured.[11]

c. Additionally, for a cash basis C corporation, the collection of accounts receivables after its conversion to an S corporation can create a built-in-gains tax liability, as that gain on collection relates to a C corporation year and therefore falls within the scope of Code § 1374.

E. **Example**. Jill, an individual, is the sole shareholder of XYZ Corporation, a C corporation. Jill has a $100,000 basis in her stock in XYZ Corporation. On January 1, 2015, Jill

[10] *See* Code § 1363(d).
[11] *See* Code § 1373(b).

makes an election to treat XYZ Corporation as an S corporation. As of January 1, 2015, XYZ Corporation's assets have a tax basis and fair market value as follows:

		Basis	FMV
Cash		$100,000	$100,000
PP&E		$200,000	$500,000
Real Property #1		$100,000	$100,000
	Total	$400,000	$700,000

At the time of the S election, the difference between XYZ's basis in its assets and the assets' FMV is $300,000 ($700,000 - $400,000), and thus XYZ's built-in-gain is $300,000. On September 1, 2015, Jill learns that Tesla Motors, Inc. is building its new Gigafactory on land adjacent to XYZ's real property, quadrupling its value. As of September 4, 2015, XYZ Corporation's assets have a tax basis and fair market value as follows:

		Basis	FMV
Cash		$100,000	$100,000
PP&E		$200,000	$500,000
Real Property #1		$100,000	$400,000
	Total	$400,000	$1,000,000

If XYZ sold its assets on September 4, 2015, the results would be as follows:

XYZ Built-In-Gain Tax	
Built-In-Gain	$ 300,000
Federal income tax at 35%	(105,000)
Net Proceeds	$ 195,000

Jill's Shareholder Tax	
Proceeds on liquidation	$ 895,000
Basis in Stock	(100,000)

Gain	795,000
Federal income tax at 23.8%	($ 189,210)
Total Net Proceeds	$ 705,790
Total Taxes	$ 294,210

II. AVOIDING THE BUILT-IN-GAIN TAX.

A. **The S Benefit**. Assuming the cost of making the S election is manageable, the benefit of making the election can be significant since it can reduce or eliminate any corporate tax on the sale of corporate assets, and thereby leave only one level of long term capital gain tax at the shareholder level.

B. **Wait**. "Recognition period" (i.e., when the Built-in-Gains tax is applicable) means the five-year period beginning with the first day of the first taxable year for which the corporation elected to be an S corporation. As a result of the 2015 PATH Act[12], the recognition period is now generally five years.[13] Consequently, one option is simply avoid selling assets which would generate capital gain, until at least the day after the fifth anniversary of the corporation's S election (when the Code § 1374 tax ceases to be a factor).

C. **Stock Sale**. One of the most fundamental means of avoiding the built-in-gains tax is to sell the S corporation stock, rather than selling the assets. Unfortunately, buyers are more inclined to buy assets in order to:

1. Reduce the Buyer's Risk to Corporate Liability. In an asset sale, the buyer leaves many liabilities (including contingent and unknown liabilities) behind with the selling corporation, as opposed to purchasing the corporation subject to these liabilities; and

2. Increase Buyer's Basis. In an asset sale, the buyer receives a step up in tax basis in all of the assets, thereby allowing the buyer to receive larger future depreciation of tangible property and amortization of goodwill or other intangible property. If the buyer purchased the stock of the corporation, there would be no adjustment to the basis of the corporation's assets. In a stock sale, upon any future sale of the corporation's assets, the taxable gain would be determined by the corporation's old basis in the asset, not the fair market value at the time the buyer purchased the corporation. Also, depending on the timing of any future sale of the S corporation's assets by the buyer, the built-in-gains tax may still apply. Because the buyer does not get a stepped-up basis in the corporation's assets, it can be expected that the

[12] The Protecting Americans from Tax Hikes Act of 2015, P.L. 114-113.

[13] Code § 1374(d)(7)(A). In 2009 and 2010, the recognition period was 7 years. Example, if a C corporation makes an S election on December 31, 2001, and sells assets on January 1, 2009 through December 31, 2009, no Built-in-Gains tax was applicable.

buyer would reduce its purchase price by the present value of the tax benefits of the step-up (and possible the built-in-gains tax).

D. **C Corporation Graduated Rates of Tax**. Because the built-in-gains tax is a flat 35%, the graduated (differing tax brackets) tax rates do not apply. Depending on the income of the C corporation, it may be beneficial (prior to making the S election) to sell its appreciated assets and pay taxes at any lower corporate rates applicable.

E. **Purchase Price Allocation**. If an S corporation's assets are sold outside the ordinary course of business (e.g., either a bulk sale of certain assets or sale of substantially all or all the assets), the taxpayer and buyer may agree to allocate the purchase price to particular assets, or to other agreements entered into as part of the transaction (e.g., covenants not to compete or consulting agreements). If the purchase price allocation does not allocate amounts to built-in-gain assets above their adjusted basis at the time of the S election, then no built-in-gains tax should be applicable. Of course, the seller must be prepared to justify that the allocation are generally consistent with the fair market value of the assets sold.

F. **1031 Exchange**. Depending on the assets of the corporation, a 1031 exchange may be used to defer the recognition of the built-in-gains tax. Under Code § 1031, the exchange of certain types of property may defer the recognition of capital gains or losses due upon sale (including built-in-gains tax[14]). "Other property" or boot received in the exchange would cause recognition of gain on the transaction, which would be subject to the built-in-gains tax.

1. To qualify under Code § 1031, the properties exchanged must be held for productive use in a trade or business or for investment. Stocks, bonds, and other properties are expressly excluded under Code § 1031.

2. The properties exchanged must be of "like kind", i.e., of the same nature or character, even if they differ in grade or quality.

a. *U.S. versus Non-U.S.* Property used predominantly in the United States and property used predominantly elsewhere are not like-kind properties.

b. *Real Estate*. Real properties generally are of like kind, regardless of whether the properties are improved or unimproved.

c. *Non-Realty*. Items of tangible personal property are frequently not of like kind. "Like-class" refers to tangible, depreciable personal property that falls within the same General Asset Class or within the same Product Class, sharing the same 6-digit NAICS code. Treas. Reg. §1.1031(a)-2. The Product Classes are found in Sectors 31 through 33 of the North American Industry Classification System (NAICS).

G. **Lease Property**. Built-in-gains tax is generally due upon the disposition of property subject to the tax. Therefore it may be possible to avoid the tax by leasing such property to third-parties. However, the taxpayer should be confident the lease will not be treated as a sale for federal income tax purposes.

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[14] Code § 1374(d)(6).

1. Generally, a lease is a contract by which one (the lessor) conveys to another (the lessee) real estate, equipment, or facilities for a specified term (including "at will") and for a specified rent.

2. Federal Tax Purposes: A 'true lease' for Federal tax purposes is where the lessor qualifies for the tax benefits of ownership and the lessee may often claim the lease payment as a current tax deduction. In other words, based on the facts and circumstances of the 'lease,' the lessor must have retained a sufficient amount of the benefits and burdens of ownership of the property for the IRS to agree the transaction is a lease, as oppose to (for example) a sale.

a. *Conditional Sales Contract:* Sometimes payments are listed as "rent" when in reality they are actually for the purchase of the property. A conditional sales contract generally exists when at least part of the payments are applied toward the purchase or entitle the taxpayer to acquire the property under advantageous terms.[15] Conditional sales contracts would not qualify as a lease, and payments would be subject to the built-in-gains tax. Whenever certain characteristics of a transaction – such as an option to purchase – are coupled with a real estate lease, a tax question arises as to whether the sale will be deemed to have occurred before the option is exercised. Facts and circumstances suggesting that the "lessor" is parting with ownership may suggest that the transaction should be characterized as an installment sale rather than a lease. This issue is addressed by analyzing the terms of the lease to determine whether, based on all of the facts and circumstances, the lease effectively transfers to the tenant virtually all of the benefits and burdens of owning the leased real estate. In Rev. Rul. 55-540, 1955-2 C.B. 39, the IRS set out a series of guidelines on the sale versus lease issue. Rev. Rul. 55-540 states that in the absence of compelling persuasive factors of contrary implication an intent warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement may in general be said to exist if, for example, one or more of the following conditions are present:

(1) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee.

(2) The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make.

(3) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title.

(4) The agreed "rental" payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property.

(5) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be

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[15] IRS Fact Sheet, FS-2007-14, February 2007

exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared to the total payments which are required to be made.

(6) Some portion of the periodic payments is specifically designated as interest or otherwise readily recognizable as the equivalent of interest.

b. *Triple Net Lease with Purchase Option.* The classic example of a sale versus lease issue involves a triple net lease which grants the tenant the option to purchase the leased real estate at less than full fair market value (because the rentals paid apply, either expressly or tacitly, toward purchase). From a tenant's point of view, re-characterization of a lease as an installment sale means that all rent deductions will be disallowed, and the tenant will be treated as if the tenant had been the owner of the real estate from the inception of the lease and the purported "rent" will be regarded as installments in reduction of the purchase price and not deductible. However, the tenant may be entitled to imputed interest and depreciation deductions. The landlord will be treated as having sold the real estate and may be entitled to report any gain as an installment sale.

c. *Leveraged leases:* Leveraged lease transactions may not be considered leases and generally involve three parties: a lessor, a lessee, and a lender to the lessor. Usually, under a leverage lease, the lease term covers a large part of the useful life of the leased property, and the lessee's payments to the lessor are enough to cover the lessor's payments to the lender. Revenue Procedure 2001-28 contains the guidelines the IRS use to determine if a leveraged lease is a lease for federal income tax purposes.[16] Many leveraged lease transactions involve a sale-leaseback arrangement. An issue which may arise is whether the owner-lessor is the true owner of the property or merely a provider of financing to the lessee, who should be treated as the true owner. It should be noted, however, that the basic principles applicable to a leveraged lease transaction are similar to those applicable to a non-financed lease, i.e., does the owner-lessor possess sufficient benefits and burdens of ownership to be treated as the true owner for federal tax purposes? The IRS set out advance ruling guidelines with respect to leveraged leases in Rev. Proc. 2001-28, 2001-1 C.B. 1156. Rev. Proc. 2001-28 provides that, unless other facts and circumstances indicate a contrary intent, for advance ruling purposes only, the IRS will consider the lessor in a leveraged lease transaction to be the true owner of the property and the transaction a valid lease if all of the guidelines described below are met:

(1) The lessor must make an initial minimum unconditional "at risk" investment in the property of 20% of its cost.

(2) The minimum investment must remain at least 20% of the property's cost at all times throughout the lease term.

(3) The lessor must represent and demonstrate that the property's fair market value at the conclusion of the lease is reasonably expected to be at least 20% of original cost.

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[16] IRS Publication 535 (2014), Business Expenses

(4) In general, no part of the cost of the property or any improvement, modification, or addition to the property may be furnished by a member of the lessee group. The lessee group consists of the lessee, shareholders of the lessee, persons whose stock ownership would be attributed to the lessee under Code § 318, and persons who would constructively own (under Code § 318) stock owned by the lessee.

(5) No member of the lessee's group may lend funds to the lessor to finance the property's acquisition or guarantee any of the lessor's acquisition indebtedness.

(6) The lessor must represent and demonstrate that the property's useful life at the conclusion of the lease term may reasonably be expected to be at least 20% of the originally estimated useful life, or if longer, one year.

(7) The lessee's group may not have a contractual right to purchase the property from the lessor for less than its fair market value when the right is exercised.

(8) When the lessee first places the property in service, the lessor may not have a contractual right to cause any party to purchase the property, and the lessor must represent that it has no present intention to acquire such a contractual right.

(9) The lessor must establish that it expects profits from the transaction, aside from tax benefits.

3. Financial Accounting Purposes: How a lease should be categorized for financial accounting purposes can generally be determined under the direction of FASB ASC Topic 840. However, how a lease is classified for financial accounting purposes has no bearing on its classification for tax purposes, occasionally resulting in a discrepancy between a lease's tax and accounting treatment.

H. **Contribute Depreciated Assets to C Corporation**. Prior to making the S election, a taxpayer may contribute depreciated assets to its C corporation prior to the corporation's S election.[17] By limiting the "net unrealized built-in gain" (NUBIG) (as discussed above), total exposure to the built-in-gains tax is limited.

1. Anti-stuffing rule. If a corporation acquires an asset before or during the Code § 1374 recognition period with a principal purpose of avoiding the tax imposed under Code § 1374, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the Code § 1374 tax. Thus, if a principal purpose of the acquisition of an asset by the S corporation is to avoid the built-in-gains tax, the action may be disregarded.[18]

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[17] *See* Code § 351.
[18] *See* Treas. Reg. § 1.1374-9.

2. Avoiding the Anti-Stuffing Rule. To avoid the anti-stuffing rule, it is important to *either*:

a. demonstrate a clear and substantial relation between the contributed property and the conduct of the corporation's business; *or*

b. contribute (before the date of conversion) property that is expected to decline in value, because losses accrued between the contribution date and the effective date of the S election date should be allowed to reduce the NUBIG calculated on the date of conversion.

I. **Limit Taxable Income**. Remember, the built-in-gains tax is computed on the *lesser* of (i) the built-in-gain or (ii) taxable income. Thus, if there is no or little taxable income, then there is no or little built-in-gains tax to pay. If the S corporation is successful in preventing the built-in-gains tax in the first year that it arises, the S corporation must continue to have no taxable income for the remainder of the recognition period. This may be accomplished through the sale of assets with fair market values below their bases, through the payment of salaries, year-end bonuses, etc.

1. Example: Mrs. Szlarb, a CPA, incorporated her practice as Szlarb Corp. in 1997 as a cash-basis, calendar-year C corporation. On January 1, 2008, Mrs. Szlarb converts her practice to an S corporation. At the time of conversion, the corporation has $100,000 of accounts receivable and $60,000 of accounts payable. Thus, Szlarb Corp. will have $40,000 of "net recognized built-in gain." Assume in 2008, Mrs. Szlarb was paid a salary of $40,000 which zeroed out all of Szlarb Corp.'s income for 2008 so that no tax was due. In 2009, Szlarb Corp. earned $10,000 of income. As a result, in 2009, the corporation pays built-in-gains tax on $10,000, leaving $30,000 remaining for future years. If Szlarb Corp. has no further taxable income until the year 2013, the remaining $30,000 should never be subject to the built-in-gains tax.

2. Determining reasonable compensation. Paying salary may reduce taxable income; however, it is important to remember that the salaries must be reasonable in amount.

a. *The Nine-Factor Test*. In *Mayson Manufacturing Company v. Commissioner*,[19] the court set forth nine factors to use in evaluating the reasonableness of an employee's compensation. The factors include: (i) the employee's qualifications; (ii) the nature, extent, and scope of the employee's work; (iii) the size and complexities of the business; (iv) the business's gross income and the net income during the relevant time period; (v) the prevailing general economic conditions in the market; (vi) a comparison of salaries with distributions to shareholders; (vii) the prevailing rates of compensation for comparable positions and comparable businesses; (viii) the salary policy of the taxpayer for all employees; and (ix) the compensation paid to the particular employee in prior years where the business is a closely-held corporation.[20] These factors have generally been used in one form or another in almost all subsequent cases

[19] 178 F.2d 115 (6th Cir. 1949).
[20] *Id*. at 119.

analyzing the reasonableness of compensation.[21] Since Texas is in the Fifth Circuit, this nine-factor test will apply in Texas.

b. *The Five-Factor Test*. In *Elliotts, Inc. v. Commissioner*,[22] the Ninth Circuit re-classified the *Mayson* factors into five categories to determine reasonable compensation: (i) the employee's role in the company, including the position held, hours worked, duties performed by the employee and the role the employee plays in the success of the company; (ii) an external comparison of the employee's salary with those paid by similar companies for similar services, including combining salaries for persons serving in multiple roles; (iii) the character and condition of the company as indicated by its sales, net income, and capital value, together with the complexities of the business, as well as general economic conditions; (iv) any relationship between the corporation and its shareholder-employee which might permit the company to disguise nondeductible corporate distributions as deductible salary expenditures with application of the independent investor standard (discussed more fully below); and (v) a reasonable, long-standing, consistently-applied compensation plan is evidence that the compensation paid for the years in question is reasonable.

c. *9 or 5 Factors?* As the Fifth Circuit stated in *Owensby & Kritikos, v. Commissioner*,[23] "In Elliotts, … the Ninth Circuit divided the factors into five broad categories:… For all intents and purposes, these are the same as the factors enumerated in Mayson."

d. *The IRS's Test*. The IRS has developed its own set of favorable and unfavorable factors to determine the reasonableness of an employee's compensation.[24]

(1) *Favorable Factors*. The factors weighing in favor of distributions being characterized as compensation include: (i) long hours; (ii) uniqueness of the employee's contribution; (iii) success in turning the company around; (iv) the company's above-average growth or profitability; (v) experience level of the employee; (vi) high productivity and effectiveness of the employee; (vii) bonus arrangements entered into prior to becoming a stockholder; (viii) whether the employee was offered a higher salary by outsiders; (ix) inability of the employee to control compensation levels or dividends; (x) salary compared favorably with that of employees of other companies; (xi) employee was undercompensated in previous years; and (xii) high return on equity.[25]

(2) *Unfavorable Factors*. The factors weighing against distributions being characterized as compensation include: (i) whether the compensation rate exceeded that of comparable companies; (ii) the lack of dividend payments; (iii) inappropriate compensation formulas; (iv) the lack of unique employee skills; (v) the employee spending little time on the job or working less than in previous years; (vi) the Board of Directors not being

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[21] *See, e.g., Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987); *Wagner Const., Inc. v. Commissioner*, 2001 WL 739234, *22, T.C. Memo. 2001-160; *Rutter v. Commissioner*, 853 F.2d 1267, 1271 (5th Cir. 1988).

[22] *Elliotts, Inc. v. Comm'r*, 52 AFTR 2d 83-5976 (9th Cir. 1983).

[23] 819 F.2d 1315, 1324 n.21 (5th Cir. 1987).

[24] *See* I.R.M., Part IV, Examination, at § 4.3.1.5.2.5.2.2.

[25] Id.

independent; (vii) salary increased without increase in duties; and (viii) bonus formulas being changed because of high profits.[26]

e. *An Interesting Wrinkle: The Independent Investor Test*. In *Elliotts*, the Ninth Circuit employed an "independent investor test" as part of its five factor analysis. This test implies compensation will be reasonable as long as the corporation's return on equity remains at a level necessary to satisfy an independent investor.

(1) *Determinative*? In *Dexsil Corp. v. Commissioner*, the Second Circuit found that the compensation paid to an employee in a closely held corporation was unreasonable (and vacated the decision of the Tax Court).[27] The court relied on *Rapco, Inc. v. Commissioner*,[28] stating that "in this circuit the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed", elevating the independent investor test from a mere factor in determining reasonable compensation to the determinative test.[29]

(2) *Or Mere Factor*? In *Exacto Spring Corp. v. Commissioner*,[30] the Seventh Circuit applied the independent investor test in holding that the salary paid to a shareholder-employee was reasonable. However, in following the Second Circuit, Chief Judge Posner stated that "[b]ecause judges tend to downplay the element of judicial creativity in adapting law to fresh insights and changed circumstances, [*Dexsil* and *Rapco*] prefer to say... that the 'independent investor' test is the 'lens' through which they view the seven...factors of the [*Mayson*] test. But that is a formality. The new test dissolves the old and returns the inquiry to basics."[31]

f. *The Take-Away*. As a fact intensive test, determining whether a bonus payment is appropriate can rarely be done with any kind of certainty. However, the more factors weighing in favor of compensation, the better.

J. **Installment Sales**. An installment sale may help defer the recognition of the built-in-gains tax, and it may help to reduce the build-in-gains tax depending on other losses. In general, if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under Code § 453 during *or after* the recognition period, that income is subject to the built-in-gains tax.[32]

1. Taxable Income Limitation Circumvented. Is it possible to eliminate or reduce the built-in-gains tax by using the installment sale method of reporting in conjunction with the taxable income limitation (as discussed above)? The answer is no. See Treas. Reg. Section 1.1374-4(h), which alters the taxable income limitation from its usual computation (noted above) to instead equal in any installment reporting year the amount of unrecognized built-in gain.

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[26] Id.
[27] 147 F.3d 96 (2d Cir. 1998).
[28] 85 F.3d 950, 954 (2d Cir. 1996).
[29] 147 F.3d at 101.
[30] 196 F.3d 833 (7th Cir. 1999).
[31] Id. at 838.
[32] Code § 1374(d)(7)(E); Treas. Reg. § 1.1374-4(h).

2. Planning for Offsetting Built-In Losses.

a. *Use of Losses and Code § 1374 Attributes*. If income is reported under the installment method by an S corporation for a taxable year after the recognition period and the income is subject to tax under Treas. Regs. Section 1.1374-4(h)(1), the S corporation's Code § 1374 attributes may be used to the extent their use is allowed under all applicable provisions of the Code in determining the Code § 1374 tax. However, the S corporation's loss recognized for a taxable year *after* the recognition period that would have been recognized built-in loss if it had been recognized in the recognition period may not be used in determining the Code § 1374 tax.

b. *Use of Built-In Losses on Sale*. There is no carryover from one year to the next of excess built-in-losses; therefore, if possible, taxpayers should recognize built-in-gain each year to the extent of built-in-losses recognized for such year.

c. *NOLs Carried Forward into the Recognition Period*. Although an S corporation cannot deduct a net operating loss carryover, an S corporation may deduct against its tax under Code § 1374 a loss carryover generated while it was a C corporation.[33]

K. **Leveraged Partnership**. A leveraged partnership structure allows a partner to transfer most of the economic interest in a business in exchange for cash without triggering current taxes, including built-in-gains taxes. In a leveraged partnership, the corporation would contribute assets to a partnership, with another partner contributing cash. The partnership would then borrow money and distribute the cash to the corporation. In a typical structure, the corporation guarantees the debt of the partnership in an amount equal to the cash distributed to the corporation.

1. Gain Deferral. The S corporation's tax gain is deferred, in general, until such time as (i) the corporation exits the partnership, (ii) the assets of the partnership contributed by the corporation are sold, (iii) the debt is repaid, or (iv) the guarantee no longer exists.

2. Beware the Disguised Sale Rules.[34] The general rule applicable to disguised sales is that if, within a two-year period a partner transfer property to a partnership and the partnership transfers money or other consideration to the partner, the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish otherwise.[35] The assumption of debt by a partnership may similarly be treated as proceeds in a disguised sale, subject to an exception for certain qualified liabilities. Even if the transfer occurs after two years, that transfer might be determined (although not presumed) to be disguised sale if based on all the facts and circumstances (i) the transfer of money or other consideration would not have been made but for the transfer of property; and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. In general, a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration

[33] Treas. Reg. § 1.1374-5(a).
[34] Treas. Reg. § 1.707-3(b)(1).
[35] Treas. Reg. § 1.707-3(c).

(including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only.

a. *Facts and Circumstances*.[36] The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists. Among the facts and circumstances that may tend to prove the existence of a sale are the following:

(1) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(2) That the transferor has a legally enforceable right to the subsequent transfer;

(3) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(4) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(5) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(6) That a partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(7) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(8) That partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

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[36] Treas. Reg. § 1.707-3(b)(2).

(9) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(10) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

b. *Transfers Made within Two Years – Presumed Sale*.[37] If within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale. However, if such transfers are more than two years apart, the transfers are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.

c. *Example*.[38] A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market value of $4,000,000 and an adjusted tax basis of $1,200,000. Immediately after the transfer, the partnership transfers $3,000,000 in cash to A. Assume that, under Code § 707, the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Because the amount of cash A receives on April 9, 1992, does not equal the fair market value of the property, A is considered to have sold a portion of property X with a value of $3,000,000 to the partnership in exchange for the cash. Accordingly, A must recognize $2,100,000 of gain ($3,000,000 amount realized less $900,000 adjusted tax basis ($1,200,000 multiplied by $3,000,000/$4,000,000)). Assuming A receives no other transfers that are treated as consideration for the sale of the property under Code § 707, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,000,000 of the fair market value of the property with an adjusted tax basis of $300,000.

d. *The Key: Debt-Financed Distributions*. Certain distributions, however, are not regarded as being part of a disguised sale. One category of distributions which are not regarded as being part of a disguised sale are distributions made with proceeds of new debt (i.e., so-called "debt-financed distributions").[39] The exception for debt-financed distributions only applies if the debt in question is a new debt, not an existing debt assumed by the partnership. Moreover, the exception for debt-financed distributions only applies to the extent that the partner's share of the debt is at least equal to the amount of the debt financed distribution. Any portion of a debt-financed distribution which exceeds the partner's share of the debt will be subject to the general disguised sale rules, including the presumption that the distribution is part of a disguised sale, if made within two years of the contribution of property by the partner to the partnership. The leveraged partnership technique uses and depends on this exception for debt-financed distributions. The loan guarantee made by the S corporation is what

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[37] Treas. Reg. § 1.707-3(c), (d).
[38] Treas. Reg. § 1.707-3(f).
[39] Treas. Reg. § 1.707-5(b).

assures the S corporation that the debt funding the distribution will be regarded as all belonging to the S corporation.

III. CODE § 303 REDEMPTIONS.

If a shareholder holds stock until his death, tax planning under code § 303 may be utilized. Code § 303 provides an exception to a general classification of a corporate redemption receiving dividend treatment under code § 302(a). Code § 303 permits sale treatment for corporate redemptions where the proceeds from a stock redemption are used to pay (i) "death" taxes (e.g., federal estate tax, state inheritance tax and state estate tax) and (ii) funeral and estate administration expenses deductible under code § 2053, provided that (a) the decedent's stock comprises more than 35% of the decedent's adjusted gross estate[40]; (b) the distribution does not exceed the sum of all federal and state estate and inheritance taxes (including interest thereon) and code § 2053 funeral and estate administration expenses[41]; and (c) and the redemption occurs within three (3) years and ninety (90) days after filing the decedent stockholder's federal estate tax return[42] subject to extension (1) if a tax court petition is filed for a redetermination of federal estate tax or (2) federal estate taxes are being paid in installments under code § 6166.

Code § 303 applies to C corporations and S corporations which still have C corporation earnings and profits (accumulated in years during which the S corporation was previously a C corporation). Community property law also applies when determining the percentage of the adjusted gross estate. For example, if a business owner's estate includes a community property business interest of $400,000 and non-business separate property of $600,000, the adjusted gross estate would be $800,000 (i.e., $600,000 of separate property and $200,000 or ½ of community property interest in the business), but the business interest would comprise only 25% of this $800,000 adjusted gross estate. Therefore, a Code § 303 redemption would not be available to the business owner's estate.

IV. BASIS STEP-UP PLANNING: MAKING THE BEST OUT OF THE INEVITABLE.

It may be hard to convince a client that his or her death can be part of a successful income tax minimization strategy. However, Code § 1014 does provide an extremely effective method to reduce potential capital gains and depreciation recapture taxes, using one of life's certainties (death) to reduce the other (taxes). In general, property which passes from a decedent (and property which is included in his or her estate for federal estate tax purposes) receives a new basis equal to its fair market value as of the date of death. While this includes property owned by either the decedent, a revocable living trust created by the decedent, or a marital trust for the benefit of the decedent (and for which a qualified terminable interest property—or QTIP—election was made), it generally will NOT include property previously sold by the decedent or transferred by the decedent to an irrevocable trust. Even if the decedent's estate is not required to file a federal estate tax return, most estate assets receive a basis equal to their fair market value on the decedent's date of death.

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[40] Code § 302(b)(2).
[41] Code § 302(a)(1)-(2).
[42] Code § 302(b).

A. **Basis Step-Up (or Step-Down) On Death**. While most refer to this adjustment as a basis "step-up" because it erases built-in gain, it is important to remember that a basis adjustment could potentially result in a downward basis adjustment, erasing any built-in loss.

1. Deemed Long-Term Holding Period. If the basis of property acquired from a decedent is determined pursuant to Code § 1014, the recipient is immediately deemed to have held that property for more than 1 year.[43] As a result, capital gain which might be realized on the sale of such asset would likely qualify as long-term capital gain.

2. Exception for Certain 2010 Decedents. For taxpayers who died in 2010, executors could elect out of any estate tax liability. By making this election, the assets includible within the deceased taxpayer's estate did not obtain a basis adjustment under Code § 1014. Instead, the estate's assets received a modified carry-over basis pursuant to former Code § 1022. As a result, additional inquiry may be required to determine the basis of property acquired from a taxpayer who died in 2010.

B. **Both "Halves" of Community Property Receive Basis Adjustment**. In certain states, each spouse has an undivided one-half interest in the income acquired by the other during marriage. Texas is one of these "community property" states, as are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Washington, and Wisconsin. In addition, couples in Alaska can "opt-in" to community property treatment. Upon the death of a spouse, even though only one-half of the couple's community property is includible in the deceased spouse's estate, all of the couple's community property receives a basis adjustment (not just the deceased spouse's one-half interest).[44] Although property acquired prior to marriage typically is not community property, it may be possible to convert this "separate property" into community property by written agreement of the couple, thereby achieving a greater basis adjustment upon the death of either spouse.[45] However, converting separate property to community property should not be taken lightly, as it may expose such converted property to the creditors of the other spouse. Further, under Texas divorce law, community property is subject to "equitable" division between spouses upon divorce, whereas a court cannot order that one spouse's separate property become the property of the other spouse upon divorce. Nevertheless, converting highly-appreciated separate property to community property may provide significant future income tax savings.

C. **Exception Related to Income in Respect of a Decedent**. The Code § 1014 basis adjustment does not apply to certain property which is income in respect of a decedent (or "IRD").[46] Pursuant to Code § 691, IRD includes gross income to which a decedent was entitled, but not taxed, prior to death, typically as a result of a decedent's accounting method. Instead of being taxed on a decedent's final tax return, IRD is taxable in the hands of the recipient when received. For example, for a cash basis taxpayer, IRD includes amounts payable for goods or services prior to death, such as a decedent's final paycheck.[47] Pre-tax contributions to a decedent's traditional (non-Roth) 401(k) plan or traditional Individual Retirement Accounts are also IRD. While a recipient of IRD property may not receive a basis "step-up", they are allowed

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[43] Code § 1223(9).
[44] Code § 1014(b)(6).
[45] See Tex. Fam. Code § 4.202.
[46] Code § 1014(c).
[47] Treas. Reg. § 1.691(a)-2(b) ex. (1).

to claim a deduction with respect to the amount of any estate tax which was paid attributable to such property.[48]

D. **Exception Related to Previously Transferred Property**. In some situations, property that was previously transferred by a decedent is nevertheless includible in the decedent's estate for federal estate tax purposes. For example, if a decedent makes a taxable gift within three years of his or her death, the date-of-death value of such gifted property is included in the decedent's estate.[49] However, it is possible that the recipient of such property had already begun to take depreciation or other deductions on such property. In such a scenario, the recipient is still entitled to receive a basis adjustment; however, this basis adjustment will be reduced by the amount of previous deductions the recipient was allowed to take related to the property.[50]

E. **Exceptions Related to Estate Tax Returns**. If a decedent's estate is required to file a federal estate tax return, then an asset's basis is generally adjusted to its estate tax value. While this in most cases will still be an asset's fair market value, there are certain scenarios which may result in an asset taking a basis which is not necessarily equal to the date-of-death fair market value.

1. Alternate Valuation Date. As discussed above, for federal estate tax purposes, assets are generally given a date-of-death value.[51] However, if the total date-of-death value of a decedent's estate (plus any prior taxable gifts) exceeds the applicable exemption amount, the executor of the estate may have the option of calculating the estate's value as of a date six months later, known as the "Alternate Valuation Date".[52] If this "alternate valuation date" election is made, then the value as of the alternate valuation date is used to determine the new basis in such assets. Although some assets may increase in value in this six month period of time while others decrease, the alternate valuation date election can only be used if it results in both (a) a reduction in the aggregate value of the estate and (b) a reduction in the amount of estate tax owed. As a result, the use of an alternate valuation date will likely lead to a lower basis in some (if not all) assets compared with a traditional date-of-death valuation. Furthermore, because the alternate valuation date election must result in a reduction in the estate tax owed, it cannot be used in an effort to increase basis if assets have appreciated since death, even in estates which are non-taxable.

2. Alternate Use Valuation. Certain qualifying real property included within a decedent's estate may receive a reduced valuation if such property was used in farming or another trade or business and both the real property and the other assets of the business made up a significant portion of the estate.[53] To the extent the executor of an estate makes a valid Alternate Use Valuation election, such property will receive a basis equal to its reduced valuation.

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48 Code § 691(c); see also Treas. Reg. § 1.691(c)-1.

49 Code § 2035(a).
50 Code § 1014(b)(9).
51 Code § 2031(a).
52 Code § 2032.
53 Code § 2032A.

3. Qualified Conservation Easements. If an executor makes an election with respect to real property subject to a qualified conservation easement, then a fraction of such property will not receive a Code § 1014 basis adjustment but will instead receive a pro rata portion of the decedent's basis.

F. **Planning for Basis Step-Up**.

1. New Basis for Recapture and Depreciation Purposes. Code § 1014 is especially valuable when dealing with property that would ordinarily be subject to significant depreciation or depletion recapture upon sale or transfer. Except for items of income in respect of a decedent (as described above), an upward Code § 1014 basis adjustment has the effect of eliminating most potential sources of recapture taxes.[54]

a. *Example*. Taxpayer owns residential real property that he acquired in 1988 for $100,000 and immediately began renting. $75,000 of the purchase price was allocated to the improvement, and $25,000 of the purchase price was allocated to the land. The improvement, but not the land, is depreciable pursuant to Code § 167. Under the MACRS depreciation method, residential real property improvements are subject to a 27.5 year recovery period, and the Taxpayer depreciated the property on the straight-line method without claiming any additional or accelerated depreciation. Assuming the Taxpayer has made no additions or improvements to the property, the improvement would likely be fully depreciated by 2017.

(1) *Taxpayer Sells During his Lifetime*. If the Taxpayer sold the property in 2017 for $300,000, the Taxpayer would recognize $275,000 of capital gain. $75,000 of that gain would be characterized as "unrecaptured Code § 1250 gain" and taxed at 25%, while the remaining capital gain would be taxed up to a maximum capital gains rate of 20%.

(2) *Taxpayer Dies Owning Rental Property*. If the Taxpayer did not sell the property prior to his death, the basis of both the improvement and the land would generally be adjusted to fair-market value as of the date of death. As a result, if the property is sold immediately after death, it is highly likely that no gain would be recognized. Furthermore, any gain that is recognized would be treated as long-term capital gain.[55]

2. Preserving or Swapping for the Step-Up. As noted above, even if the decedent's estate is not required to file a federal estate tax return, most estate assets receive a basis equal to their fair market value on the decedent's date of death. As a result, elderly taxpayers may wish to avoid selling or transferring highly-appreciated assets (or assets whose basis have been subject to significant depreciation or depletion) if they have other sources of liquidity available. If they already sold low basis assets to an "intentionally defective" grantor trust and they hold an asset substitution (or "swap") power over that trust's assets, they should think about swapping high basis assets (i.e., cash) for the low basis assets owned by that trust.

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[54] See, e.g., Treas. Reg. § 1.467-7(c)(2), Treas. Reg. § 1.617-4(c)(2), Treas. Reg. § 1.1245-4(b)(1), Treas. Reg. § 1.1250-3(b)(2), Treas. Reg. § 1.1254-3(a)(4); but see Treas. Reg. § 1.1014-9 (retaining some recapture related to DISC stocks).
[55] Code § 1223(9).

3. Sale to Avoid the Step-Down. As noted above, a basis adjustment could potentially result in a downward basis adjustment, erasing any built-in loss. This means that, while the elderly taxpayer may wish to avoid selling property with built-in gain, it may make sense to sell property with built-in loss prior to death if such losses can be used to offset other income.

4. Gifts to Older Generations. Some may attempt to "accelerate" the Code § 1014 basis step-up by gifting appreciated property to older relatives, who would provide in their will that such gifted property to pass back to the original donor. In attempt to dis-incentivize gifts made to persons near death for this purpose, a basis adjustment is not allowed if (a) a person received property by gift, (b) such property had a fair market value in excess of the donor's basis at the time of the gift, (c) the recipient dies within a year of receiving such gift, and (d) as a result of the recipient's death, the gifted property passes back to the original donor or the donor's spouse.[56] In such a scenario, the original donor does not receive a stepped-up basis in the property they originally gifted. Instead, their basis in such property the same as the basis in the hands of the deceased recipient immediately prior to his or her death.

a. The IRS has privately ruled that the provisions of Code § 1014(e) apply not only to a bequest to the donor, but may also apply to bequests to trust in which the donor has a beneficial income interest.[57] Therefore, if appreciated property is gifted to someone with a shortened lifespan, the recipient should consider making a specific bequest of such gifted assets in their will to someone other than the donor or the donor's spouse (such as the donor's descendants).

5. Partnership Interests. If a decedent owns an interest in partnership, the decedent's basis in the partnership interest (i.e., the decedent's "outside basis") automatically receives a Code § 1014 basis adjustment, subject to two further adjustments. The fair market value of the interest on the applicable valuation date (date of death or, if applicable, alternate valuation date, as discussed above) is increased by the successor's share of partnership liabilities and decreased by the partnership's items of income in respect of a decedent (as discussed above).[58] Items of partnership IRD generally include assets such as "unrealized receivables."[59] However, for this purpose, the definition of unrealized receivables is limited and does *not* include most forms of depreciation recapture.[60]

a. *Code § 754*. As with transfers of an interest in a partnership, the decedent's basis in the partnership's underlying assets (the decedent's "inside basis") does not receive a similar automatic basis adjustment unless (a) a Code § 754 election has previously been made by the partnership or (b) the partnership's adjusted basis in its assets exceeds the fair market value of those assets by more than $250,000 (in which case there is a downward adjustment).[61] In order to receive an "inside basis" adjustment relative to Code § 1014, the

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[56] Code § 1014(e).
[57] PLR 9026036; PLR 9321050.
[58] Treas. Reg. § 1.742-1.
[59] See Treas. Reg. § 1.755-1(b)(4)(ii), *Woodhall v. Commissioner*, T.C. Memo 1969-279, and *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336 (1971).
[60] Code § 751(c) (flush language).
[61] Code § 743(a).

partnership must have a valid Code § 754 election in place for the tax year in which the decedent died.

b. *Cost Segregation*. With a Code § 754 election in place, it is possible to obtain an adjustment to the "inside basis" with respect to the decedent's partnership interest based on the fair-market value of the partnership interest. Obtaining a cost segregation report might provide additional benefits through the allocation of inside basis to partnership property with a shorter MACRS recovery period. See **Section XV.E** for more detail.

V. NEW BASIS CONSISTENCY REQUIREMENTS.

As part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Congress passed several basis consistency provisions related to taxable estates. Code § 1014(f) mandates that the basis of property received from a decedent's estate which causes an increase in the amount of estate tax owed must not exceed the value of such property as finally determined for federal estate tax purposes. As a result, the recipient of property from a decedent's taxable estate (except, perhaps, for the surviving spouse) may not argue that the executor undervalued assets on the estate tax return. Proposed regulations have been issued in an attempt to clarify both the basis consistency requirements and the related reporting requirements which would apply to any estate for which Form 706 is filed after July 31, 2015.

A. **Property Subject to Basis Consistency Requirement**. Any property includible in a decedent's gross estate is generally subject to the mandate of Code § 1014(f).[62] The mandate also includes property whose basis is determined, in whole or in part, by reference to the basis of covered property. However, property which qualifies for the marital or charitable deductions for estate tax purposes is exempt from the basis consistency requirements (although may still be subject to the reporting requirement).[63] There is also an exclusion for tangible personal property items worth less than $3,000.

B. **Certain Types of Property Exempt from Reporting**. Generally, all assets that are listed on Form 706 must be reported on at least one beneficiary's Form 8971 Schedule A within 30 days of the filing of Form 706.[64] Cash (other than collectible coins or bills), tangible personal property worth less than $3,000, and items of income in respect of a decedent (as determined by Code § 691) are exempt from the reporting requirement.[65] Also exempt from the reporting requirement is property which has been sold, exchanged or otherwise disposed of in a transaction in which "capital gain or loss is recognized." It is unclear whether this would include sales which result in no gain (as would likely be the case for sales taking place shortly after death). It is also unclear whether "cash" includes cash equivalents, such as certificates of deposit.

C. **Supplemental Reports May Be Necessary**. If the estate's assets have been fully distributed within 30 days of the filing of Form 706, then each beneficiary's Schedule A lists the

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[62] Prop. Treas. Reg. § 1.1014-10(b)(1).
[63] Prop. Treas. Reg. § 1.1014-10(b)(2).
[64] Prop. Treas. Reg. § 1.6035-1(b)(1).
[65] Id.

assets the beneficiary received from the estate and the value (not necessarily the basis) as reported on Form 706 (with adjustments for certain post-death events).

1. Estate Not Fully Distributed Within 30 Days of Return Filing. If a beneficiary has not yet fully received their distribution from the estate, then such beneficiary's Schedule A must list *all* estate assets which *could possibly* be used to satisfy the bequest. The executor must then file supplemental reports within 30 days of subsequent distributions from the estate.[66]

2. Value Adjustment As a Result of Audit or Litigation. Supplemental reporting is also required in the event the value on Form 706 is adjusted as a result of events such as an estate tax return audit.[67]

3. Beneficiaries May Also Have to Issue Supplemental Schedule A's. Shockingly, a beneficiary of an estate is also required to report a subsequent gift of property previously reported on Form 8971 by providing the IRS and the subsequent recipient with a Schedule A.[68]

D. **Penalties for Failure to File Information Return**. If an executor fails to file a required Form 8971 or fails to deliver a required Schedule A, the executor may be subject to penalties as described in Code §§ 6721 and 6722 of up to $500 (adjusted annually for inflation) per unfiled return or schedule. However, those penalties are relatively minor compared with the potential negative consequences if an asset is not disclosed.

E. ***$0 BASIS FOR OMITTED OR AFTER-DISCOVERED PROPERTY!*** If property is not reported on a federal estate tax return prior to the expiration of the applicable statute of limitations, then such property receives a basis of $0 under the new proposed basis consistency rules.[69] A "supplemental" Form 706 disclosing the asset and paying additional estate tax (together with penalties and interest) will apparently not change the result if filed outside of the assessment period. It is unclear how this proposed rule would apply to certain assets (such as cash). It also remains to be seen whether the IRS would seek to extend this $0 basis penalty if assets are omitted from Form 8971 or if such form is filed late. As a result, it is vital to ensure that all estate assets are properly reported on a timely Form 706 as well as Form 8971.

VI. CHANGING ASSET BASIS WITHOUT GAIN OR DEATH.

A. **Objective**. What if, simply by waiting seven years between a property's contribution to a partnership and a subsequent distribution from a partnership, partners could achieve a basis transfer between assets at no gain? This technique of swapping basis between assets (the "Basis Swapping Technique") could be helpful where one asset is more likely to be sold after seven years than another.

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[66] Prop. Treas. Reg. § 1.6035-1(e)(4).
[67] Prop. Treas. Reg. § 1.6035-1(e)(2).
[68] Prop. Treas. Reg. § 1.6035-1(f).
[69] Prop. Treas. Reg. § 1.1014-10(c)(3).

B. **Gain on Partnership Distributions**. As a general rule, neither the partnership nor a partner will recognize gain or loss upon a distribution of property.[70] However, this general rule is subject to several exceptions, e.g., (i) where the distributed property is a "hot asset" (such as cash basis accounts receivable or depreciation recapture assets) per Code § 751, (ii) where the distributed property is a marketable security (which is treated as cash)[71], (iii) where the "anti-mixing bowl" rule applies, or (iv) where Code § 737 provides otherwise. The "anti-mixing bowl" rule and Code § 737 are discussed further below and apply to trigger gain recognition where built-in gain property previously contributed to a partnership by one partner is distributed to another partner within seven years of the prior contribution.

C. **Principal Rules Allowing the Basis Swapping Technique**.

1. Rules Determining the Basis of Distributed Assets. The partner to whom the partnership distributes property generally takes the partnership's basis in that property (i.e., the so-called "inside basis")[72], but not in excess of the distribute partner's basis in his or her partnership interest (i.e., the so-called "outside basis")[73]. This "outside basis" limitation on the basis of the distributed property essentially transfers the inherent gain in the distributee partner's partnership interest to the distributed property. But what happens to that portion of the partnership's inside basis (for the distributed property) that exceeds the "outside basis" limitation (the "Excess Basis")? If the distributee partner doesn't get the Excess Basis, who does?

2. Significance of a Code § 754 Election. The answers to the immediately preceding questions depend on whether a Code § 754 election is made by the partnership. If the election is made, the partnership gets to reallocate the Excess Basis to its other assets of a similar class (i.e., if the distributed property was a capital asset or Code § 1231 asset, then the Excess Basis is reallocated to the partnership's remaining capital assets or Code § 1231 assets). Without a Code § 754 election, the partnership does not get to reallocate the Excess Basis to its other assets.

D. **Genesis of "anti-mixing bowl" rule and Code § 737**. Since property contributions and distributions to and from partnerships can be non-recognition events, Congress was concerned that partnerships could be used to exchange properties without current gain recognition even though the exchange of properties did not qualify as a like-kind exchange under Code § 1031. To stop such exchanges, Congress enacted the "anti-mixing bowl" rule and changes to Code § 737, which are summarized below:

1. Anti-Mixing Bowl Exception. First, gain will be recognized under the "anti-mixing bowl" rule if the partnership distributes contributed property to a partner other than the partner who contributed that property.[74] This will occur when a partner contributes built-in gain property (i.e., Code § 704(c) property) to a partnership and within the immediately following seven years that partnership distributes that contributed property to another partner. In this case, the distribution is treated as a sale of that property by the contributing partner to the

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[70] Code § 731(a) – (b); Treas. Reg. § 1.731-1(a) – (b).

[71] Code § 731(c); Treas. Reg. § 1.731-2.
[72] Code § 732(a)(1); Treas. Reg. § 1.732-1(a).
[73] Treas. Reg. § 1.732-1.
[74] Code § 704(c)(1)(B).

distributee partner. Notice that, under this exception, the non-recipient partner recognizes built-in gain.

2. Code § 737 Exception. Second, under Code § 737, gain will be recognized by a partner if that partner contributes built-in gain property to the partnership and within seven years of that contribution receives a distribution of other property. Notice that, under this exception, the recipient partner recognizes built-in gain. The recipient partner will be required to recognize gain equal to ***the lesser*** of the following:

- the excess the fair market value of property (other than money) received in the distribution over the adjusted basis of the distributee partner's interest in the partnership immediately before the distribution reduced (but not less than zero) by the amount of money received in the distribution; or[75]

- The distributee partner's "net precontribution gain."[76]

The "net precontribution gain of the partner" is the net gain that would have been recognized by the distributee partner under Code § 704(c)(1)(B) if all property that had been contributed to the partnership by the distributee partner within seven years of the distribution (and was held by that partnership immediately before the distribution) had been distributed by the partnership to a partner other than the distributee partner.[77]

E. **Avoiding "anti-mixing bowl" rule and Code § 737.** As noted above, the primary benefit of the Basis Swapping Technique is that, by using a partnership, basis can be swapped between assets without having to recognize gain to do so. However, due to the "anti-mixing bowl" rule and Code § 737, this requires patient planning. Nonetheless, simply by waiting seven years between a property's contribution and subsequent distribution (and thereby qualifying for this general rule and avoiding these two exceptions), a basis transfer between assets can occur at no gain.

F. **Example**. A owns Property A having a low basis, B owns Property B having a high basis, and C owns Property C also having a high basis. B and C are A's children. A, B and C form ABC Partnership by respectively contributing Property A, Property B and Property C. Property A, Property B and Property C are equal in value, but given local market conditions for Property B, Property A will more likely sell before Property B. Seven years and one day after Property A, Property B and Property C were contributed to ABC Partnership, ABC Partnership distributes Property B to A. Since more than seven years have passed, the "anti-mixing bowl" rule and Code § 737 do not apply. Due to the "outside basis" limitation rule (noted above), rather than receiving ABC Partnership's high basis in Property B, A receives a low basis in Property B equal to A's outside basis in A's interest in ABC Partnership, and the excess of Property B's basis not passing to A remains with ABC Partnership to be reallocated between Property A and Property C. Immediately following the distribution of Property B, ABC Partnership makes a Code § 754 election, which causes the outside basis in B's and C's respective interests in ABC Partnership to be increased (in the aggregate) by this excess basis

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[75] Code § 737(a)(1).
[76] Code § 737(a)(2).
[77] Code § 737(b).

reallocated from Property B to Property A and Property C. ABC Partnership can now sell Property A with a higher basis, thereby generating less gain. The proceeds from the sale of Property A can also be distributed to B and C without additional gain due to the Code § 754 election. On the other hand, A can retain Property B until A's death and receive a step-up in basis for Property B.

G. **Administrative Considerations**. Remember that Code §§ 704(c) and 737 require partners or LLC members to maintain the built-in gains inherent in appreciated property when a partner or member contributes that property to the partnership or LLC. When part or all of a partnership interest is transferred, the transferor's capital account attributable to the transferred interest must carry over to the transferee partner. Therefore, when considering the practical issues of maintaining a chart of accounts, consider setting up a separate account system for the Code § 754 basis adjustment as well as for built-in Code § 704(c) gain. To further simplify the record and accounting requirements, it might be better to have fewer assets included in the partnership.

H. **Debt Causes Additional Complications**.

1. Reallocations of Partnership Debt Treated as Constructive Distribution. Most tax planners familiar with partnership taxation understand that, to the extent a partner's share of partnership liabilities increases, the partner is treated as having contributed additional cash to the partnership, resulting in an increase in the partner's "outside basis."[78] However, it is just as important to remember, conversely, that any reduction in a partner's share of partnership liabilities is treated as a distribution of cash to the partner.[79] If a partner's "outside basis" is reduced to zero, these constructive distributions could lead the taxpayer to unexpectedly recognize phantom income.[80] While this gain will typically be treated as a capital gain, a taxpayer could be treated as receiving a constructive distribution of ordinary income to the extent certain tax items, such as unrealized receivables, are allocated to other partners.[81] There are several scenarios which could result in one or more partners being treated as having received such a constructive distribution due to a change in the economic risk of loss among the partners:

2. Contribution to Partnership of Property Subject to Indebtedness. If property encumbered by debt is contributed to the partnership and the partnership assumes liability for the debt, the contributing partner has caused both an increase in his outside basis (of the fair market value of the property contributed to the partnership) and a decrease in his outside basis (of the amount of indebtedness assumed by the partnership). The net result of these two outside basis adjustments can cause the contributing partner to recognize gain.[82] For example:

a. *Example*. A and B wish to form a partnership, AB, in which A and B equally share all income, gain and loss. A contributes $100 cash, whereas B contributes land worth $1,000, which has a basis in B's hands of $100 and which is subject to $900 of debt. AB assumes the debt on the encumbered land. As a result of the contributions, A receives an outside basis in AB of $550 ($100 cash plus his ½ share of the $900 liability assumed by the

[78] Code § 752(a).
[79] Code § 752(b).
[80] Code § 733(a)(1).
[81] Rev. Rul. 84-102.
[82] Treas. Reg. § 1.752-1(f).

partnership). On the other hand, B will have an outside basis in AB of $0 and will recognize $350 of gain. B would have received $100 of outside basis from the contributed land. However, the Partnership assumed $900 of the indebtedness related to the land, and $450 of that indebtedness is now attributed to A. As a result, B is treated as receiving a distribution of $450 cash from AB, which first reduces B's outside basis to $0, and which then triggers $350 of gain.

3. <u>Admission of a New Partner to the Partnership</u>. If a partner is admitted to a partnership and the admitted partner assumes a share of partnership liabilities, this may also cause the existing partners to receive constructive cash distributions.

a. <u>Example</u>. Following on the previous example, assume C wishes to join AB partnership and share equally in the income, gain, and loss of AB. C contributes $100 to AB in exchange for a 1/3 interest in the partnership, which is still liable for the $900 debt on the land contributed by B. After joining the partnership, C will have an outside basis of $400 in the Partnership ($100 cash plus is 1/3 share of the $900 liability related to the land). A will be treated as having received a constructive distribution of $150 (A's share of partnership liabilities has dropped from ½ of $900 (or $450) to 1/3 of $900 (or $300)), and his outside basis in AB will drop to $400 ($100 original cash contribution plus his 1/3 share of the $900 liability related to the land). B will also be treated as having received a constructive distribution of $150 (A's share of partnership liabilities has also dropped from $450 to $300), but since B's outside basis was already $0, B will be tagged with an additional $150 of gain.

4. <u>Debt Restructuring or Partnership Amendment</u>. A change to the terms of a debt obligation or the partnership agreement itself can have similar effects, leading to a constructive distribution. For example, a partnership debt that was nonrecourse (and, as a result, allocated among the partners in proportion to their interest in partnership profits[83]), might be refinanced with a lower interest rate based on a partner giving a personal guarantee. The personal guarantee could have the effect of shifting the economic risk of loss related to the debt to the guarantor, and reducing the share of partnership liabilities attributable to the other partners.[84] A similar result could occur if there was an amendment to the partnership agreement which altered the manner in which losses are shared amongst the partners.

I. **<u>Other Complications</u>**. Just over twenty years ago, the IRS issued "anti-abuse" Treasury Regulations.[85] These Treasury Regulations allow the IRS to re-characterize any transaction involving a partnership if a principal purpose of that transaction is to reduce the present value of the partners' "aggregate Federal tax liability" in a manner inconsistent with the Subchapter K.[86] While these Treasury Regulations are potentially very broad, the examples they set forth do not seem to preclude the Basis Swapping Technique.[87] Also, these Treasury Regulations are not the only potential weapons in the IRS's arsenal. It is conceivable that the IRS may assert other theories to attack the Basis Swapping Technique, e.g., substance over form, step-transaction, and sham-transaction doctrines.

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[83] *See* Treas. Reg. § 1.752-3(a).
[84] *See* Treas. Reg. § 1.752-2(b)(3)(i).
[85] Treas. Reg. § 1.701-2.
[86] Treas. Reg. § 1.701-2(b).
[87] See Treas. Reg. § 1.701-2(d), Ex. 9 and Ex. 10.

VII. OFFSETTING GAIN: YOU CAN'T PHONE A FRIEND, BUT YOU MIGHT USE A PAL.

If a taxpayer is involved in a trade or business in which he does not materially participate (a "passive activity") losses generated from that activity can generally only be used to offset income derived from the same passive activity in a given tax year.[88] To the extent passive activity loss (or "PAL") exceeds passive activity income in a given tax year, the taxpayer is allowed an unlimited PAL carry-forward to apply to passive income in future years from the same activity.[89]

A. **Deduction of Suspended PAL Upon Disposition of Entire Interest in Passive Activity**. Code § 469(g) allows a taxpayer to claim previously suspended PAL from a single activity in the current tax year if the taxpayer's disposes of his or her entire interest in such passive activity in a taxable transaction in the same tax year. After offsetting any gain from the "disposed" activity, such previously suspended PAL can be used to first any net passive activity income or gain from other activities in the current year.[90] The amount of any remaining suspended PAL from a "disposed" activity can then be treated as loss which is *not* from a passive activity. As a result, such previously suspended PAL could possibly be used to offset gain or income from other activities.

B. **Disposition Must Be in Fully Taxable Transaction**. To use such suspended PAL, the disposition of the passive activity must be through a fully taxable transaction ("FTT").

1. "Sale" of Assets to Partner Treated as a Non-Taxable Distribution. An alleged purchase of partnership assets by a partner followed by a liquidation distribution of cash from the partnership to the same partner did not qualify as a FTT where no cash was distributed to the liquidated partner and no proof of such a sale, allowing the IRS to cast the transactions as a non-taxable partnership distribution under Code § 731.[91]

2. Worthlessness of Passive Activity Stock is Treated as a FTT. If the stock representing a taxpayer's passive investment in a construction company becomes worthless due to the insolvency of the company, the taxpayer can be considered to have disposed of his entire interest in a FTT in the year in which the company's stock became worthless.[92]

3. Foreclosure Can be Considered FTT. Similarly, the foreclosure of a mortgage can be considered a disposition in a FTT, even if all cancellation of debt ("COD") income from the foreclosure is excludable from gross income due to the insolvency of the taxpayer.[93] Furthermore, the suspended PAL is ***not*** reduced by the amount of exempt COD income. However, if the foreclosed property remains listed as an asset on company books and records (as well as tax returns), and if the taxpayer pursues litigation regarding foreclosed-upon

[88] Code § 469(a).
[89] Code § 469(b).
[90] Code § 469(g)(1)(A).
[91] Ramsburg v. Commissioner, T.C. Memo. 2005-252.
[92] Bilthouse v. United States, 553 F.3d 513 (7th Cir. 2009).
[93] C.C.A. 201415002.

property beyond the tax year of the foreclosure, a mortgage, in and of itself, might ***not*** qualify as a FTT.[94]

C. **Disposition Must Be of Entire Interest**. It is not enough that a taxpayer dispose of *some* of a passive activity in a FIT. For example, a natural disaster must result in the casualty loss of *all* property used in the passive activity if the disaster is the sole ground used to claim there was disposition of the entire passive activity.[95] Legislative history suggests that a taxpayer would have to dispose of *all* interests in entities engaged in the activity to qualify as a complete disposition.[96] However, if a taxpayer can show he or she has disposed of "substantially all" of an activity, and the taxpayer can allocate with reasonable certainty the deductions, credits, and income applicable to such activity, then the taxpayer can treat the partial disposition as the disposition of a separate activity.[97]

1. Installment Sales Can Qualify on Pro Rata Basis. If a passive activity is disposed of in a FTT that qualifies for installment sale treatment, then a portion of the suspended PAL in each tax year as payments are made.[98] The percentage of suspended PAL that is deductible in any given year is equal to the ratio of gain recognized in the given year to the gross profit from the disposition.

D. **Cannot Dispose of Interest to a Related Party**. Finally, the disposition of the passive activity will not qualify if the transferor and transferee are related parties.[99] For this purpose, related parties are defined by reference to the related party rules of Code §§ 267(b) and 707(b)(1). As a result, a transfer of a passive activity asset to close family members, their trusts, or entities which are majority owned by close family members would not qualify under Code § 469(g).

VIII. COD OR CAPITAL GAIN? NO TRANSFER OF COLLATERAL.

There are two basic forms of restructuring debt. The first form involves a reduction in the amount of an unsecured debt or a secured debt without a transfer of the asset securing the loan. Typically, the debtor will often provide additional collateral to secure the loan or provide a personal guarantee in exchange for a reduction in the amount of the debt. The debtor realizes cancellation of indebtedness income ("COD" income), in the amount of the debt reduction. COD income is ordinary income.[100] A variety of exceptions apply to the recognition of cod income, as discussed below.

A. **Transfer of Collateral**.

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[94] Herwig v. Commissioner, T.C. Memo 2014-95.
[95] IRS Notice 90-21, 1990-1 C.B. 332.
[96] S. Rept. No. 99-313 (P.L. 99-514) p. 725.
[97] Treas. Reg. 1.469-4(g).
[98] Code § 469(g)(3).
[99] Code § 469(g)(1)(B).
[100] Rev. Rul. 91-31, 1991-1 C.B. 19. Note that if the debtor satisfies the obligation by providing services, the debtor realizes compensation income, not COD income, even though there is no transfer of collateral or property in satisfaction of the loan. Treas. Reg. Section 1.61-12(a). In this case, the debtor merely satisfies his loan by providing services to the creditor, but there is no actual reduction in the amount of the debt.

1. Recourse Debt. In the second pattern, the debtor transfers property to the creditor in satisfaction of the loan. The transferred property is usually, but need not be, collateral for the loan. The tax consequences of this transactional pattern differ depending on whether the debt is recourse or nonrecourse. If the debt is recourse, the debtor is treated as selling the transferred property for an amount equal to the fair market value of the property. The excess of the debt over the fair market value of the property is COD income.[101] The exceptions to the recognition of COD income do not apply to gain realized under Code § 1001.[102]

2. Example. Debtor transfers to Creditor an asset with a fair market value of $6,000 and Creditor discharges $7,500 of indebtedness for which Debtor is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, Debtor has income from the discharge of indebtedness of $1,500 ($7,500 - $6,000).[103] Therefore, Debtor realizes $1,500 of ordinary income from the discharge of indebtedness (COD income).

3. Nonrecourse Debt. If the debt is nonrecourse, the debtor realizes gain or loss equal to the difference between the amount of the amount of the debt forgiven and the debtor's adjusted basis in the property.[104] The fair market value of the property is irrelevant.[105]

4. Partially Recourse Debt. If the debt is partially recourse and partially nonrecourse, the IRS has ruled that debt reduction is first allocated to the nonrecourse portion of the debt.[106] The IRS's rationale is that "a debtor should not be able to impair his creditor's rights by asserting that a settlement must first be applied against the recourse portion of a debt."

5. Recourse vs. Nonrecourse in the Partnership Context. Whether a debt is recourse or nonrecourse in the partnership context is likely determined under applicable state law.[107] The partnership tax rules under Code § 752 contain a set of rules for distinguishing recourse from nonrecourse debt. However, the purpose of these rules is determining how to allocate partnership debts among the partners. Under Code § 752, the terms "recourse" and "nonrecourse" have special meanings that diverge from local law and the likely economic consequences of a debt. In contrast, the determination of whether a debt is recourse or nonrecourse in the context of determining COD income or gain from sale turns on the type of income earned by the partnership (generally, a partnership level determination).

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[101] Treas. Reg. sec. 1.1001-2(c), *Example 8*.
[102] *See Danenberg v. Comm'r.*, 73 T.C. 370 (1979), *acq.*, 1980-2 C.B. 1.
[103] Treas. Reg. Section 1.1001-2(c), *Example 8*.
[104] Treas. Reg. Section 1.1001-2(c), *Example 7*.
[105] *See Commissioner v. Tufts*, 461 U.S. 300 (1983); Code § 7701(g) (in determining gain or loss with respect to any property, the fair market value of such property shall be treated as not being less than the amount of any nonrecourse indebtedness to which the property is subject.)
[106] PLR 8348001 (Aug. 18, 1983).
[107] *See* James B. Sowell, Partnership Workouts, 699 PLI/Tax 65 (2006) at II.D.

Summary Table

	Recourse	Nonrecourse
Transfer	Gain (FMV of property over Basis)	Gain (Debt over Basis)
	COD (Debt over FMV of property)	
No Transfer	COD income	COD Income

6. Transactional Strategy. The debtor faces a conundrum in applying the rules above. COD income is taxable as ordinary income, but may be excludable from income under a variety of exceptions discussed below. On the other hand, gain recognized pursuant to a debt reduction may be taxed as capital gain (if holding period requirements are satisfied), but is not excludable under the COD exceptions.

A taxpayer who seeks to have debt forgiveness characterized as COD income may seek to negotiate a write-down of the debt with the creditor before the creditor forecloses on it collateral. In *Gershkowitz v. Commissioner*[108], the Tax Court concluded that the settlement of a nonrecourse debt resulted in COD income. The collateral securing the debt was not surrendered as part of the discharge itself, but was transferred to a party closely related to the creditor approximately three months after the initial discharge.

In contrast, in *2925 Briarpark, Ltd. v. Commissioner*[109], the Fifth Circuit affirmed the Tax Court in holding that a partnership realized gain from the disposition of property, not only COD income, upon the discharge of nonrecourse loans. In *Briarpark*, a lender agreed to release its liens on a property securing a nonrecourse debt pursuant to an agreement whereby (1) the debtor partnership would sell the property to a third party, (2) the partnership would assign the net sales proceeds to the lender, and (3) the lender would then discharge the outstanding nonrecourse debt. The Tax Court held that the sale of the property followed by assignment of the sales proceeds was so closely intertwined with the debt discharge that it had the practical effect of a sale or exchange. The Fifth Circuit held that the Tax Court properly distinguished *Gershkowitz*, noting that in *Gershkowitz*, the discharged debts generating COD income were not discharged in connection with the disposition of the collateral. The Fifth Circuit approved the Tax Court's conclusion that the partnership's disposition of the property was conditioned upon the relief of its debt and was therefore the functional equivalent of a foreclosure sale.

IX. THE CAPITAL GAIN BAR – THE WORST BAR IN TOWN.

A. **Disallowance of Capital Gains On Sales Between Related Parties**. If an asset is sold or exchanged between related parties, and the property is subject to depreciation in the hands of the transferee, then any gain realized by the transferor is treated as ordinary income (the

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108 88 T.C. 984 (1987).
109 163 F.3d 313 (5th Cir. 1999), *aff'g per curiam*, T.C. Memo 1997-298.

"Capital Gain Bar Rule").[110] Understanding the Capital Gain Bar Rule can help prevent your clients from inadvertently triggering ordinary income when selling capital assets.

B. **Who is a Related Party?** For purposes of Code § 1239, a related party includes the following:

1. Controlled Entities as to the Taxpayer. If the Taxpayer owns more than 50% of an entity, such entity is a related party as to the Taxpayer.[111] Entities which are more than 50% controlled by the same persons are also treated as related parties to one another.[112]

2. Trust for Benefit of Taxpayer (or Taxpayer's Spouse). If the taxpayer (or the taxpayer's spouse) is the beneficiary of a trust, the trust is a related party as to that taxpayer.[113] There is an exception, however, if the taxpayer's beneficial interest is a "remote contingent interest", whereby the taxpayer's interest in the trust will not lead to such related party status.[114]

3. Decedent's Estate and its Beneficiaries. An estate and its beneficiaries are generally related parties to one another.[115] However, if a distribution from an estate in satisfaction of a pecuniary bequest is deemed to be a sale or exchange, then the estate and its beneficiaries are not considered related parties.[116]

4. Employers and Welfare Benefit Funds. An employer will be treated as a related party with respect to any welfare benefit fund (defined in Code § 419(e)) that is directly or indirectly controlled by the employer.[117]

5. Attribution Rules. In addition, a taxpayer will be treated as owning entity interests held by certain relatives similar to the attribution rules of Code § 267(b).[118] As a result, a taxpayer selling assets to an entity in which the taxpayer owns no interest whatsoever might still be considered a related party for Capital Gain Bar purposes. The following attribution rules apply:

a. interests owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be treated as being owned proportionately by or for its shareholders, partners, or beneficiaries;[119]

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[110] Code § 1239(a).
[111] Code §§ 1239(b)(1), (c)(1).
[112] Code § 1239(c)(1)(C) (citing §§ 267(b)(3), (10), (11) & (12)).
[113] Code § 1239(b)(2).
[114] Code § 318 (a)(3)(B)(i) (defining a "remote contingent interest" as a beneficial interest actuarially valued at 5% or less of the trust's total assets, assuming the maximum exercise of discretion by the trustee in favor of such beneficiary).
[115] Code § 1239(b)(3).
[116] Id. See also Treas. Reg. § 1.661(a)-2(f).
[117] Code § 1239(d).
[118] Code § 1239(c)(2) (not attributing the stock owned by a fellow partner of a partnership).
[119] Code § 267(c)(1).

b. interests owned, directly or indirectly, by a taxpayer's spouse, siblings, ancestors, and descendants shall be treated as being owned by the taxpayer;[120] and

c. if a taxpayer is deemed to constructively own an interest through application of the family attribution rules, that constructively owned interest cannot then be attributed to another family member.[121]

6. Example. Assume a taxpayer owns none of the outstanding stock of ABC Corporation. However, 51% of ABC Corporation is owned by a trust (T) created for the primary benefit of A's son, S. The 51% of ABC Corporation owned by T will be attributed to S. In turn, S's attributed 51% ownership of ABC Corporation will be attributed to the taxpayer. As a result, the taxpayer and ABC Corporation will be considered related parties for purposes of the Capital Gain Bar Rule, even though the taxpayer does not own any interest in ABC Corporation.

C. **What Counts as Depreciable Property?** Any property subject to depreciation allowances under Code § 167 is included within the ambit of the Capital Gain Bar Rule, even if the taxpayer fails to claim depreciation deductions.[122] However, Code § 1239 also treats patent applications (which are ordinarily subject to amortization) as depreciable property subject to the Rule.[123] Other items considered to be depreciable property for purposes of the Capital Gain Bar Rule include certain items subject to amortization, such as Code § 197 intangibles (including goodwill)[124] and leasehold interests[125]

D. **Possible Exception?** If gain is treated as ordinary income under the Capital Gain Bar Rule, can a taxpayer use the principal residence exclusion of Code § 121 to offset some or all of that income? While it is unclear, the IRS previously considered a similar issue in private letter rulings that discussed former Code § 1034.[126] Under former Code § 1034, a taxpayer would not recognize gain to the extent the taxpayer acquires a new principal residence within two years with a purchase price in excess of the sales price of the former residence. In private letter rulings, the IRS has previously stated that the language of Code § 1034 did not expressly prohibit sales between related parties.[127] The current version of Code § 121 similarly lacks any prohibition on sales between related parties. As a result, the logic of the IRS described in those private letter rulings should continue to apply, and a taxpayer should be able to offset some of the negative effects of the Capital Gain Bar Rule upon the sale of a principal residence.

X. SALE OF MINERAL INTERESTS—ROYALTY INCOME OR CAPITAL GAIN?

Determining whether the transfer of an interest in oil and gas is a sale or lease is important for U.S. income tax purposes. The income tax consequences of a sale are much different than the income tax consequences of a lease. The tax law does not consider how the

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[120] Code §§ 267(c)(2) & (4).
[121] Code § 267(c)(5).
[122] Code § 1239(a).
[123] Code § 1239(e).
[124] Treas. Reg. § 1.197-2(g)(8).
[125] Baker v. Commissioner, 38 T.C. 9 (1962).
[126] James R. Hamill and Craig G. White. *Choice of Entities for Real Estate Development*, 1 Business Entities 5 (Sept. 1999) (citing PLR 8350084 and PLR 9625035).
[127] PLR 8350084 and PLR 9625035.

transaction is characterized for state law purposes. Also, the law as to when there is a sale or lease of a mineral interest has occurred largely in the context as of mineral tax law without regard to the sale v. lease characterization in other contexts.

A. **Importance of Classification of Conveyances**. Each type of conveyance has different tax consequences to the parties involved. Mineral conveyances may be categorized as follows:

1. lease or sublease;

2. sale or exchange;

3. production payment; or

4. sharing arrangement.

Federal tax consequences are determined by reference to the interests of the parties involved and to the consideration for which such interests were transferred. Labels that the parties use are not controlling.

B. **Leases and Subleases of Oil and Gas Property—Non-Operating Interest Retained**. A transaction will be classified as a lease or a sublease in any case in which owner of an operating mineral interest assigns all or a portion of such rights and retains a continuing, non-operating interest in production. All payments received by the lessor under the lease are ordinary income and, except for delay rentals, are generally depletable.

1. Example. The owner of the working interest, assigns the working interest to B and retains an overriding royalty. This is a sublease. A may claim depletion on the royalty payments that he receives. A has not entered into a sale that generates gain.

2. Assignment Compared with Retention. A transaction is characterized by the type of interest assigned and type of interest retained. There is no lease or sublease if any type of interest other than the operating mineral interest is assigned.

If A had assigned an overriding royalty and retained a working interest, the transaction would not be a sublease because A did not assign the working interest or operating mineral interest. The transaction would be a sale. A would have gain for which he probably would be entitled to elect installment sale treatment depending on the particular facts of the situation.

3. Leases. Some of the conveyances that would be classified as a lease or a sublease are as follows:

Property Owned Before Conveyance	Property Retained	Property Conveyed
1. Minerals (8/8 of 8/8)	a. Royalty (1/8 of 8/8)	a. Working Interest (7/8 of 8/8)
	b. Net profits interest (40% of net profits from the interest conveyed)	b. Minerals (8/8 of 8/8) subject to net profits interest.
2. Lease (subject to landowner royalty)	a. Royalty	a. Working Interest
	b. Net Profit Interest	b. Working Interest

C. **Grantee of Non-Producing Properties**. The grantee of an oil and gas lease usually pays lessor or grantor a sum of money called a "lease bonus." A lease bonus is regarded as a prepaid royalty by the grantee. Like rent paid in advance for a period longer than a year, payment is not deductible when made but amortized over the life of the property through depletion. If property does not become productive and the lease lapses, expires or is released, lessee charges off his investment as an abandonment loss.

1. Example. A, the owner of minerals, grants a lease to B, retaining a 1/8th royalty, and B pays A \$10,000 for the lease. B, the grantee, capitalizes as leasehold cost the \$10,000 lease bonus paid to A. If the property becomes productive, B will recover such cost through depletion allowances. If the property does not become productive, B may claim a \$10,000 loss at the time of termination or expiration of the lease.

D. **Grantor of Non-Producing Properties**. A lease bonus is considered an advance royalty, and is ordinary income in the year of receipt. Grantor's basis in the mineral property prior to the assignment is carried over and becomes the basis of his retained royalty interest.

1. Example. D has acquired ownership in all minerals in tract of land for \$15,000. D grants an oil and gas lease, retaining a royalty, to E for a cash consideration of \$10,000. Cash received is a lease bonus. D realizes taxable income of \$10,000 upon granting of

lease. Such income is subject to depletion. Taxpayer is not, however, entitled to statutory depletion on lease bonuses.[128] For computation of cost depletion on lease bonuses, see Treas. Reg. §. 1.612-3(a)(1). Basis of the mineral interest is carried over to the retained royalty, but must be reduced by depletion claimed the on bonus.

E. **Grantee of Producing Properties**. If the property has been partially or fully developed before assignment, part of the cash consideration paid by grantee may be for equipment on the properties that are used to lift the production to the service and process it (i.e., pumps and separators).[129]

F. **Grantor of Producing Properties**. When a leasing or subleasing transaction occurs after production commences and grantor owns equipment on the property, part of the consideration received is applicable to equipment. The IRS contends that any cash must be applied first to recovery of depreciable basis, and excess cash received must be treated as lease bonus.[130]

G. **Sales or Exchanges**. Transaction will be treated as sale or exchange under any of the following circumstances, if consideration received is cash or its equivalent.[131]

1. Sale Transactions. A sale occurs when the owner of any kind of property interest assigns all of his interest or a fractional interest identical, except as to quantity, with fractional interest retained. Thus, if A owns working interest and assigns the entire working interest to B, he has made a sale or exchange because B has received all A's rights and B's interest is identical with that formerly held by A.

A also made sale or exchange if he assigns an undivided 1/4th interest to B, because B's retained interest is identical, except as to quantity, with that held by A.

A sale occurs when the owner of a working interest assigns any type of continuing, non-operating interest in property and retains working interest. This transaction embraces carving out of various interests from a working interest.

A sale occurs when the owner of any kind of continuing property interest assigns that interest and retains a non-continuing interest in production. For example, the assignor retains a production payment upon assignment of a continuing interest in property for cash or other property of unlike kind.

2. Tax Treatment of Grantor on a Sale. The grantor of a mineral property in a sale or taxable exchange realizes income or incurs loss to extent of difference between fair market value of consideration received and basis of property conveyed.

Such basis would include both depreciable and depletable costs.

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[128] Code § 613A(d).
[129] *Columbia Oil and Gas Company*, 41 BTA 38 (1940) *aff'd* 118 F.2d 459 (5th Cir. 1941).
[130] *See* Rev. Rul. 55-35, 1955-1 C.B. 286.
[131] *See* Russell, Income Taxation of Natural Resources, Section 3.03.

Income realized by the grantor in taxable sale or exchange may be ordinary income, capital gain or gain subject to the provisions of Code § 1231. Generally, mineral leases, developed or underdeveloped, are real property used in trade or business, and related buildings or equipment are depreciable property used in trade or business. If held for more than requisite holding period, all are Code § 1231 assets. Except to extent gain on sale of equipment is subject to recapture, taxpayer's net gain from the sale or exchange of equipment is generally treated as long-term capital gain. Pursuant to Code § 1254, a taxpayer also recaptures as ordinary income IDC previously deducted and depletion taken to the extent of the taxpayer's basis in the property. Taxpayer's loss is treated as ordinary loss under the usual rules of Code § 1231.

H. **Tax Treatment to Grantee**. In a taxable transaction, grantee will assign his costs to various properties acquired and if property other than cash is given up in exchange, grantee is grantor of such property and may realize income or incur loss. If the exchange is nontaxable, grantee prorates basis of the property or properties given up among various properties received.

1. Sale Treatment. Sale of a mineral estate ordinarily triggers recognition of gain. Part of the gain may constitute recapture under Code §§ 1245 and 1254. The balance is entitled to capital gain treatment in most situations. The taxpayer's basis in the property reduces the gain that is subject to tax.

2. Lease Treatment. A lease will result in ordinary income to the lessor. The taxpayer's basis in the property does not reduce the gains subject to tax. Instead, the taxpayer's basis in the property becomes the taxpayer's basis in the retained. The taxpayer may claim cost depletion as to the retained interest if there is production.

3. Example of Sale v. Lease Treatment. X acquires a mineral lease for $100,000. X transfers the lease for $200,000.

If the transfer is a sale, X will recognize $100,000 of gain. If X has held the lease for at least 12 months, the gain is long-term capital gain. The tax is $15,000.

If the transfer is a lease, X will have $200,000 of ordinary income. If X is taxed at a 35%, the tax would be $70,000. X will have a $100,000 basis in the retained interest. X may claim depletion as to this royalty interest if there is production.

4. Working Definition of a Lease. A lease exists when the owner of an operating mineral interest transfers that interest or a fractional part thereof but retains a continuing interest in the severed portion. The definition of a lease is largely derived from court cases. It has developed over time in the context of mineral taxation. The courts have taken the position that federal tax law governs what is a lease v. sale for federal income tax purposes. State law characterization of the transaction is irrelevant.[132] A good discussion of what the Tax Court sees as a lease compared to a sale is in *Richard Wayne Crooks*[133]. As a general rule, the courts have taken a very board view of whit is a lease.

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[132] *Burnet v. Harmel*, 287 U.S. 103 (1932).

[133] 92 TC 816 (1989).

5. Note: Many parties consider employing transactions involving contingent purchase prices that are sometimes used in other industries. The taxpayer must be careful to consider how the sale/lease rules discussed here would apply to those transactions.

6. Examples of Leases and Sales. Below are some examples of typical lease and sale transactions.

a. X is a landowner. X signs a lease with Y and receives a bonus payment of $100,000. The lease grants the landowner a royalty from future production. This is a lease transaction for income tax purposes. X has $100,000 of ordinary income on receipt of the lease bonus.[134]

b. Y transfers the lease acquired from X to Z for $200,000, plus a 5% overriding royalty interest. This is a sublease. Y has $200,000 of ordinary income.[135] Y has a $100,000 basis in the overriding royalty interest.

c. Y transfers the operating interest and retains a net profits interest. This transaction is a lease. Same results as 2 above. The net profits interest is treated as a continuing economic interest in the mineral just like a royalty.[136]

d. Y transfers 50% of the lease that it acquired from X. Y does not retain a continuing interest in the severed portion. Transaction is a sale.[137]

e. Y transfers the lease that it acquired from X for a recourse promissory note from Z. Z has other assets. Transaction is a sale.

f. Y transfers the lease that it acquired from X for a recourse promissory note from Z. Z. has no other assets. Transaction is in the form of a sale. Is the substance a sale?

g. Y acquires a lease from X. Y is a C corporation. Y assigns a 5% overriding royalty interest to its sole shareholder. One year later, Y assigns all of its owning interest to Z. Is this a sale? There is not a related party that will cause Y to be treated as owning the interests owned by its shareholders. Transaction is apparently a sale.

h. Y acquires a lease from X. Y is a C corporation. Y assigns a 5% overriding royalty interest to its sole shareholder and assigns the working interest simultaneously. Is this a sale?

i. Y acquires a lease from X. Y assigns the lease and receives a production payment that burdens the working interest. The production payment ends when 90% of the minerals are produced. A production payment is not a continuing economic interest in the mineral. However, a production payment for tax purposes is an interest that is reasonably certain to end substantially prior to the end of the underlying mineral interest. If the transferred interest

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[134] See *Richard Wayne Crooks*, 92 TC 816 (1989).
[135] *F.T. Hogan,* 141 F.2d 92 (5th Cir-1944); *H.R. Cullen,* 118 F.2d 92 (5th Cir-1941); Rev. Rul 69-352.
[136] PLR 20953011.
[137] *US v. White*, 311 F.2d 399 (10th Cir., 1962).

is not a producing property, it is not reasonably certain that the property will produce and the production payment will end prior to the underlying mineral interest. The retained interest is probably a royalty. If the property is producing, it is not clear how much shorter than the burdened property the production payment should be.

j. Y acquires a lease interest from X. Y contributes the lease to a partnership for a partnership interest. Z, the other partner, contributes $500,000 to the partnership. The partnership distributes $500,000 to Y. Under the terms of the partnership agreement, Y is entitled to an amount equal to 5% of the gross income from the lease. Y is not required to make additional capital contributions. Z makes additional capital contributions that are used to fund drilling and completion of a well on the property. Although the form of this transaction is a sale, the IRS might assert that this transaction is actually a lease. Would the answer be different if Y has a 5% partner interest?

k. X, the landowner, sells one-half of the mineral estate to Y for $100,000 and enters into a lease of the other one-half of the mineral estate. The purchaser and the lessee are the same party. Is this a sale as to the one-half mineral interest transferred to Y for $100,000? In *West v. Comm'r*[138], the Fifth Circuit Court of Appeals said this transaction was a lease.

XI. DÉJÀ VU ALL OVER AGAIN: SALE OF INTELLECTUAL PROPERTY—ROYALTY INCOME OR CAPITAL GAIN?

To qualify for capital gains tax rates, a sale of intellectual property (e.g., patents, copyrights, or trademarks) must qualify as the sale of the capital asset under Code § 1221 and Code § 1231, and to qualify for capital gains treatment, the taxpayer must transfer all the rights the taxpayer has in the intellectual property.[139] In this regard, the discussion above concerning the disposition of a complete versus partial interest of a mineral interest is similarly applicable to a deposition of complete versus a partial interest in intellectual property. With the exception of a transfer of an undivided interest in all substantial rights to a patent (as noted below), the transfer of less than the entire interest in the intellectual property will be taxed as ordinary income. The normal one year holding period applies for most interests in intellectual property (other than patents) and this period will begin when that interest is reduced to practice.[140]

While the analysis of whether the transfer of an interest intellectual property qualifies for capital gains treatment will be similar as provided in Section X, it is important to note that Code § 1235 provides the following special treatment for the transfer of all substantial rights to patents[141] or rights which are eligible to be patented[142] intellectual property by creators or financial backers to persons who are not related to those creators or financial backers:

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[138] 150 F.2d 723 (5th Cir., 1945)
[139] *MacDonald v Comm'r*., 55 T.C. 840 (1971); Rev. Rul. 78-328.
[140] *Lamar v. Granger*, 99 F.Supp. 17, 42 (DC Penn 1951); *CTS Corporation v. Piher International*, 593 F. 2d 777 (7th Cir. 1979).
[141] Treas. Reg. § 1.1235-2(a).
[142] S. Rept No. 83-1622 (PL 83-591), p. 440; Treas. Reg. § 1.1235-2(a); *Channing Gilson*, TC Memo 1984-447; *Edward Myers*, 6 TC 258 (1946).

- The one-year holding period for capital assets does not apply to the sale of a patent by an individual (but not an entity) who created the patent.[143]

- A transfer of undivided interest in all substantial rights is also eligible.

- Sales of patents to foreign corporations are taxed at ordinary income rates.[144]

- Persons are deemed related to a taxpayer if they are described in Code §§ 267(b) or 707(b), except that, in applying Code §§ 267(b), 267(c) or 707(b),

    - o "25% or more" is substituted in lieu of "more than 50%" appears in Code §§ 267(b) or 707(b); and

    - o Code § 267(c)(4) is to be treated as providing that the family of an individual only includes that individual's spouse, ancestors and lineal descendants.

XII. CODE § 751 "HOT ASSETS".

Upon the sale of a partnership interest, the selling partner generally recognizes capital gain income. Whether the capital gain is long-term or short-term capital gain depends on the partner's holding period in his partnership interest. However, the tax rate applicable to long-term capital gain is determined on a look through basis. As such, depending on the partnership's assets, the selling taxpayer's long-term capital gain will be taxed at 15, 20, 25 (applicable to unrecaptured section 1250 gain) or 28 (applicable to net collectibles gain) percent, not counting the 3.8% net investment income tax. Code § 1(h). The selling partner will recognize ordinary income on the sale of a partnership interest, under Code §§ 741 and 751, to the extent that the partnership possesses two types of property – (1) unrealized receivables or (2) inventory items allocable to the selling partner. The pro rata distribution of hot assets should not trigger code § 751 gain. Code § 751(b)(2) also provides exceptions to the general rule in the case of property distributed to the same partner that contributed such property and payments under Code § 736(a) (considered as distributive share or guaranteed payment) to a retiring partner or successor in interest of a deceased partner.

A. Definition of Code § 751 Property - Unrealized Receivables and Inventory Items. Unrealized receivables are defined under Code § 751(c). The term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for (1) goods delivered or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered or to be rendered. They include amounts earned by a cash basis taxpayer but not yet received or reported as income, as well as recapture income pursuant to Code §§ 1245, 1250 and 1254, trademarks, tradenames, stock in DISCs and CFC's, and market discounts in bonds.

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[143] Code §1235.
[144] Code §1249.

B. Inventory Items. The term "inventory items" means (1) property of the partnership of the kind described in Code § 1221(a)(1), (2) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in Code § 1231, and (3) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in paragraph (1) or (2).[145] In general, distribution of inventory is distinguishable from inventory items in a sale or exchange of a partnership interest. A distribution of inventory requires that the inventory "have appreciated substantially in value" in order for it to be a hot asset. In general, substantial appreciation means that the fair market value of the inventory exceeds 120% of the adjusted basis to the partnership of the inventory.

C. Computation. Treas. Reg. 1.751-1(a)(2) provides for the following calculation of Code § 751(a) gain:

1. Determine the total gain or loss realized by the selling partner from the sale of the interest (i.e. the difference between the total amount realized and the partner's basis in the partnership interest);

2. Calculate the gain or loss from Code § 751(a) property which would be allocated to the partner if the partnership sold all of its assets for their fair market value immediately prior to the sale of the selling partner's interest. That amount of gain or loss is characterized as ordinary income by Code § 751(a);

3. Subtract the amount characterized as ordinary income under Code § 751(a) from the selling partner's total gain. This is the amount of capital gain or loss under Code § 741.

Example. Assume the balance sheet of the ABC Partnership at the date of the partnership is as follows:

Assets	**Adjusted Basis**	**Fair Market Value**
Cash	$30,000	$ 30,000
Inventory	30,000	39,000
Land	39,000	45,000
Total	$99,000	$114,000

Assume that there are no recapture assets. The fair market value of the inventory ($39,000) is more than its adjusted basis ($30,000). To determine the character of the gain on the sale of the partnership interests, the selling partner must allocate the selling price between the

[145] Code § 751(d).

inventory item and the balance of the partnership assets. If a one-third partnership interest is sold for $38,000, $13,000 of the sale proceeds is allocated to inventory. The gain attributable to the partner's interest in the inventory is $3,000 and ordinary income. The remaining $2,000 of gain is capital gain.

XIII. QUALIFIED SMALL BUSINESS CORPORATION (CODE § 1202).

A qualified small business corporation ("QSB") is a subset of C corporations. Under Code § 1202, a non-corporate investor may exclude some or all of the gain which they realize on the disposition of QSB stock held for more than 5 years. The exclusion is only available to taxpayers who own eligible stock in a QSB which actively conducts a qualified trade or business and that meets a maximum gross assets test (both discussed below). In addition, there is a per-issuer limitation (discussed below).

A. **Portion of Gain Excludible**. For all QSB stock acquired after September 27, 2010, non-corporate taxpayers can exclude 100% of any gain realized on the sale or exchange of QSB stock held for more than five years. This 100% exclusion was to expire after 2014, but the 2015 Path Act permanently extended the 100% exclusion for QSB stock acquired after September 27, 2010. For QSB stock acquired by a non-corporate taxpayer after February 17, 2009 and on or before September 27, 2010, the exclusion is 75%. For QSB stock acquired by a non-corporate taxpayer before February 18, 2009, and held for more than five years, the exclusion is 50% of the realized gain (60% for QSB stock invested in certain corporations doing business in a few designated areas referred to as empowerment zones).[146] No election is required for the exclusion to apply. Any gain not excluded is taxable at 28%.[147]

B. **QSB Corporation Requirements**. For gain on its stock to qualify for the exclusion, a corporation must be a domestic C corporation other than: (i) a DISC or former DISC, (ii) a regulated investment company, (iii) a real estate investment trust, (iv) a real estate mortgage investment conduit, (v) a cooperative, or (vi) a corporation electing Puerto Rico and Possessions tax credit or having a direct or indirect subsidiary so electing.[148]

C. **Qualified Trade or Business**. Under Code §1202(e)(3), qualified trades or businesses are those other than:

1. Trades or businesses performing services in the fields of accounting, actuarial science, architecture, athletics, brokerage services, consulting, engineering, financial services, health, law, the performing arts, or any trades or businesses whose principal asset is the reputation or skill of one (1) or more of its employees;

2. Banking, financing, insurance, investing, leasing, or similar businesses;

3. Farming (including raising or harvesting trees);

4. Trades or businesses extracting or producing natural resources eligible for percentage depletion; or

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[146] Code §1202(a)
[147] Code §1(h).
[148] Code §1202(e)(4).

5. Trades or businesses operating hotels, motels, restaurants, or similar businesses.

D. **Eligible Stock**. Eligible stock is stock originally issued after August 10, 1993, for money, property other than stock, or as compensation for services other than underwriting.[149] A taxpayer's stock is not eligible stock if the issuing corporation buys any of its own stock from the taxpayer, or persons related to the taxpayer within the four (4) years beginning two (2) years after the issue date.[150] "Related persons" are those persons related under the general rules disallowing the deduction of losses, expenses, and interest between persons related under Code §267(b) and those related under the Controlled Partnership rules of Code §707(b).[151]

E. **Active Business Test**. For substantially all of the taxpayer's holding period, the corporation must use at least eighty percent (80%) by value of its assets in the active conduct of one (1) or more qualified trades or businesses.[152] This includes assets used in furtherance of a perspective active business, i.e., in Code §195(c)(1)(A) start-up activities, Code §1202(c)(3)(B), Code §174 research and experimentation, and Code §41(b)(4) in-house research.[153] It also includes working capital, investments expected to finance research and experimentation or increase working capital within two (2) years, and computer software rights that produce active business royalties under Code §543(d)(1).[154] After the corporation has existed for two (2) years, no more than half of the corporate assets may be (i) working capital or (ii) investments held for future research or working capital.[155] Portfolio Securities, other than securities in a subsidiary corporation, cause the corporation to fail the active business test for any period during which they constitute more than ten percent (10%) of the corporate net worth.[156] Note that the active business requirement is waived for specialized small business investment companies licensed by the Small Business Administration under Code §301(d). In applying the active business test, a look through test is used for issuers owning subsidiaries.[157]

F. **Gross Assets Test**. Both before and immediately after the issue date, a QSB corporation's aggregate gross assets cannot exceed $50,000,000.[158] In addition, the gross assets of the corporation or any predecessor cannot have exceeded $50,000,000 at any time on or after August 10, 1993.[159] For the purposes of this computation, gross assets are cash plus the aggregate adjusted basis of all other corporate property. The basis of contributed property is determined as if the basis were equal to the property's fair market value immediately after the contribution.[160] Subsequently exceeding the $50,000,000 limit does not disqualify otherwise qualifying stock, but the corporation can never again issue qualified stock. In applying the gross

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[149] Code §1202(c)(1)(B).
[150] Code §1202(c)(3)(A).
[151] *Id*.
[152] Code §1202(e).
[153] Code §1202(e)(2).
[154] Code §1202(e)(8).
[155] Code §1202(e)(6).
[156] Code §1202(e)(5)(B).
[157] Code §1202(e)(5)(A).
[158] Code §1202(d)(1).
[159] *Id*.

[160] Code §1202(d)(2)(B).

assets test, all members of the parent-subsidiary controlled group are treated as one (1) taxpayer. A parent-subsidiary controlled group is one defined by Code §1563(a)(1), using a more-than-fifty-percent ownership criteria on, and excluding Code §1563(A)(4) insurance companies.[161]

G. **Per-Issuer Limitation**. Under Code §1202(b)(1), eligible gain from any one (1) issuer in any given tax year is taken into account only to the extent that it does not exceed the greater of:

1. $10,000,000 reduced by the aggregate amount of eligible gain taken into account by the taxpayer in prior years and attributable to dispositions of stock issued by the corporation; or

2. Ten (10) times the aggregate adjusted basis of all qualified stock of the issuer that the taxpayer disposed of during the tax year. The conference committee report states that for purposes of the ten (10) times-basis limitation, the basis of property contributed to the issuing corporation is its fair market value as of the contribution date.

H. **Pass-Through Entities**. Gain on qualified stock held by a partnership, S corporation, regulated investment company, or common trust fund, is excludable if the entity held the stock for more than five (5) years and if the partner, shareholder, or participant to whom the gain passes through held an interest in the entity when the entity acquired the stock and at all times thereafter.[162] However, gain cannot be excluded to the extent that the individual's share in the entity's gain is greater than what it was when the entity acquired the qualified stock.[163]

XIV. LOSSES.

A. **Abandonment Gives Rise to Ordinary Loss**. In *Pilgrim's Pride v. C.I.R.*[164], the Court of Appeals for the Fifth Circuit, reversed the Tax Court and ruled that an abandonment of stock gives rise to an ordinary loss under Code § 165 rather than a capital loss from the sale or exchange of a capital asset under Code § 1234A. Although this particular case involved abandoned stock in a corporation, this principle can also apply to abandoned partnership interests. See *B. Philip Citron*.[165]

In this *Pilgrim's Pride* case, the taxpayer (in 1999) bought stock in a corporation for $98.6 million. After performing poorly, the corporation offered to purchase the stock back from the taxpayer for $20 million. However, the taxpayer's board of directors decided to abandon the securities for no consideration because a $98.6 million ordinary loss would produce tax savings greater than the $20 million offered by the corporation. The taxpayer subsequently surrendered the securities back to the corporation and took a $98.6 million ordinary abandonment loss deduction on its tax return, which the IRS disputed.

The taxpayer relied on the sale or exchange rule, which requires that for a capital asset to produce a capital gain or loss, it must be disposed of in a sale or exchange. Historically, the

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161 Code §1202(d)(3)(B).
162 Code § 1202(g).
163 Code § 1202(g)(3).
164 141 T.C. No. 17 (12/11/2013).
165 97 TC 200 (1991).

courts and IRS have held previously that when a capital asset is abandoned, it is neither sold nor exchanged and should therefore be treated as an ordinary loss under Code § 165.[166] However, in finding for the IRS, the Tax Court relied on Code § 1234A and ruled that such abandonment was a deemed sale or exchange. Code § 1234A reads as follows:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—
>
> (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
>
> (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,
>
> shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).

In overruling the Tax Court, the Fifth Circuit Court of Appeals concluded that Code § 1234A(1), applies to the termination of rights or obligations *with respect to* capital assets (e.g., the termination of contractual or derivative rights), and not to the abandonment of capital assets themselves.

XV. DEPRECIATION.

A. **Overview**. If a tangible asset is depreciable, the taxpayer is entitled to a series of annual deductions up to an amount not in excess of the asset's basis. Depreciation is typically calculated pursuant to a formula which provides for a theoretical annual percentage decrease in the asset's basis over a given recovery period. Typically, recovery periods will be set at a number of years roughly equivalent to the asset's useful life. An asset is "depreciable" only if: (1) the nature of the property is such that it should decline in value over time, and (2) it is used in a business or held for investment. Land, inventory, and personal residences are not depreciable. The nature of the asset determines the length of its recovery period. For administrative ease and other reasons, the applicable tax law (generally known as "MACRS") categorizes property into different groups or classes, with each class having a different recovery period.

B. **MACRS Property Classification**. All property is assigned to a class with a recovery period that (in theory) most closely resembles the property's anticipated useful life. For example, cars are assigned to the class of property having a five (5) year recovery period and must be depreciated over five (5) years (i.e., "five-year property").

C. **2016 Changes to Depreciation and Expensing Rules**. Code § 179 may provide significant benefits for the year in which property is placed in service. Under Code § 179, certain taxpayers may elect to treat all or some of the cost of certain qualified property as a

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[166] *B. Philip Citron*, 97 TC 200 (1991); *Audrey L. Zeeman v. U.S.*, 21 AFTR 2d 679, 275 F Supp 235 (1967, DC NY); *In re James Kreidle*, 71A AFTR 2d 93-4408 (1991, Bktcy Ct CO), affd on other issue 143 BR 941 (1992, DC CO); Rev Rul 70-355, 1970-2 CB 51 clarified and superseded by Rev. Rul. 93-80, 1993-2 CB 239.

deductible expense. "Qualifying property" for these purposes is property purchased for use in the active conduct of a trade or business that is (1) depreciable tangible property; (2) computer software; and (3) Code § 1245 property, as well as certain "qualified real property." The dollar limit for this expensing rule is $500,000, and is reduced dollar-for-dollar for each dollar of equipment bought in such year that exceeds another limit (to be inflation adjusted): $2,010,000 in 2016. Bonus depreciation was extended through 2019, allowing businesses to depreciate 50% of the cost of equipment acquired and put in service during 2015, 2016 and 2017, 40% in 2018, and 30% in 2019.

D. **Code § 1250's 25% Rate on "Unrecaptured" Depreciation**. Straight line depreciation is the only method of depreciation allowed for Code § 1250 Property (i.e., real property) under MACRS. Thus, if MACRS is used for real property, a 25% tax rate will apply to the extent the capital gain recognized does not exceed to cumulative amount of straight line depreciation previously deducted; all other capital gain will be taxed at customary long term capital gain rates. If the non-corporate taxpayer computes depreciation for realty other than under MACRS (e.g., depreciable realty placed in services before 1987), then upon the sale of "Code § 1250 Property", a 25% tax rate will apply to the extent of gain recognized does not exceed to cumulative amount of straight line depreciation previously deducted and depreciation deductions taken in excess of straight-line depreciation will be taxed at the maximum rate (for non-corporate taxpayers) applicable to that taxpayer for ordinary income (i.e., up to 39.6%).[167] "Code § 1250 property" is all real property that is subject to an allowance for depreciation and that is not and never has been "Code § 1245 property".[168] This includes buildings, permanent improvements and structural components that are permanently fixed to the real property as well as leasehold interests subject to an allowance for depreciation. A fee simple interest in real property does not qualify as Code § 1250 property because it is not depreciable. Note that property originally classified as Code § 1250 property may be re-characterized as Code § 1245 property and be treated as if it had always been Code § 1245 property. If and when the converted Code § 1250 property is later sold, all of the taxpayer's depreciation recapture tax liability will be calculated under Code § 1245, including the period of in which the property was characterized as Code § 1250 Property. See the discussion below regarding cost segregation studies and the allocation of property as Code § 1245 Property or Code § 1250 Property.

E. **Should We Be Doing That Cost Segregation Study?.** When it comes to deductions, sooner is usually better than later. Therefore, the shorter the recovery period, the greater the present value of the deductions. The significance of planning to maximize depreciation deductions should not be overlooked. Careful planning of depreciation deductions (in particular for real estate) generally involves three (3) techniques to boost depreciation deductions:

1. Cost Segregation Study. A cost segregation study can be performed to reclassify portions of the building as (i) personal property (or Code § 1245 property), or (ii) land improvements (or Code § 1250 property), both of which are eligible for more rapid depreciation. Personal property deductions under MACRS are fully taken after 5-years and 7-years (depending on the property) and land improvements deductions are fully taken after 15 years. By conducting a cost segregation study and segregating tangible personal property, depreciation deductions are

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[167] Code § 1250(c).
[168] *Id.*

not increased but the taxpayer will benefit from shorter recovery periods and possibly increased first year expensing benefits under Code § 179. For example, if personal property in a building can be identified and segregated from the building, it can be separately depreciated over 7 years rather than 27.5 or 39 years.

2. Determining Structural Components. Reg. § 1.48-1 is helpful in determining which components are structural and thus not eligible for personal property classification. The regulation refers to property that "relates to the operation or maintenance of a building" and may include walls, floors, and ceilings, and permanent covers such as windows and doors, as well as central air conditioning, electrical wiring, plumbing and fixtures, and sprinkler systems. Other guidelines that help to identify tangible personal property include answering questions such as whether the property can be moved, how difficult it would be to remove it, whether it is designed to remain permanently in place, and whether there are circumstances that tend to show the intended length of affixation.

3. Practices. While the idea behind cost segregation is simple, the practice can be difficult because the taxpayer must (i) identify eligible personal property, (ii) analyze cost data and (iii) prepare cost breakdowns. The best time to perform a cost segregation study is when the building is purchased, constructed or renovated. A cost segregation study should not be based on "non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records."[169]

F. **Allocating Basis Between Land and Building**. Applicable tax law sets no specific guidelines for allocating costs between land and improvements. Therefore, taxpayers are left to rely on the past court decisions in deciding how acquisition costs should be allocated between land and improvements. Approved allocation methods include:

1. Contract Allocation Method. A purchase contract may contain an allocation of the purchase price between the land and the building. The IRS and the courts will not accept this type of allocation unless it has an economic effect on both parties and results from legitimate negotiations between parties who have interests which are adverse to one another.

2. Appraisal Method. An appraisal of the property by a professional appraiser will carry some weight with the IRS and the courts. However, none of the traditional appraisal methods (i.e., market, cost, and income approaches) directly allocate costs between land and buildings. Consequently, the traditional appraisal solution uses either the building residual method or the land residual method.

3. Building Residual Method. Under the building residual method, the land value (as unimproved) is estimated from sales of comparable parcels. The resulting land value is then subtracted from the total value of the entire property to arrive at the building value.

4. Land Residual Method. Alternatively, this method is often used when the building represents a proper (highest and best) use of the site and the building value can be

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[169] See CCA 199921045.

reliably estimated. In some cases, the replacement cost of building improvements has been subtracted from the total value of the real estate to arrive at the residual value of the land.

5. Property Tax Assessments Method. In some cases, courts have determined that land and building allocations may be based on local real estate tax assessments. However, for this method to be successfully accepted, there must be some evidence that the valuation is a realistic one.

G. **Non-Depreciated Land and Depreciable Land Improvements**. After establishing a favorable land-to-building cost allocation and working through a cost segregation analysis for personal property, planning can still be directed to the physical aspects of property to identify the "land improvements" noted above, in order to maximize depreciation deductions. Land improvements, such as sidewalks, parking lots, roads, landscaping, and fences, can generally be depreciated at more than twice the rate of a non-residential building (i.e., 15 years vs. 39 years), are not included in the definition of 27.5-year residential property, 31.5-year property or 39-year property and appear to qualify for the 150% declining balance method over a 15-year period.[170]

1. Example. Jane purchases for $280,000 a small commercial office building for her production company. Closing costs total $12,000 and general improvements to the building (e.g., new paint, carpet, new appliances, elephant light fixtures, etc.) cost an additional $25,000. Jane finances approximately $235,000 of the cost to acquire the building with a local bank at a 9.5% interest rate (she's a credit risk) and a repayment schedule amortized over 15 years, subject to a five (5) year balloon. Jane's loan payments are $2,454 per month (exclusive of real estate taxes and insurance), which are comprised (on an average monthly basis) of approximately $1,698 as a deductible interest expense and $756 as a reduction of principal. Also, assume Jane allocates 30% of the building's acquisition cost to the land on which the building is situated. Jane's annual depreciation expense over the term of the loan will be $5,333.33, i.e., 1/39th of $208,000 ([$280,000 x 70%] + 12,000). This means his monthly depreciation expense will only be $444 ($5,333.33/12). This is in sharp contrast to Jane's average monthly principal reduction of $756. While principal reduction on real estate purchase money loans is not deductible, Jane gets a depreciation deduction for a portion of what the principal purchased, i.e., the building improvements. Therefore, for every dollar of rent Jane collects that is used to reduce the principal of the loan, she only has 58.74 cents of depreciation deduction, with the balance (i.e., 41.36 cents per $1.00 of rent paid against principal) being "phantom" income (i.e., taxable income without current cash for the payment of the tax attributable to that income). Over the course of each full year of the loan, this means there will be an average of $2,200 of phantom income per year (i.e., [.4136 x $444] x 12 = $2,200). This phantom income may be temporarily avoided somewhat by carefully planning for increased annual depreciation deductions.

H. **Basis Allocation Among Contiguous Tracts**. If a taxpayer acquires more than one (1) piece of property or parcel (or one tract which will be sold off in parcels) at the same time, the purchase price must be allocated among the properties or parcels to determine the basis of each. The applicable income tax regulations provide that this is a fact question, which must

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[170] *See* Rev. Proc. 87-56, 1987-2 C.B. 674.

be done in a fair and equitable manner, usually based on the relative fair market value of each property or parcel at the time of purchase. The purchaser may determine allocations based on bona fide offers received from willing buyers, appraisals made by a qualified appraiser, or sometimes assessed values imposed by the county assessor (if reasonable). Amounts set forth in a purchase agreement are acceptable as proof of a proper allocation if the allocation is the result of arm's length bargaining and has a substantial effect on both parties. If the allocation is made solely for the benefit of one party, however, or if it gives rise to an artificial value or unreasonable tax result to one party, it will likely be disregarded. In most cases, however, an allocation set forth in a purchase agreement will be respected where the parties have opposing interests (i.e., one party is adversely affected by the allocation which is beneficial to the other party).

1. Practice Tip. Careful basis allocation can be helpful in situations where a developer incurs debt to purchase several parcels together or a large tract which will be subdivided and sold in several parcels, or where a real estate investor simply wants to defer paying income tax. In situations involving purchase money debt, it is common for the lending bank or other financial institution to require all proceeds from the first sale(s) of real estate to be used to pay-down the debt owed to it. In these situations, the taxpayer can find himself having to pay income taxes on "phantom" income (i.e., taxable income without current cash for the payment of tax on that income) since the lender has taken all of the sales proceeds in repayment of the purchase money debt.

2. Example. John purchases a large tract of real estate ("Blackacre") for \$1,000,000. John pays 20% in cash and finances the rest of the purchase price with a bank loan. The bank takes a first lien against Blackacre under a deed of trust. John plans to sell roughly 1/4 of Blackacre on December 31 for \$550,000 (the "First Parcel"). The deed of trust contains partial release provisions which permit John to sell the First Parcel, provided the bank receives all of the \$550,000 sale proceeds. If John allocates 1/4 of his \$1,000,000 basis or \$250,000 to the First Parcel, he will have "phantom income" of \$300,000 (i.e., \$550,000 amount realized less \$250,000 basis). If John is in an effective 40% income tax bracket, the \$300,000 of "phantom income" will result in \$120,000 of tax currently due. The bank refuses to allow John to grant a second lien on Blackacre to borrow the funds necessary to complete the payment of his tax on the \$300,000 "phantom income." Therefore, unless he has other funds, John has a \$120,000 tax deficiency, subject to interest and non-payment penalties. One solution to the phantom income tax problem is to negotiate with the lender to allow John to retain enough sales proceeds to pay the taxes attributable to the sale of the First Parcel. Another possible solution is adjusting the manner in which the \$1,000,000 basis is allocated. For instance, because the First Parcel is the most valuable part of Blackacre, John may be able to justify a disproportionately higher basis allocation to the First Parcel. If John allocates \$500,000 of basis to the First Parcel, his "phantom income" is reduced to \$50,000 (i.e., \$550,000 amount realized less \$500,000 basis). At an effective income tax rate of 40%, John's current tax bill is only \$20,000.

XVI. DEALER STATUS.

The federal income tax consequences of a real estate activity differ greatly depending on whether the owner primarily holds the real estate (i) for sale to customers in the ordinary course of a trade or business or (ii) for productive use in a trade or business or as an investment. Real estate held primarily for sale to customers in the ordinary course of a trade or business as "dealer property," while the term "investor property" is often used to describe real estate held for productive use in a trade or business or as an investment. The distinction between investor property versus dealer property is significant since "dealer" property is not eligible for (i) long term capital gain treatment, (ii) depreciation, (iii) like-kind exchange treatment under Code § 1031, or (iv) installment sale treatment under Code § 453. in addition, gain from dealer realty may be subject to (i) self-employment tax under Code § 1401, (ii) in the case of tax-exempt organizations or qualified plans, unrelated business income tax under Code § 511, or (iii) in the case of real estate investment trusts, the 100% prohibited transactions tax under Code § 857(b)(6).

A. **Benefits of Investor Status**. For long term capital gain treatment, Code § 1221(a) defines a "capital" asset as property held by the taxpayer (whether or not connected with the taxpayer's trade or business), but specifically excludes *". . . property held by the taxpayer primarily for sale to customers in the ordinary course of his or her trade or business"*. Similarly, Code § 1231(a)(3)(A) says "section 1231 gain" includes any recognized gain on the sale or exchange of *property used in the trade or business,* and Code §1231(b)(1), in defining "property used in the trade or business," excludes *property of a kind which would properly be included in inventory of the taxpayer* . . ." The key definitional language is "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" or "property . . . properly . . . included in inventory."

1. Dealer versus Investor. Whether a taxpayer intends to hold a property for resale, or to hold for investment, is the critical issue. This analysis is commonly known as the "dealer versus investor test", and requires numerous factual determinations, none of which are controlling. The continued differential between the tax rates for long-term capital gains and all other kinds of income brings heightened significance to a real estate owner's status as a "dealer." Dealer status (resulting in ordinary income) and investor status (resulting in capital gains treatment) is determined on a taxpayer by taxpayer basis. For example, authority exists which says that dealer status is determined at the partnership level as opposed to the partner level. However, because limited partnerships are each separate taxpayers for this purpose, the dealer status (if any) of one partnership should not affect the non-dealer status of another limited partnership.

2. Taxpayer Intent Determinative. A taxpayer's intent in holding a property is a question of fact, and it is the taxpayer's intent at the time of sale which is determinative.[171]

a. *Initial Intent Highly Suggestive of Intent Upon Sale*. Often, the taxpayer's initial intent suggests the intent at the time of sale.[172]

b. *But Intent Can Change Prior to Sale*. However, taxpayers have frequently demonstrated a changed intent, from being a "dealer" to begin an "investor" at the time of sale. As a general rule, taxpayers tend to be more successful in proving a change in intent where they can demonstrate the change took place for a suitable period prior to the sale

[171] *Cottle v. Commissioner*, 89 T.C. 467, 487 (1987); *Austin v. Commissioner,* 263 F.2d 460, 461 (1959).
[172] *Neal T. Baker Enters. v. Commissioner*, 76 T.C.M. 301 (1998).

rather than on the eve of sale.[173] Further, the Fifth Circuit has stated that, where unanticipated, externally induced factors or events occur, changed intent will be more convincing.[174]

c. *Proving Changed Intent*. In *Allen v. United States*[175], the taxpayer in *Allen* (a construction engineer by trade) admitted to originally acquiring the subject realty for the purpose of developing and reselling it. He argued, though, that over time he decided not to develop the property, but continued to hold it "for investment" until he could sell all of the realty, which finally occurred twelve years after the initial acquisition. The Tax Court granted summary judgment in favor of the IRS and found that the taxpayer originally acquired the property for development and resale, and that the taxpayer failed to adequately prove he changed his intent to "holding the property for investment." In deciding for the IRS, the court focused on the following facts: (i) from 1987 to 1995, the taxpayer attempted to develop the property on his own; (ii) the taxpayer admitted his initial intention to develop the property on his own, and searched for partners to help in the property's development; (iii) from 1995 to 1999, the taxpayer brought in partners who contributed capital for development; (iv) in 1999, the taxpayer sold the property to a developer for a lump sum (used to pay-off encumbering debt and prior partners), along with 22% of the buyer's profits and a set fee per developed lot sold; and (v) the taxpayer made significant efforts to develop the property over many years (e.g., the preparation of 10 engineering studies in respect to the subject realty) and failed to substantiate when his actions changed with regard to the property. It is interesting to note that there was no mention of whether the taxpayer ever engaged in any marketing activities for the realty at issue or made any physical improvements. The result in *Allen* may not have been the same if decided by or in the Fifth Circuit, given the precedence of *Suburban Realty* (discussed below) and given (i) Allen's twelve year holding period, (ii) no prior sales, (iii) lack of physical improvements, (iv) minimal if any marketing activities, and (v) that the taxpayer in *Allen* appears to have decided to simply liquidate the investment.

B. **5th Circuit Factors in Determining Dealer Status**. In *Suburban Realty Co. v. U.S.*[176], the Fifth Circuit developed a framework for determining whether sales of land are considered sales of a capital asset or sales of property held for sale to customers in the ordinary course of a taxpayer's business. The three principal questions that must be considered are --Was the taxpayer engaged in a trade or business, and if so, what business? Was the taxpayer holding the property for sale in that business? Were the sales contemplated by the taxpayer "ordinary" in the course of that business? The *Suburban Realty* court looked to the earlier Fifth Circuit decision in *Biedenharn Realty Co. v. U.S.*[177] for seven factors that should be considered when answering these three questions. The factors that should be considered are:

1. the nature and purpose of the acquisition of the property and the duration of the ownership;

2. the extent and nature of the taxpayer's efforts to sell the property;

3. the number, extent, continuity and substantiality of the sales;

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[173] See *Tibbals v. U.S.*, 362 F.2d 266, 273 (1966); *Eline Realty Co. v. Commissioner*, 35 T.C. 1, 5 (1960).
[174] See *Biedenharn Realty Co. v. U.S.*, 526 F.2d 409, 421 (5th Cir. 1976).
[175] 2014-1 U.S.T.C. (CCH) ¶50,300 (N.D. Cal. 2014).
[176] 615 F.2d 171 (5th Cir. 1980).
[177] 526 F.2d 409 (5th Cir. 1976).

4. the extent of the subdividing, developing, and advertising to increase sales;

5. the use of a business office for the sale of the property;

6. the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and

7. the time and effort the taxpayer habitually devoted to the sales.[178]

The frequency and substantiality of sales is the most important factor, although no one factor alone is decisive.[179] The extent of development activity and improvements also seems to carry significant weight. Given the multi-factor analysis, diversifying the risk as to dealer status is generally advisable. Note that authority exists for the argument that a taxpayer's status as a dealer of residential property does not necessarily classify the taxpayer as a dealer of commercial property.

C. **Other Factors in Determining Dealer Status**. For taxpayers outside of the Fifth Circuit, the Tax Court has developed other factors to determine whether a taxpayer is considered a dealer or an investor. However, these lists of "dealer" factors in should be less of a concern for taxpayers residing in the Fifth Circuit since the *Suburban Realty* factors listed above should apply.[180]

1. List of Attributes. In *Oscar M. Fraley v. Commissioner*[181], the Tax Court confirmed the "attribute" laundry list that needs to be examined to determine the owner's intent. This list of attributes was compiled based on a series of Sixth Circuit decisions, in which the court upheld the axiom that, "whether land is held primarily for sale to customers in the ordinary course of a taxpayer's trade or business is a purely factual determination."[182] The attributes include the following:

a. The purpose for which the property was acquired.
b. The purpose for which the property was held.
c. The extent of improvements made to the property.
d. The frequency of sales.
e. The nature and substantiality of the transactions.
f. The nature and extent of the taxpayer's dealings in similar property.
g. The extent of advertising to promote sales.
h. Whether the property was listed for sale either directly or through brokers.

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[178] See also *U.S. v. Winthrop*, 417 F.2d 905, 910 (5th Cir. 1969).
[179] *Suburban Realty*, 615 F.2d at 178; *Biedenharn*, 526 F.2d at 416.
[180] See, e.g., *Jack E. Golsen*, 54 TC 742 (1970).
[181] TC Memo 1993-304.
[182] See *Case v. United States*, 633 F.2d 1240, 1245 (6th Cir. 1980); *Gartrell v. United States*, 619 F.2d 1150, 1152-1153 (6th Cir. 1980); *Philhall Corp. v. United States*, 546 F.2d 210, 214 (6th Cir. 1976); *Maddux Construction Co. v. Commissioner*, 54 T.C. 1278, 1284 (1970).

2. Attributes List in Application. In *Phalen v. Commissioner*[183], the Tax Court applied the taxpayer's factual situation to the attributes discussed in the *Fraley* decision. The activities articulated in *Phalen* are similar to those an investor may have to undertake to maximize the value of his investment without crossing the line to engage in "dealership." The *Phalen* attributes include:

a. The owners of the development entity (some of whom were real estate developers in their other activities and owned their interests in the same percentages as investors) did not taint the taxpayer partnership's investment status. However, the individuals, personally, were not real estate brokers or agents.

b. "Development" activities (in this context, physical improvements) were not directly undertaken by the investor partnership.

c. A guarantee by the investment partnership of the performance of the development agreement was not fatal.

d. The investment partnership succeeded to rights under agreements put in place by the former bankrupt developer/owner, and assumption of these rights did not taint the investment purpose.

e. The investment partnership's participation in financing the activity of the developer who was the buyer and financing the municipal improvement district (which was obligated to construct the improvements) was not fatal.

f. The sale of multiple tracts to different buyers over four years was acceptable. All sales were unsolicited.

g. Soil testing to evaluate the development alternatives for the property was acceptable.

h. The investor partnership's participation in amended and final site plans was acceptable.

i. All corporate and partnership formalities were carefully followed-even between related investor/dealer entities.

j. Good business reasons existed for the sale to related (through ownership) development entities and for structuring of activity among the investment partnership, municipal improvement district, and the financing.

D. **Practice Tip**. Real estate developers frequently establish separate limited partnerships or other entities in an effort to avoid dealer status. This strategy is more likely to succeed if the separate entities are established at different times with different partner-investors. Occasionally, a real estate developer uses a wholly-owned limited liability company that is a disregarded entity for federal income tax purposes. The unfortunate real estate developer in such

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[183] TC Memo 2004-206.

a situation has achieved nothing with respect to avoiding dealer status. It should also be noted that care should also be taken to avoid operating the businesses of these separate entities as alter egos. Additionally, it may be useful to avoid using the word "development" in naming entities, or in describing the purpose of an entity, which will construct and own real estate. IRS agents often point to the use of the word "development" when arguing that the entity has dealer status.

E. **<u>Subdividing Into Lots</u>**. A taxpayer's subdivision of a tract into separate lots is strong evidence that the taxpayer is in the business of selling real estate in the ordinary course, although the Fifth Circuit has held that such activities do not affect investment status when used as reasonable means of disposing of the property.[184] The IRS has not acquiesced in this distinction, however.[185] However, Code § 1237 grants capital gains treatment under certain circumstances even though subdividing activities have occurred. Code § 1237 permits an individual who is not otherwise determined to be a real estate dealer to subdivide and sell real estate, without running the risk of being deemed a dealer solely because of the subdividing and sales activities. In order to qualify for Code § 1237 treatment, the taxpayer must (i) hold the property for at least five (5) years, unless the property is acquired by inheritance; (ii) not make any improvements that substantially enhance the value of the parcel sold; and (iii) not sell lots or parcels that have been previously held for sale to customers in the ordinary course of business, and in the year of sale, the taxpayer must not have held any other real property as a dealer. A taxpayer who fails to meet Code § 1237's requirements may still be deemed to be an investor and not a dealer.

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[184] *See Temple vs. United States,* 229 F. Supp. 687, *aff'd*, 355 F.2d 67 (5th Cir. 1966); *see also Buono v. Commissioner.*, 74 T.C. 187 (1980) (subdividing land into separate lots for purposes of enhancing selling price not evidence of dealer status where intention was to sell land as single tract).

[185] *See* Rev. Rul. 59-91, 1959-1 CB 15.

Planning for Capital Gains, Losses and Depreciation

2727 Allen Parkway
Suite 1700
Houston, Texas 77019
P: (713) 739-7007
F: (713) 739-8403
www.cjmlaw.com

August 25, 2016

Chris M. Goodrich
cgoodrich@cjmlaw.com

CRADY, JEWETT & McCULLEY LLP

Overview

* For C corporations, there is no break on tax rates applicable to capital gains (i.e., treated the same as ordinary income).
* For S corporations, either (i) a flat 35% built-in gains tax rate applies (per §1374) or (ii) the tax rates applicable to individuals apply.
* For LLCs and partnerships, tax rates applicable to individuals apply.
* For individuals, the capital gains tax rates are 15%, 20%, 25% (unrecaptured §1250 depreciation) and 28% (on collectibles and non-excluded §1202 gain). PLUS a possible 3.8% Obamacare surtax.

Beware S Corporations With Built-In Gains Under Code § 1374

* Tax Base. The built-in-gain tax rate is imposed on the lesser of:
  * (i) net recognized built-in-gain (but not in excess of net unrealized built-in gain); or
  * (ii) taxable income (i.e., the "taxable income limitation").
* Tax Rate. A flat 35%, and it's in addition to (not in lieu of) the rest Sub S tax regime, i.e., a shareholder tax applies too, with the §1374 tax being deducted as a loss from S income passed through.
* Assets. Any asset carried over from the C corporation to an S corporation is subject to the built-in-gain tax.

Beware S Corporations With Built-In Gains Under Code § 1374

* Common Issues.
  * Treatment of sales of inventories during the recognition period
  * Application of the tax to cash method account receivables
  * The most efficient use of losses and C corporation attributes to reduce or eliminate the built-in-gain tax
    * Pre-S Corp. NOLs can reduce the tax (except per §382-384)
    * Recognized Built-In Losses have no carryover (so timing is critical)

Beware S Corporations With Built-In Gains Under Code § 1374

* If any of the S Corporation's assets are sold within five years of the effective date of the S Corporation election, then the corporation will be liable for a built-in-gain tax.
  * This includes LIFO inventory (with recognition spread over 4 years)
* Also, collection of pre-S election cash basis accounts receivable are subject to the flat 35% built-in-gain tax (which makes the taxable income limitation important).

<u>Beware S Corporations With Built-In Gains Under Code § 1374</u>

- <u>Subsequent Appreciation</u>. All appreciation of the corporation's assets after the S election effective date will not be subject to the built-in gains tax.
  - <u>Tip</u>: Paper the client's tax file with appraisals of corporate assets (including goodwill), valued as of Sub S effective date.
- Note that the shareholder tax rate on non-built-in gains varies based on the nature of the assets sold, e.g., inventory versus capital assets.

Determining Built-In Gains

* C Corporation must calculate unrealized built-in-gain when the corporation makes the S election – again, get appraisals.
* The total gain subject to the built-in-gain tax cannot exceed the corporation's "net unrealized built-in gain" ("NUBIG")
    * The amount by which the aggregate FMV of all assets of the S corporation (determined on the first day of its first tax year as an S corporation) exceeds the aggregate adjusted bases of such assets at that time

Determining Built-In Gains

- The amount realized by the electing corporation on a hypothetical sale of all assets on the first day of the recognition period to an unrelated party who or which assumed all of the corporation's liabilities,
- Less, any liability that would otherwise be included in the amount realized as calculated in (1) above that is deductible for tax purposes when paid (e.g., accounts payable, salaries payable, etc., of a cash basis taxpayer),

Determining Built-In Gains

* Less, the aggregate adjusted bases of the corporation's assets on the first day of the recognition period,
* Plus or less, any Section 481 adjustments of the corporation on the first day of the recognition period, and increased by
* Plus, any recognized built-in loss that would not be allowed under Sections 382, 383, or 384.

Avoiding The Built-In-Gain Tax

- Wait for the "recognition period" (i.e., when the Built-in-Gains tax is applicable) to expire.
  - The 2015 PATH Act changed the Recognition Period to five years.
- Sell the S corporation stock, not the assets.
- Before making S election, sell appreciated assets and pay taxes at graduated (lower) corporate tax rates.

Avoiding The Built-In-Gain Tax

- Use a Code § 1031 exchange to defer the recognition of the built-in-gain tax.
- "True" lease the appreciated assets instead of selling them (caveat purchase options).
- Before S election, contribute loss assets to corporation to limit NUBIG. But caveat the anti-stuffing rule:
  - Clear & substantial relation of contributed property to corporation's business; <u>or</u>
  - Contribute property likely to decline in value between contribution and the S election effective date.

<u>Avoiding The Built-In-Gain Tax</u>

* Limit taxable income.
  * See page 10 example (e.g., $40,000 of NUBIG A/R never taxed because of salary deductions in recognition period.
* Consider reasonableness of salary deductions.
  * The Nine-Factor Test (<u>Mayson</u>) (used in the 5th Circuit)
  * The Five-Factor Test (<u>Elliott's</u>)
  * 9 or 5 Factors? "In Elliott's, … the Ninth Circuit divided the factors into five broad categories:… For all intents and purposes, these are the same as the factors enumerated in Mayson." *Owensby & Kritikos, v. Commissioner.*

Avoiding The Built-In-Gain Tax

* IRS's Favorable Factors (in C corporate context) supporting higher compensation:
  * long hours
  * uniqueness of the employee's contribution
  * success in turning the company around
  * the company's above-average growth or profitability
  * experience level of the employee
  * high productivity and effectiveness of the employee
  * bonus arrangements entered into prior to becoming a stockholder
  * whether the employee was offered a higher salary by outsiders
  * inability of the employee to control compensation levels or dividends
  * salary compared favorably with that of employees of other companies
  * employee was undercompensated in previous years and
  * high return on equity

Avoiding The Built-In-Gain Tax

- IRS's Factors (in C corporate context) unfavorable to supporting higher compensation:
  - compensation rate exceeded that of comparable companies
  - lack of dividend payments
  - inappropriate compensation formulas
  - lack of unique employee skills
  - employee spent little time on the job or worked less than in previous years
  - the Board of Directors was not independent
  - salary increased without increase in duties
  - bonus formulas changed because of high profits

Avoiding The Built-In-Gain Tax

- Independent Investor Test: Compensation can't be so high that an independent investor would fail to get an reasonable return on investment.

- Determinative Test or a Mere Factor?
  - "in this circuit the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed." *Rapco, Inc. v. Commissioner*
  - "the 'independent investor' test is the 'lens' through which they view the seven…factors of the [*Mayson*] test. But that is a formality. The new test dissolves the old and returns the inquiry to basics." *Exacto Spring Corp. v. Commissioner* (7th Circuit)

Avoiding The Built-In-Gain Tax

* Installment sales won’t avoid tax per taxable income limitation (‘cuz reg.s increase the limitation for not yet recognized deferred gain)

* But installment gain may be timed (e.g., through partial note sale or pledge) so all of any built-in losses (which can’t be carried-over) can offset built-in gain

* Pre-S election C corporation NOL can reduce built-in gain.

Avoiding The Built-In-Gain Tax

* Leveraged partnership structure to defer sale gain
  * In a leveraged partnership, a corporation contributes assets to a partnership, with another partner contributing cash. The partnership then borrows and distributes cash to the corporation. The corporation guarantees the borrowed cash.
  * This allows a partner to transfer most of the economic interest in a business in exchange for cash without triggering current taxes, including built-in-gains tax.

Avoiding The Built-In-Gain Tax

* Leveraged partnership structure (continued)

* Caveat disguised sale treatment
  * 2 year rebuttable presumption
  * facts & circumstances risk after 2 years
  * Key: debt-financed distribution exception to disguised sale treatment.

Section 303 Redemptions

* Section 303 Redemptions of Corporate Stock attain capital gain treatment as opposed to dividend treatment.
  * Use of basis reduces gain realized.
  * Post-mortem appreciation taxed at capital gains rate.

Postmortem Basis Step-Up

- Decedent’s estate gets basis adjustment to FMV.
  - “Step-Up” to FMV at death eliminates pre-death gain.
  - However, property could also receive a “step-down.”
- Deemed 1 year holding period for post-death appreciation
- Both halves of community property receive “step-up” (or “step-down”) at first spouse’s death
  - Consider conversion of separate property to community property (caveat: effect on creditors or divorce)

Postmortem Basis Step-Up Exceptions

* Exception for Certain 2010 Decedents
  * Could elect out of estate tax.
    * Dan Duncan
    * Janet Morse Cargill
    * George Steinbrenner
  * Property took modified carry-over basis.

Postmortem Basis Step-Up Exceptions

* IRD exception to § 1014 Basis Adjustment
  * Income in Respect of a Decedent (§ 691)
    * Income not properly includible on final income tax return.
  * Examples:
    * Installment sale payments received post-mortem
    * Qualified Plans & IRAs
    * Non-Qualified Deferred Compensation
  * Can take an income tax deduction on estate tax paid (to partially offset the pain of no step-up – if the estate is taxable).

Postmortem Basis Step-Up Exceptions

* Previously Transferred Property
  * Taxable gifts made within 3 years of Donor's death
  * If included in Donor's estate, entitled to § 1014 basis ***less*** any deductions claimed by Donee (e.g., depreciation) in interim period between the "clawback" gift and the Donor's death.

Postmortem Basis Step-Up Exceptions

* § 2032 Alternate Valuation Date limits step-up.
  * Estate's assets valued as of 6 months after DOD.
  * Can only use § 2032 Election if it reduces taxable estate.

* § 2032A Special Use Valuation limits basis step-up.
  * Farm/business real estate valued on "qualified use."
  * FMV reduction capped (for 2016: $1,110,000).

* Conservation Easements.

Planning for Basis Step-Up

* Avoid selling highly-appreciated assets.

* Avoid selling significantly depreciated/depleted assets.
  * Rental real estate.
  * Oil and gas interests.

Planning for Basis Step-Up

* Consider using Grantor Trust "Swap Power"
  * Swap equal value high basis assets (e.g., cash) for low basis assets.
* Consider selling built-in loss property.
  * Will "lose" the possible deduction at death.

Planning for Basis Step-Up

* Gifts (or General Powers of Appt.) to parents, etc.
  * If parents do not have taxable estate, Donor gets a free step-up.
* § 1014(e) limitation on "boomerang" gifts.
  * Property received by gift;
  * FMV in excess of basis on date of gift;
  * Donee dies within a year of gift; and
  * Property passes back to donor (or donor's spouse) (or to a trust for Donor?).

Planning for Basis Step-Up

* Partnership interests held by decedent.
  * "Outside basis" gets adjusted.
  * "Inside basis" adjustment requires § 754 election.
  * For real estate, consider a cost segregation valuation report (to maximize the benefit of the § 754 election).

New Basis Consistency Requirements

- Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.
  - § 1014(f) – basis consistency.
  - § 6035 – basis reporting requirement.
  - Tacked on as a revenue raiser (from the unwitting).
  - Applies if estate files Form 706 after July 31, 2015.
- Proposed/Temp. regs. leave much to be desired.
  - § 1.1014-10T
  - § 1.6035-1T

<u>New Basis Consistency Requirements</u>

- Property subject to new basis consistency ***<u>reporting</u>*** requirement:
  - All assets listed on Form 706.
  - Form 8971 must be filed within 30 days of Form 706.

New Basis Consistency Requirements

* Property for which basis does not need to be reported:
  * Cash.
  * Marital/charitable deduction property.
  * Tangible personal property < $3,000.
  * Property which is "Income in Respect of a Decedent."
  * Property sold/exchange/disposed of in transaction where "capital gain or loss is recognized."
* New Mantra: "Sell before 706 Filed"

New Basis Consistency Requirements

* Reporting – Form 8971
  * You are reporting "value" from Form 706 (not basis).
  * A Schedule A must be completed for each estate beneficiary listing property they will or could receive.
  * Send Form 8971 and all Schedule A's to the I.R.S.
    * Draft Form 8971 instructions prohibit any attachments.
    * Cannot just attach a copy of Form 706.
  * Send Schedule A to respective beneficiaries.

New Basis Consistency Requirements

* Schedule A
  * List ***all*** property beneficiary ***could*** receive from estate.
    * If one or more beneficiary gifts have not been funded, must list ***all*** property which could possibly fund the gift.
  * Must file supplemental Schedule A's with beneficiary and estate within 30 days of subsequent distributions.
  * Must file supplemental Schedule A's if value is adjusted due to audit or litigation.
  * ***<u>Beneficiaries may have to report subsequent gifts of previously-reported property!</u>***

New Basis Consistency Requirements

- What happens if you fail to report on Form 8971?
  - Information return penalties up to $500 per § § 6721 & §6722.

- What happens if you fail to report on Form 706?
  - If property is omitted from Form 706 and is not reported prior to statute of limitation expiration, ***property takes a zero basis!***

Change Asset Basis without Gain or Death

- **Basis Swapping Technique Example**: A owns Property A, B owns Property B, and C owns Property C. Property B and Property C have high basis. Property A has low basis. B and C are A's children. A, B and C form ABC Partnership by respectively contributing Property A, Property B and Property C. Property A, Property B and Property C are equal in value, but given local market conditions for Property B, Property A or Property C will more likely sell before Property B.

Change Asset Basis without Gain or Death

* Seven years and one day after Property A, Property B and Property C are contributed to ABC Partnership, ABC Partnership distributes Property B to A.
* Since more than seven years have passed, the "anti-mixing bowl" rule and Code § 737 do not apply.

Change Asset Basis without Gain or Death

* Due to the "outside basis" limitation, rather than receiving ABC Partnership's high basis in Property B, A receives a low basis in Property B equal to A's outside basis in A's interest in ABC Partnership, and the excess of Property B's basis remains with ABC Partnership to be reallocated between Property A and Property C.

Change Asset Basis without Gain or Death

* Immediately following the distribution of Property B, ABC Partnership makes a Code § 754 election, which causes the outside basis in B's and C's respective interests in ABC Partnership to be increased (in the aggregate) by this excess basis reallocated from Property B to Property A and Property C.
* ABC Partnership can now sell Property A with a higher basis, thereby generating less gain.

Change Asset Basis without Gain or Death

* The proceeds from the sale of Property A can also be distributed to B and C without additional gain due to the Code § 754 election.
* On the other hand, A can retain Property B until A's death and receive a step-up in basis for Property B.

Change Asset Basis without Gain or Death

- Basis Swapping Technique in Summary:
  - Contribute appreciated property
  - Make Code § 754 election
  - Wait seven years

Change Asset Basis without Gain or Death

* The Anti-Mixing Bowl Rule requires gain recognition if the partnership distributes contributed property to a partner other than the contributing partner within 7 years of the original contribution.
* Code § 737 requires gain recognition if a partner contributes property with built-in gain to the partnership and within seven years of that contribution receives a distribution of some other property.

Change Asset Basis without Gain or Death

* Anti-Abuse Regulations Applicable?
  * Adopted just over 20 years ago.
  * Allows IRS to re-characterize transactions where the principal purpose is to reduce the present value of the partners' aggregate Federal tax liability in a manner inconsistent with Subchapter K.
  * Potentially broad, but the examples set forth in these regulations do not seem to apply to the Basis Swapping Technique.

Using PALs to Offset Gain

* Passive activity losses ("PAL") generally can only offset income from passive activities.
  * Unlimited PAL carry-forward.

* But if the passive activity is disposed of through **a fully taxable transaction** ("FTT"), the taxpayer can deduct all of those activity's losses as if non-passive.

Using PALs to Offset Gain

* What qualifies as a FTT?
  * Must dispose of ***entire*** interest.
    * Installment sales qualify on a pro rata basis.
    * Can allocate pro rata if one disposes of "substantially all" of a passive activity. Treas. Reg. § 1.469-4(g)
    * Cannot dispose of asset to a "related party" (Code §§ 267(b) and 707(b)(1)), e.g., close family members, their trusts or their controlled entities.

Using PALs to Offset Gain

- Examples of Fully Taxable Transactions (“FTT”):
  - PAL stock becomes worthless.
  - PAL asset foreclosed upon.

Using PALs to Offset Gain

- What does not qualify as a FTT?
  - Cannot dispose of asset to a “related party.”
    - § 267(b); § 707(b)(1).
  - “Sales” to partners which are really § 731 distributions.
    - Must be able to prove a bona fide sale.
  - Foreclosed property if taxpayer continues to assert ownership.
    - e.g., lawsuits over the property after foreclosure.
    - Listing foreclosed property as asset on books and records.

COD or Capital Gain?

* Generally, a debtor realizes cancellation of indebtedness income for a debt reduction.
* Transfer of Collateral:
  * Recourse Debt: treated as sale for fair market value, with remaining deficiency
  * Nonrecourse Debt: gain or loss equal to the difference between the amount of debt forgiven and the debtor's adjusted basis in the property
  * Partially Recourse: debt reduction is first allocated to the nonrecourse portion

Restructuring Debt: Ordinary Income or Capital Gain?

* *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987).
  * Write-down of nonrecourse debt before foreclosure resulted in COD income.
  * *The collateral securing the debt was not surrendered as part of the discharge* itself, but was transferred to a party closely related to the creditor approximately three months after the initial discharge.

* *2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999).
  * There is no COD where a partnership realized gain from the disposition of property because a discharge of the encumbering nonrecourse loan was connected to the disposition. Gershkowitz distinguished by 5^{th} Cir.

Related Party Sale of Depreciable Property

* § 1239 – Capital Gain Bar Rule
  * No capital gain on sale of capital asset to ***related party*** if the capital asset is ***subject to depreciation*** in the hands of the ***transferee.***
  * Gain on such sales treated as ordinary income.

Related Party Sale of Depreciable Property

* Related Parties:
  * Taxpayer owns >50% of entity (also entity attribution).
  * Trust for benefit of taxpayer (or taxpayer's spouse).
  * Decedent's estate and beneficiaries (unless deemed sale from funding pecuniary bequest).
  * Employers and welfare benefit funds.
  * Attribution of ownership applies.

Related Party Sale of Depreciable Property

* Attribution - § 267(b) generally applies
  * Entity – interests owned, directly or indirectly, by or for:
    * Corporation, partnership, estate, or trust deemed owned pro rata by shareholders, partners, or beneficiaries.
    * No constructive ownership of partner's stock (§ 267(c)(3)).
  * Family – interests owned, directly or indirectly, by or for:
    * Taxpayer's spouse, siblings, ancestors, and descendants.
    * No "double attribution" for family.

Related Party Sale of Depreciable Property

* Subject to Depreciation:
  * § 167 depreciable property (even if taxpayer fails to claim).
  * §1239(e) includes patent applications (amortizable).
  * Case law has extended further:
    * § 197 intangibles (incl. goodwill).
    * Leasehold interests.

<u>Related Party Sale of Depreciable Property</u>

- Depreciable in Hands of Transferee:
  - Character in Seller's hands irrelevant.
  - Example: Father sells vacation house to son, who then begins renting the property.

- Possible exception?
  - § 121 exclusion could ***<u>possibly</u>*** be used to offset ordinary income.

Sale of Mineral Interests: Royalty Income or Capital Gain?

* Classification Matters! Each type of conveyance has different tax consequences to the parties involved.
  * lease or sublease
  * sale or exchange
  * production payment
  * sharing arrangement
* Biggest Trap: Selling an operating interest but retaining a non-operating interest makes the gain ordinary instead of capital.

Sale of Patents

- For capital gains tax rates to apply on the sale of intellectual property (e.g., copyrights, trademarks or patents): (1) Code §§ 1221 and 1231 must apply and (2) the seller must transfer all rights in the property.

- Compare the tax rule for needing to sell all non-operating interests in minerals if the working interest is sold.

Sale of Patents

* Patent Exception (Code § 1235): For creators and financial backers of the patent or patentable technology:
  * one-year holding period does not apply;
  * may transfer an undivided interest in all substantial rights;
  * sales to foreign corporations are taxed at ordinary rates;
  * Sale cannot be to a related person (as defined per modified Code §§ 267(b) and 707(b) rules).

§751 Hot Assets

* As a general rule, a sale of a partnership interest results in short term or long term capital gain (depending on the holding period).

* Exception: Code §751.

§751 Hot Assets

* A selling partner will recognize ordinary income on the sale of a partnership interest to the extent that seller receives a non-prorata distribution of the following kinds of partnership property:
  * Unrealized Receivables: (i) rights to payment for goods delivered or to be delivered or services rendered or to be rendered; and (ii) § § 1245 & 1250 recapture items.
  * Inventory Items: Code § 1221(a)(1) property, property other than a capital asset and other than property described in Code § 1231

§1202

- **Basic Rule**
  - A seller of qualified small business stock, which has been held in excess of five years, can exclude from tax up to 50% of his or her gains from such sale.
  - The 2010 Tax Relief Act increased this exclusion to 100%.
- **Not Available for S Corporations**
  - The qualified small business stock must be issued by a C-Corporation.
  - Stock issued by an S corporation that later becomes a C-Corporation is not eligible for this benefit.

§1202

- For its stock to be qualified small business stock, the corporation must engage in a business <u>other than:</u>
  - personal services such as law, accounting, health care, brokerage, consulting, engineering, architecture, performing arts, financial services, etc.;
  - Banking, insurance, leasing, investing;
  - Farming;
  - Extracting or producing natural resources;
  - Hotels, motels or restaurants.

§1202

* Stock must be issued after 8/10/93
* Stock must be issued in exchange for cash, property (other than stock) or services (other than underwriting)
* Issuing corp. can't have purchased from the taxpayer or related persons (per Code §§267(b) or 707(b)) any of its own stock in the 4 years immediately following the 2nd anniversary of issuing the taxpayer's stock.

§1202

* For substantially all of the taxpayer's holding period, the issuing corp. must have used at least 80% of its assets in the active conduct of at least one trade or business.
* After its first 2 years, no more than 50% of the corporation's assets may be working capital or investments held to fund future research or working capital.
* No more than 10% of assets may be portfolio securities.

§1202

* Gross assets test:
  * Before and immediately after issuance, the corporation's gross assets can't exceed $50MM.
  * Pre-issuance of the QSB stock, the corporation's or its predecessor's gross assets can't have ever exceeded $50MM after 8/10/93.
  * $50MM is computed based on cash and adjusted basis of non-cash, with FMV of contributed assets upon contribution being regarded as the contributed asset's basis.

§1202

* Per issuer Limit. Excluded gain per issuer per year can't exceed the greater of:
  * The excess of $10MM over any §1202 gain previously excluded by the pertinent taxpayer; or
  * Ten times taxpayer's adjusted basis in QSB stock that taxpayer disposed of in the pertinent year, with the FMV of non-cash property contributed to the corporation being treated as the adjusted basis of the stock issued in exchange for that property.

Abandonment Gives Rise to Ordinary Loss

- ***Pilgrim's Pride v. C.I.R.***: Fifth Circuit reversed the Tax Court and ruled that an abandonment of stock gives rise to an ordinary loss under §165 rather than a capital loss from the sale or exchange of a capital asset under §1234A.
  - §1234A was thought to apply to terminating derivative securities.
  - The Fifth Circuit concluded that Section 1234A imposes capital loss treatment on rights or obligations which terminate *with respect to capital assets but not to the capital assets themselves*.
- ***B. Philip Citron* (1991):** Similar result for partnerships

Depreciation – Basis Allocation

* One collective purchase price must be allocated among multiple properties to determine basis
* Allocate price based on relative fair market values as of the date of purchase, determined by:
  * Bona fide offers from third-parties;
  * Appraisals;
  * Assessed Values;
  * Contractual purchase price allocation that has substantial effect on both parties.

Depreciation – Basis Allocation

* Allocation of acquisition cost basis for property.
  * Ex: 1 large tract that will be subdivided into 10 lots and sold. Should the basis be equally allocated 1/10 to each lot?
* Bank may require that the net proceeds from the sale of each lot be used to pay down and pay off note.
* Depending on basis allocation, phantom income may be generated from sales.

Depreciation – Basis Allocation

- Planning Example:
  - John purchases Blackacre for $1M ($800K loan)
    - Blackacre will be subdivided into 4 lots
  - Basis is allocated evenly - $250k/lot
  - Sells First Parcel for $550K
    - Taxable Gain of $300K
      - Taxes (assuming 40% rate): $120K
    - If all proceeds are used to pay-off loan, John has no money to pay the taxes
  - Solution: disproportionate allocation based on fair market value of each parcel or lot (due to being "frontage" property or other reasonable explanation)

Depreciation Planning

* Consider a **cost segregation study** to identify items which can be depreciated faster:
  * Section 1245 Property: tangible personal property
    * 5-year or 7-year depreciation
  * Section 1250 Property: structural, relates to the operation or maintenance of a building
    * 15-year depreciation
* Consider avoiding 1250 recapture on cost segregate items.

Depreciation Recapture

* Recapture limits the tax benefits of depreciation
* Sale of property triggers recapture
  * Section 1245 property (i.e., personalty)
    * Ordinary income rates
  * Section 1250 property (i.e., realty)
    * 25% tax rate (for individuals and pass-through entities) for that portion of depreciation in excess, or not in excess, of straight line, depending on when the realty was placed in service (i.e., pre-1981, 1981-1986, or post-1986).
    * Note this 25% rate affords some permanent tax break (i.e., 25% tax on gain vs. 39.6% tax benefit from depreciation deduction)

Dealer Status

* Real estate held:
  * For productive use in a trade or business or as an investment ("investor property")
  * Primarily for sale to customers in the ordinary course of business ("dealer property")
* Dealer property not eligible for:
  * Long-term capital gain treatment
  * Depreciation
  * Like-kind exchanges
  * Installment sales
  * Exclusion of sales gain from Texas franchise tax

5^{th} Circuit Factors to Determine "Dealers"

(intent upon acquisition; caveat proof of change in intent)

* Nature and purpose of the acquisition of the property and the duration of the ownership
* Extent and nature of the taxpayer's efforts to sell the property
* Number, extent, continuity and substantiality of the sales**
* Extent of the subdividing, developing, and advertising to increase sales**
* Use of a business office for the sale of the property
* Character and degree of supervision exercised by the taxpayer over anyone selling the property
* Time and effort the taxpayer habitually devoted to the sales

Avoiding Dealer Status

* Separate entities to hold different real estate projects
  * Should not be structured as disregarded subsidiary entities
  * Query: use of Series LLCs?
* Different investors and formation dates support "investor" status
* Caveat: use of "Development" in company name

2727 Allen Parkway
Suite 1700
Houston, Texas 77019
P: (713) 739-7007
F: (713) 739-8403
www.cjmlaw.com

CHRIS M. GOODRICH
CGOODRICH@CJMLAW.COM

CRADY, JEWETT & McCULLEY LLP

TAX SECTION
State Bar of Texas

September 28, 2016

Via E-mail to Teresa.Bostick@cpa.texas.gov

Teresa G. Bostick
Director, Tax Policy Division
PO Box 13528
Austin, Texas 78711-3528

RE: **Comments on Proposed Amendments to 34 Tex. Admin. Code § 3.292, "Repair, Remodeling, Maintenance, and Restoration of Tangible Personal Property"**

Dear Ms. Bostick:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to 34 Tex. Admin. Code § 3.292.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION 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 TAX SECTION, 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 TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, 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 TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 3.292, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 3.292

These comments on Proposed Amendments to 34 Tex. Admin. Code § 3.292 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of COGS, reviewed these Comments. Stephen Long, Vice-Chair of the SALT Committee, Kirk Lyda, Vice-Chair of the SALT Committee, and Robin Robinson, a member of the SALT Committee, also reviewed the Comments and made substantive suggestions on behalf of COGS.

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

Contact Person:

Sam Megally
K&L Gates LLP
1717 Main Street, Suite 2800
Dallas, Texas 75201
T: 214.939.5491
F: 214.929.5849
Sam.Megally@KLGates.com

Date: September 28, 2016

I. INTRODUCTION

These Comments are in response to the request from the Texas Comptroller of Public Accounts (the "Comptroller") for comments on a draft of proposed amendments to 34 Tex. Admin. Code § 3.292, concerning repair, remodeling, maintenance, and restoration of tangible personal property ("Proposed Rule 3.292" or the "Proposed Rule").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing Proposed Rule 3.292. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

These Comments are intended to convey only our preliminary, high-level reactions to Proposed Rule 3.292; the Proposed Rule makes extensive changes to the current version of rule 3.292 (the "Current Rule"), and could yield unintended results beyond those identified herein. We therefore respectfully suggest that the Comptroller convene a roundtable meeting of interested parties to discuss in more detail the Proposed Rule; we would welcome the opportunity to participate in such a roundtable meeting.

II. COMMENTS REGARDING PROPOSED RULE

A. Definitions of "care, custody, and control"

Pursuant to Tex. Tax Code § 151.302(a), the "sale for resale of a taxable item is exempted from" Texas sales and use tax.[1] Tex. Tax Code Ann. § 151.302(b), however, provides that "[t]angible personal property used to perform a taxable service is not considered resold unless the care, custody, and control of the tangible personal property is transferred to the purchaser of the service."[2] Tex. Tax Code Ann. § 151.0101(a) includes "repair, remodeling, maintenance, and restoration of tangible personal property" among the specifically enumerated services that are subject to sales and use tax in Texas.[3] The Current Rule provides that a service provider "may issue a resale certificate instead of paying sales or use tax to the supplier when purchasing materials that will be transferred to the care, custody, and control of a customer," and that sales or use tax applies to purchases by a service provider of "supplies, tools, and equipment...for use in the performance of the repair but that are not transferred to the care, custody, and control of the customer."[4]

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[1] Tex. Tax Code Ann. § 151.302(a) (West 2016).

[2] Tex. Tax Code Ann. § 151.302(b) (West 2016).

[3] Tex. Tax Code Ann. § 151.0101(a)(5) (West 2016).

[4] 34 Tex. Admin. Code § 3.292(b)(2),(c) (amended to be effective September 5, 2006, 31 Tex. Reg. 7133).

The terms "care," "custody," and "control" have not been defined by statute or rule, though they have been interpreted in court cases and Comptroller hearings and rulings.[5] *Sharp v. Clearview Cable TV, Inc.* addressed a cable television service provider's claim that it was eligible to purchase certain equipment tax-free for resale to its customers as an integral part of performing its services; the court ultimately upheld a trial court judgment that the taxpayer had transferred care, custody, and control of the equipment and was therefore entitled to claim the resale exemption on its purchases.[6] The Comptroller's office has in the preamble to Proposed Rule 3.292 cited *Clearview* for its discussion of the concept of transferring "care, custody, and control."

At issue in *Clearview* were "an antenna, a down converter, [and] connecting wire," which were installed by Clearview outside its customers' premises.[7] The Comptroller conceded that Clearview had transferred custody of all equipment to its customers,[8] but argued that one who has "care" of the equipment must have the "responsibility for servicing and maintaining the equipment," and that one who has "control" of the equipment must have "authority to manage and guide the use of the equipment."[9] Importantly, the court declined to characterize the "care" and "control" standards in the manners proposed by the Comptroller, noting that:

> [t]hese definitions ... are unreasonable for several reasons. First, these definitions do not take into account the fact that both Clearview and the subscribers are going to have some degree of joint care and control over the equipment.
>
> * * *
>
> Second, under the Comptroller's definition of "care" and "control," Clearview would have to completely divest itself of all care and control of property it owns in order to assert the benefit of the tax exemption. Such actions are unreasonable and would be detrimental to both Clearview and its subscribers.[10]

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[5] *See, e.g., Sharp v. Clearview Cable TV, Inc.*, 960 S.W.2d 424 (Tex. App.—Austin 1998, pet. denied).

[6] *See generally id.*, construing Tex. Tax Code Ann. § 151.302(b) (West 2016).

[7] *Id.* at 426. (The Comptroller conceded Clearview's position regarding a "power supply unit and set top converter" that were installed inside Clearview's customers' premises. *Id.*)

[8] *Id.* at 427.

[9] *Id.*

[10] *Id.* at 427-28.

Ultimately, the court elected instead to consider which party had "primary possession" of the equipment, as determined by indicia of who primarily controlled and had primary care of the equipment.[11] In holding that Clearview had transferred to its subscribers primary control of the equipment, the court noted that the subscribers determined when and how the equipment was used.[12] The court held as well that subscribers had primary care of the equipment simply because they had "the primary responsibility not to intentionally harm or damage the equipment."[13]

We respectfully submit that the definition of "care" in Proposed Rule 3.292 is inconsistent with the holding of the Clearview case. The Proposed Rule defines "[c]are of tangible personal property" to mean "[t]he primary responsibility to properly maintain the tangible personal property." Significantly, this definition is nearly identical to the definition urged by the Comptroller—and overruled by the court—in the *Clearview* case.[14] We note respectfully that the definition of "care" in the Proposed Rule goes far beyond the *Clearview* requirement of "primary responsibility not to intentionally harm or damage" property, and we respectfully suggest that the Comptroller redefine the term "care" to track more closely the *Clearview* holding. Requiring the service provider's customer to "properly maintain" an item in order to have "primary care" of the item suggests a much more active role by the customer than that contemplated by *Clearview*. Incorporating the term "maintain"—and thus "maintenance"—as the standard for "primary care" seems to go well beyond the test in *Clearview*.

The Proposed Rule defines "control of tangible personal property" to mean:

> [t]he right, superior to the right of others, to determine when, how, and by whom tangible personal property is used. The right to use tangible personal property for a temporary period of time in a manner that precludes the use of the property by others is not control of tangible personal property. For example, a gym member does not have control of a wall-mounted hair dryer provided in the locker room.

We respectfully note that the definition of "[c]ontrol of tangible personal property" in Proposed Rule 3.292(a)(5) may also be inconsistent with the test adopted by the *Clearview* court. The Clearview court noted that:

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[11] *Id.* at 428.

[12] *Id.*

[13] *Id.*

[14] *Id.* at 427.

> It is the subscriber, not Clearview, that determines: (1) when the equipment can be used; (2) how long the equipment can be used; and (3) what, if any, programming is going to be received by the antenna and converted into a signal that can be received by the subscriber's television set. The subscriber controls all of these factors because the subscriber controls the ultimate piece of the integrated system: the power supply. Moreover, the subscriber, not Clearview, determines who can use the equipment and where the equipment should be placed. Therefore, we hold that Clearview has transferred primary control of the Outside Equipment to its subscribers.[15]

Although the Clearview court did determine that Clearview's subscribers had primary control of the equipment based on the specific facts of that case, we note that it is not at all clear that the court intended to adopt a conjunctive test that would require a purchaser to acquire the right to determine all of "when, how, and by whom" an item is used in order to acquire control of the item.[16] We also note that the absence of one or more such indicia of control should not *per se* negate a finding of control. We respectfully suggest further that the Comptroller should consider incorporating into the Proposed Rule the *Clearview* court's holding that Clearview's subscribers controlled each of the factors recited above because they controlled "the ultimate piece of the integrated system: the power supply."[17] We view this holding to allow for a determination of control of multiple, integrated items when there is control of a single, "ultimate" item in the system, and we respectfully note that the Proposed Rule should be amended to include a similar concept.

Another, more recent case—*Fitness International, LLC v. Hegar*—addressed whether a taxpayer gym resold to its members certain equipment used by the members while they were in the taxpayer's facility.[18] The court of appeals in that case upheld a trial court determination that Fitness International had resold—i.e., transferred the care, custody, and control of—"towels, basketballs, and personal sanitation consumables (e.g., body wash, shampoo, and hand sanitizer)."[19] However, the appellate court also upheld the trial court's determination that Fitness International had not transferred the care, custody, and control of certain other items, including

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[15] *Id.* at 428.

[16] *Id.*

[17] *Id.*

[18] *Fitness International, LLC v. Hegar*, No. 03-15-00534, 2016 WL 3391606 (Tex. App.—Austin June 16, 2016, pet. filed).

[19] *Id.* at *1, *2.

cardio machines, abdominal machines, stretch machines, arm/shoulder equipment, leg equipment, weight racks, scales, and promotional flyers.[20]

The *Fitness International* opinion specifically lists a number of examples of equipment that the trial court determined the taxpayer had not effectively resold to its members;[21] the Appellant's Brief filed by Fitness International, LLC with the appellate court also lists a number of items at issue in the dispute with the Comptroller's office.[22] A petition for review in the *Fitness International* case is still pending before the Texas Supreme Court.[23] We respectfully note that including the example of a wall-mounted hair dryer in a gym locker room (at Proposed Rule § 3.292(a)(5)) gives the impression that the Comptroller is codifying a settled legal principle; because the resale of certain other kinds of gym equipment is an issue currently in active dispute, we respectfully suggest that the Comptroller delete the example from the Proposed Rule.

B. "Care, custody, and control" of software

The term "tangible personal property" includes computer programs.[24] The repair, remodeling, maintenance, or restoration of a computer program "not sold by the person performing [such] repair, remodeling, maintenance, or restoration service" is not subject to Texas sales or use tax.[25]

The Proposed Rule defines "custody" to mean

> Possession of and the right to remove or relocate tangible personal property from the service provider's premises. Custody requires more than transitory physical possession.

We are aware that the Comptroller's office and taxpayers have been struggling for years to apply authority construing the sale-for-resale exemption to software. With respect to the definition in the Proposed Rule of "care," we respectfully reiterate our comments above. We respectfully note as well that the Comptroller's office and taxpayers alike may find it very challenging to apply the Proposed Rule's definition of "custody" to software that is purchased for resale and ultimately resold; indeed, it may in many instances be impossible to determine

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[20] *Id.*

[21] *Id.*

[22] Appellant's Brief, *Fitness International, LLC v. Hegar*, No. 03-15-00534, 2016 WL 3391606 (Tex. App.—Austin June 16, 2016, pet. filed).

[23] Petition for Review, *Fitness International, LLC v. Hegar*, No. 16-0482 (Tex. petition filed August 31, 2016).

[24] Tex. Tax Code Ann. § 151.009 (West 2016).

[25] Tex. Tax Code Ann. § 151.0101(a)(5) (West 2016).

precisely where—i.e., with a service provider or with a customer—software is located. We suggest that redefining "care, custody, and control" to take into account the realities and practicalities of businesses purchasing and reselling software should be the topic of a roundtable meeting, and we would welcome the opportunity to participate in such a meeting.

C. Definitions of "remodeling" and "processing"

The Proposed Rule defines "remodel" as follows:

> To modify or make tangible personal property over again, in a similar but different manner, or to change the style, shape, or form of tangible personal property, without causing a loss of its identity or without causing it to operate in a new or different manner.

We respectfully suggest that this revised definition is confusingly worded, in part because it is not clear whether "over again" is meant to modify only the word "make" or also the word "modify." We suggest as well that including the phrase "tangible personal property" is redundant and confusing because in several places where the term "remodel" appears in the Proposed Rule, the Proposed Rule refers to specific items that may be remodeled.[26] We respectfully suggest that the Comptroller consider rewording this definition, perhaps as follows:

> To modify an item, to make an item over again in a similar but different manner, or to change the style, shape, or form of an item without causing such item a loss of identity or causing such item to operate in a new or different manner.

The Proposed Rule also defines "processing" by tracking almost verbatim the definition of "processing" already appearing in current rule 3.300 ("Current Rule 3.300").[27] That definition provides that "processing" includes the "physical application of the materials and labor necessary to modify or to change the characteristics of tangible personal property."[28] However, the last sentence of the "processing" definition appearing in Current Rule 3.300 provides that "[p]rocessing does not include remodeling,"[29] whereas the last sentence of the "processing" definition in the Proposed Rule provides that "[t]o remodel tangible personal property belonging to another does not constitute processing."

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[26] See, e.g., Proposed Rule 3.292(b) ("Taxability of services to repair, remodel, maintain, or restore tangible personal property…"); (b)(1)(A) ("Service providers who repair, remodel, maintain, or restore aircraft…"); (b)(1)(B) ("Service providers who remodel motor vehicles…").

[27] 34 Tex. Admin. Code § 3.300(a)(10) (amended to be effective October 12, 2004, 29 Tex. Reg. 9551).

[28] *Id.*

[29] *Id.*

We submit that the Proposed Rule's version of this proviso may cause confusion and uncertainty as to whether there is an intended distinction between the Proposed Rule and the Current Rule definition of "processing." We respectfully suggest that the Comptroller consider adopting verbatim the proviso appearing in Current Rule 3.300.

Additionally, we note that the definition of "remodeling" appearing in Current Rule 3.300—which the Comptroller has also repeated almost verbatim in the Proposed Rule—could be read to include activities that should more appropriately fall into the category of "processing." More specifically, the Current Rule "remodeling" definition includes the phrase "to change the style, shape, or form of tangible personal property,"[30] which could be read to include the activity of "chang[ing] the characteristics of tangible personal property," which is language appearing in the "processing" definition.[31] To address this potentially confusing overlap, we respectfully suggest that the Comptroller consider adopting in the definition of "remodeling" clarifying language similar to the proviso already appearing in the "processing" definition in Current Rule 3.300. Such a new proviso in the Proposed Rule's "remodeling" definition could read simply: "Remodeling does not include processing." Further, although we acknowledge that the Comptroller is not currently proposing amendments to Current Rule 3.300, we respectfully suggest that the Comptroller consider adopting a change to that rule's definition of "remodeling" along the lines of the one we are suggesting with respect to the Proposed Rule's definition of "remodeling."

D. Certain taxable services

Proposed Rule 3.292 reiterates certain provisions that appear in the Current Rule, including a number of examples of repair, remodeling, maintenance, and restoration services that might be taxable even though they are performed on tangible personal property that was exempt at the time of its purchase. The Proposed Rule provides in part that

> A service to repair, remodel, maintain, or restore tangible personal property that, if sold, leased, or rented at the time the service is performed, would be exempt under Tax Code, Chapter 151 ... due to its nature or its use is exempt from sales and use taxes. Tax is due on the sale of services to repair, remodel, maintain, or restore tangible personal property that was exempt at the time of purchase but would not be exempt at the time the service is performed. For example, services to repair, remodel, maintain, or restore the following are taxable:

[30] 34 Tex. Admin. Code § 3.300(a)(11) (amended to be effective October 12, 2004, 29 Tex. Reg. 9551).

[31] 34 Tex. Admin. Code § 3.300(a)(10) (amended to be effective October 12, 2004, 29 Tex. Reg. 9551).

> (i) tangible personal property purchased from an organization exempted from paying sales or use tax by Tax Code, Chapter 151

Although we acknowledge that this concept exists in the Current Rule, we respectfully note that it is confusing and potentially misleading as worded, including because the introduction to the examples—"services to repair, remodel, maintain, or restore the following are taxable"—suggests that other exemptions might not apply in the listed scenarios; such a conclusion would, of course, be inconsistent with the first full sentence of section (b)(1)(E) and with the meaning of this provision. We respectfully suggest that the Comptroller consider rewording the sentence introducing the list of examples as follows:

> For example, services to repair, remodel, maintain, or restore the following tangible personal property will not qualify for exemption based solely on the fact that such tangible personal property was exempt at the time of its purchase.

Similarly, though the example appearing in section (b)(1)(E)(i) is present in the Current Rule, we respectfully note that it is also confusingly worded, and we suggest that the Comptroller clarify the specific provision or provisions of Tax Code, Chapter 151 addressed by this provision.[32]

E. "Parts and materials"

The Proposed Rule provides that

> A service provider may issue a properly completed resale certificate instead of paying sales or use tax on the purchase of parts and materials that are integral to repairing, remodeling, maintaining, or restoring tangible personal property belonging to another and are transferred to the care, custody, and control of the purchaser of the taxable service.

We respectfully suggest that the Comptroller delete references to "parts and materials" and instead refer to "tangible personal property," both for clarity and to avoid inadvertently limiting the category of items to which the resale exemption should apply.

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[32] We understand that the Comptroller may intend to refer in this provision to organizations listed in Tex. Tax Code Ann. §§ 151.309 and 151.310(a).

F. Examples of "consumable supplies"

We respectfully note that the examples of consumable supplies in Proposed Rule 3.292(a)(4) may cause confusion as drafted. The Proposed Rule includes "grit used for sandblasting" as a consumable supply, suggesting that such grit is "completely used up or destroyed" after a single use. We note that in some industries, grit for sandblasting is captured during the sandblasting process so that it may be reused in subsequent jobs. Such grit is perhaps therefore more appropriately considered a "material" that is used in repair, and not a consumable supply. We respectfully suggest that the Comptroller should consider either striking the listed examples or listing different examples in the definition of "consumable supplies."

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. We also reiterate our earlier request for a roundtable meeting to address these issues, and would welcome the opportunity to participate in such a discussion. Thank you for your consideration.

TAX SECTION
OF
THE STATE BAR OF TEXAS

2016 – 2017 CALENDAR

June 2016	
6	**Pro Bono Calendar Call-Houston**
8	**2016-2017 Tax Section Officer Planning Retreat** Meadows Collier 901 Main Street, Suite 3700, Dallas, TX 75202 11:30 a.m. – 3:30 p.m.
8 – 10	**Annual Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
15	**Leadership Academy Reception & Dinner @ Reata Restaurant** 310 Houston Street Fort Worth, TX 76102 6:30 p.m. Reception & 7:00 p.m. Dinner
15 - 17	**Leadership Academy Program (2nd of 4 programs)** Fort Worth Omni and Convention Center 1300 Houston St. Fort Worth, TX 76102
16	**2016-2017 Tax Section Council Planning Retreat** Location: City Club, Speaker's Room – 4th Flr. 301 Commerce St. Fort Worth, TX 76102 1:00 p.m. - 4:00 p.m.
16	**2016 Tax Section Annual Meeting Speaker's Dinner** Reata Restaurant 310 Houston St. Fort Worth, TX 76102 Cocktails @ 6:30 p.m. – Roof Top Terrace Dinner @7:30 p.m.- the Dome
16	**Presentation of Law Student Scholarship Awards** Award Presentations at State Bar Annual Meeting, Speakers' Dinner Reata Restaurant 310 Houston St. Fort Worth, TX 76102 Cocktails @ 6:30 p.m. – Roof Top Terrace Dinner @7:30 p.m.

17	**2016 Tax Section Annual Meeting Program** Fort Worth Omni and Convention Center 1300 Houston St. Fort Worth, TX 76102
17	**Presentation of 2016 Outstanding Texas Tax Lawyer Award** Award Presentation During Tax Section Annual Meeting Program
21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# Jeff Blair hosting 9:00am
28	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
July 2016	
14-16	**Texas Bar College** Summer School Moody Gardens Hotel Galveston, TX
19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
25	**SBOT Chair and Treasurer Training** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
26	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
August 2016	
4 – 9	**ABA Annual Meeting** **Taxation Section – Aug. 5th @ Four Seasons** San Francisco, CA
16	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
23	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
26	**Meeting of Council, Committee Chairs, and Committee Vice Chairs (up to 30-40 pp)** Hosted by Jones Day Dallas, TX 10:30 a.m. – 12:30 a.m. w/lunch Dial-in information will be distributed via email.
27	**Tax Resolution Day (for Taxpayers scheduled for the 9/26 and 10/17 trial sessions** **9:00 a.m. – 12 Noon (extend timeframe if needed)**
Sept 2016	
12	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** Houston

15	**Deadline for Appointment of Tax Section Nominating Committee** Chair: David Colmenero
16	**Submission Deadline – Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Michelle Spiegel mspiegel@mayerbrown.com
20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
22	**Leadership Academy Tour – Menil Collection &** **Dinner-Link Lee Mansion – Univ. of St. Thomas** Houston, TX 5:00 p.m.
23	**Leadership Academy (3rd of 4 programs)** Norton Rose Fulbright Houston, TX
26	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** Dallas
27	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
29	**ABA Joint Fall CLE Meeting** Westin Boston Waterfront Boston, MA
	Outreach to Law Schools Texas Tech University School of Law Lubbock, TX
Oct 2016	
4	**State and Local Tax Committee Annual Comptroller Briefing** **Co-Sponsored with TSCPA and TEI** Austin, TX
	Outreach to Law Schools Southern Methodist University Dedman School of Law Dallas, TX
7	**Council of Chairs Meeting** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
15	**Tax Resolution Day (for Taxpayers scheduled for the 11/14 and 11/28 trial sessions** **9:00 a.m. – 12 Noon (extend timeframe if needed)**
17	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Dallas
18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am

25	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
25-26	**Advanced Tax Law Course** **Co-Sponsored with TexasBarCLE** Location: TBD Austin, TX Note: Information re: program, registration and hotel will be available 2 mths. prior to program date.
28-29	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting** **San Francisco, CA**
31*	**Pro Bono Calendar Call** **Regular and Small Tax Case Calendar** **United States Tax Court** El Paso ***Note: *10/31 (3) - Starting Date (Duration)***
Nov 2016	
3	**Pro Bono Calendar Call** **Regular & Small Tax Case Calendar** **United States Tax Court** Lubbock ***Note: *11/03 (2) - Starting Date (Duration)***
3	**19th Annual International Tax Symposium** **Co-Sponsored with the Dallas CPA Society** Cityplace Conference Center Dallas, TX
4	**19th Annual International Tax Symposium** **Co-Sponsored with the Houston CPA Society** 777 Post Oak Blvd., Suite 500 Houston, TX 77056
10	**Meeting of Council** (approx. 20-24pp) Meadows Collier 901 Main Street, Suite 3700, Dallas, TX 75202 Dallas, TX 10:30 a.m. – 12:30 a.m. w/lunch
14	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** Dallas
15	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
22	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
28	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Dallas

Dec. 2016	
5	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Houston
13	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
27	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
Jan. 2017	
6	**Nomination Period Opens for 2017 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2017 • Nomination forms to be posted on website and distributed via eblast • Submit nomination forms to Tax Section Secretary: Catherine Scheid (ccs@scheidlaw.com)
9	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** San Antonio
13	**Submission Deadline – Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Michelle Spiegel mspiegel@mayerbrown.com
16	**Application Period Opens for Law Student Scholarship Program**
17	**Leadership Academy Happy Hour w/Austin Chapter CPA Leap Group** Location and Time: TBD
18	**Leadership Academy (4th of 4 programs)** Norton Rose Fulbright **Leadership Academy Graduation Dinner w/Talmadge Boston** Max's Wine Dive 6:00 p.m. – 9:00 p.m. Austin, TX
19-21	**ABA Midyear Meeting** Hilton Bonnet Creek & Waldorf Astoria Orlanda, FL
24	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
24	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
27	**Meeting of Council, Committee Chairs, and Committee Vice Chairs (up to 30-40 pp)** Hosted by Norton Rose Fulbright Houston, TX 10:30 a.m. – 12:30 a.m. w/lunch Dial-in information will be distributed via email.
30	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Dallas

Feb. 2017	
3	**Tax Law in a Day CLE** Location: Dallas (Cityplace Conference Center)
13	**Pro Bono Calendar Call** **Small Tax Case Calendar** **United States Tax Court** Houston
17	**Council of Chairs Meeting** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
28	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
March 2017	
1	**Nomination Deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
6	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Houston
	Calendar Call - Dallas
	Calendar Call – Houston
	Calendar Call – San Antonio
21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
27	**Pro Bono Calendar Call** **Regular Case Calendar** **United States Tax Court** Houston
28	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
April 2017	
1	**Nominations for Outstanding Texas Tax Lawyer Due to Catherine Scheid** Email**:** (ccs@scheidlaw.com)
7	**Law Student Scholarship Application Deadline**
11	**Nominating Committee Report Due to Council**
14	**Submission Deadline – Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Michelle Spiegel mspiegel@mayerbrown.com
18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am

21	**Meeting of Council (20-24 pp)** Meadows Collier 901 Main Street, Suite 3700, Dallas, TX 75202 10:30 a.m. – 12:30 a.m. w/lunch <u>Note: Council Vote and Selection of Recipient of 2017 Outstanding Texas Tax Lawyer Award</u>
21	**Council Vote and Selection of Recipient of 2017 Outstanding Texas Tax Lawyer Award**
25	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
	Property Tax Committee Meeting and Legal Seminar Location: TBD
May 2017	
11-13	**ABA May Meeting** Grand Hyatt Washington, DC
	Pro Bono Calendar Call – San Antonio
	Pro Bono Calendar Call – Houston
	Pro Bono Calendar Call – Dallas
23	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
23	**SBOT Tax Section Officer Monthly Call/Meeting @ 4:00 p.m.**
June 2017	
	Pro Bono Calendar Call - Houston
14-16	**Annual Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00am
22-23	**SBOT Annual Meeting** Hilton Anatole Dallas, TX
22	**Tax Section Council Planning Retreat** Hilton Anatole Dallas, TX 1:00 p.m. - 4:00 p.m.
22	**2017 Tax Section Annual Meeting Speaker's Dinner** Location: TBD Dallas, TX
22	**Presentation of Law Student Scholarship Awards** Award Presentations at State Bar Annual Meeting, Speakers' Dinner Location: TBD Dallas, TX

23	**2017 Tax Section Annual Meeting Program** Hilton Anatole Dallas, TX
23	**Presentation of 2017 Outstanding Texas Tax Lawyer Award** Award Presentation During Tax Section Annual Meeting Program Hilton Anatole Dallas, TX
TBD	**2017-2018 Tax Section Council Planning Retreat**

TAX SECTION
STATE BAR OF TEXAS

LEADERSHIP ROSTER
2016-2017

Officers

David Colmenero (Chair)
Meadows, Collier, Reed, Cousins,
Crouch & Ungerman, L.L.P.
901 Main Street, Suite 3700
Dallas, TX 75202
214.749.2462 or 214.744.3700
dcolmenero@meadowscollier.com

Stephanie M. Schroepfer (Chair-Elect)
Norton Rose Fulbright
1301 McKinney, Suite 5100
Houston, Texas 77010
713-651-5591
stephanie.schroepfer@nortonrosefulbright.com

Catherine Scheid (Secretary)
Law Offices of Catherine C. Scheid
4301 Yoakum Blvd.
Houston, Texas 77006
713-840-1840
ccs@scheidlaw.com

Charolette F. Noel (Treasurer)
Jones Day
2727 North Harwood Street
Dallas, Texas 75201
214-969-4538
cfnoel@jonesday.com

Appointed Council Members

Jason B. Freeman
Government Submissions (COGS) Co-Chair
Freeman Law, PLLC
2595 Dallas Parkway, Suite 420
Frisco, Texas 75033
214-984-3410
jason@freemanlaw-pllc.com

J. Michael Threet
CLE Chair
Hayes & Boone
2323 Victory Avenue, Suite 700
Dallas, Texas 75219
214-651-5000
michael.threet@hayesboone.com

Henry Talavera
Government Submissions (COGS) Co-Chair
Polsinelli PC
2501 N. Harwood, Suite 1900
Dallas, Texas 75201
214-661-5538
htalavera@polsinelli.com

Michelle Spiegel
Newsletter Editor
Mayer Brown, LLP
700 Louisiana Street, Suite 3400
Houston, Texas 77002
713-238-3000
mspiegel@mayerbrown.com

Ira Lipstet
Government Submissions (COGS) Co-Chair
DuBois, Bryant & Campbell, LLP
303 Colorado, Suite 2300
Austin, Texas 78701
512-381-8040
ilipstet@dbcllp.com

Christi Mondrik
Leadership Academy Co-Program Director
Mondrik & Associates
11044 Research Blvd., Suite B-400
Austin, Texas 78759
512-542-9300
cmondrik@mondriklaw.com

Robert C. Morris
Leadership Academy Co-Program Director
Term expires 2017
Norton Rose Fulbright
1301 McKinney, Suite 5100
Houston, Texas 77010
713-651-8404
robert.morris@nortonrosefulbright.com

Juan Vasquez, Jr.
Pro Bono Chair
Chamberlain, Hrdlicka, White,
Williams & Aughtry LLP
1200 Smith Street – 14th Floor
Houston, Texas 77002
713-654-9679
juan.vasquez@chamberlainlaw.com

Jim Roberts
Sponsorship Task Force Chair
Glast, Phillips and Murray, PC
14801 Quorum Drive, Suite 500
Dallas TX 75254
972-419-7189
jvroberts@gpm-law.com

Elected Council Members

Lora G. Davis
Term expires 2017
Davis Stephenson, PLLC
100 Crescent Court, Suite 440
Dallas, Texas 75201
214-396-8801
lora@davisstephenson.com

Robert C. Morris
Term expires 2017
Norton Rose Fulbright
1301 McKinney, Suite 5100
Houston, Texas 77010
713-651-8404
robert.morris@nortonrosefulbright.com

Jeffry M. Blair
Term expires 2017
Hunton & Williams, LLP
1445 Ross Ave., Suite 3700
Dallas, Texas 75202
214-468-3306
jblair@hunton.com

Sam Megally
Term expires 2018
K&L Gates, LLP
1717 Main Street, Suite 2800
Dallas, Texas 75201
214-939-5491
sam.megally@klgates.com

Chris Goodrich
Term expires 2018
Crady, Jewett & McCulley, LLP
2727 Allen Parkway, Suite 1700
Houston, Texas 77019
713-739-7007 Ext 174
cgoodrich@cjmlaw.com

Jaime Vasquez
Term expires 2018
Chamberlain, Hrdlicka, White,
Williams & Aughtry LLP
112 East Pecan Street, Suite 1450
San Antonio, Texas 78205
210-507-6508
jaime.vasquez@chamberlainlaw.com

Richard Hunn
Term expires 2019
Norton Rose Fulbright
1301 McKinney, Suite 5100
Houston, Texas 77010
713-651-5293
richard.hunn@nortonrosefulbright.com

David C. Gair
Term expires 2019
Gray Reed & McGraw P.C.
1601 Elm Street, Suite 4600
Dallas, Texas 75201
214-954-4135
dgair@grayreed.com

Robert D. Probasco
Term expires 2019
The Probasco Law Firm
9113 La Strada Ct.
Dallas, Texas 75220
214-335-7549
robert.probasco@probascotaxlaw.com

Ex Officio Council Members

Alyson Outenreath
Immediate Past Chair
Texas Tech University School of Law
1802 Hartford Avenue
Lubbock, Texas 79409
806-834-8690
alyson.outenreath@ttu.edu

Professor Bruce McGovern
Law School Representative
South Texas College of Law
1303 San Jacinto
Houston, Texas 77002
713-646-2920
bmcgovern@hcl.edu

Matthew C. Jones
Assistant General Counsel
Litigation & Taxation
Texas Comptroller of Public Accounts
P.O. Box 13528
Austin, Texas 78711-3528
512-936-8590
matthew.jones@cpa.texas.gov

Abbey B. Garber
IRS Representative
Internal Revenue Service
MC 2000 NDAL
13th Floor
4050 Alpha Road
Dallas, Texas 75244
469-801-1113
abbey.b.garber@irscounsel.treas.gov

TAX SECTION

THE STATE BAR OF TEXAS

COMMITTEE CHAIRS AND VICE CHAIRS

2016-2017

COMMITTEE	CHAIR	VICE CHAIR
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2. **Continuing Legal Education**	**J. Michael Threet** Haynes & Boone, LLP 2323 Victory Ave., Suite 700 Dallas, Texas 75219 214-651-5091 michael.threet@haynesboone.com	**Amanda Traphagan** Seay Traphagan 807 Brazos St., Suite 304 Austin, Texas 78701 512-582-0120 atraphagan@seaytaxlaw.com **Jim Roberts** Glast, Phillips & Murray, PC 14801 Quorum Dr., Suite 500 Dallas, Texas 75254 972-419-7189 jvroberts@gpm-law.com
3. **Corporate Tax**	**Jeffry M. Blair** Hunton & Williams, LLP 1445 Ross Ave., Suite 3700 Dallas, Texas 75202 214-468-3306 jblair@hunton.com **Ryan Gardner** Gardner Firm PLLC 6793 Old Jacksonville, Ste. B Tyler, Texas 75703 903-705-1101 rg@glgtx.com	

COMMITTEE	CHAIR	VICE CHAIR
4. Employee Benefits	**Susan A. Wetzel** Haynes & Boone 2323 Victory Ave., Suite 700 Dallas, Texas 75219 214-651-5389 susan.wetzel@haynesboone.com	**(Joe) Robert Fowler** Baker Botts, LLP 910 Louisiana St. Houston, Texas 77002-4995 713-229-1229 rob.fowler@bakerbotts.com
	Henry Talavera Polsinelli PC 2501 N. Harwood, Suite 1900 Dallas, Texas 75201 214-661-5538 htalavera@polsinelli.com	**Sarah Fry** Locke Lord Edwards 2200 Ross Ave., Suite 2200 Dallas, Texas 75201 214-740-8424 sarah.fry@lockelord.com
		James R. Griffin Jackson Walker 901 Main St., Suite 600 Dallas, Texas 75202 214-953-5827 jgriffin@jw.com
5. Energy and Natural Resources Tax	**Crawford Moorefield** Strasburger & Price 909 Fanning St., Suite 2300 Houston, Texas 77010 713-951-5629 crawford.moorefield@strasburger.com	**Todd Lowther** Thompson & Knight, LLP 333 Clay St., Houston, Texas 77002 713-653-8667 todd.lowther@tklaw.com
		Hersh Verma Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010 713-651-5151 hersh.verma@nortonrosefulbright.com

COMMITTEE	CHAIR	VICE CHAIR
6. Estate and Gift Tax	**Celeste C. Lawton** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 713-651-5278 celeste.lawton@nortonrosefulbright.com	**Matthew S. Beard** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main St., Suite 3700 Dallas, Texas 75202 214-749-2450 mbeard@meadowscollier.com
	Laurel Stephenson Davis Stephenson, PLLC 100 Crescent Ct., Suite 440 Dallas, Texas 75201 214-396-8800 laurel@davisstephenson.com	**Carol Warley** RSM US LLP 1400 Post Oak Blvd., Suite 900 Houston, Texas 77056 713-625-3500 or 713-625-3583 carol.warley@rsmus.com
7. General Tax Issues	**Brian Teaff** BRACEWELL LLP 711 Louisiana St., Suite 2300 Houston, Texas 77002 713-221-1367 brian.teaff@bracewelllaw.com	**Prof. Bruce McGovern** South Texas College of Law 1303 San Jacinto Houston, Texas 77002 713-646-2920 bmcgovern@hcl.edu
8. International Tax	**John Strohmeyer** Crady, Jewett & McCulley, LLP 2727 Allen Pkwy., Suite 1700 Houston, Texas 77019 713-739-7007 jstrohmeyer@cjmlaw.com	
	Benjamin Vesely BDO USA, LLP 700 N. Pearl St., Suite 2000 Dallas, Texas 75201 214-665-0763 bvesely@bdo.com	**Austin Carlson** Gray Reed & McGraw, PC 1300 Post Oak Blvd., Ste. 2000 Houston, Texas 77056 713-986-7213 acarlson@grayreed.com

COMMITTEE	CHAIR	VICE CHAIR
9. Partnership and Real Estate	**Steve A. Beck** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main St., Suite 3700 Dallas, Texas 75202 214-749-2401 sbeck@meadowscollier.com	
	Chester Grudzinski Kelly Hart & Hallman 201 Main St., Suite 2500 Fort Worth, Texas 76102 817-878-3584 chester.grudzinski@kellyhart.com	**Christopher Ohlgart** Norton Rose Fulbright US LLP 1301 McKinney, Ste. 5100 Houston, Texas 77010 713-651-5151 christopher.ohlgart@nortonrosefulbright.com
10. Property Tax	**Rick Duncan** Blackwell & Duncan, PLLC 500 N. Central Expy, Suite 427 Plano, Texas 75074 214-380-2810 duncan@txproptax.com	**Braden Metcalf** Nichols, Jackson, Dillard, Hager & Smith, LLP 1800 Lincoln Plaza, 500 N Akard St. Dallas, Texas 75201 214-736-1664 bmetcalf@njdhs.com
11. Solo and Small Firm	**Sara Giddings** Smith Rose Finley 36 W Beauregard Ave., Ste 300 San Angelo, Texas 76903 325-600-4319 sgiddings@smithrose.com	
	Dustin Whittenburg Law Office of Dustin Whittenburg 4040 Broadway, Suite 450 San Antonio, Texas 78209 210-826-1900 dustin@whittenburgtax.com	**Lee Wilson** The Wilson Firm 2002 Timberloch Pl, Suite 550A The Woodlands, Texas 77380 281-210-0140 lwilson@thewilsonfirmpllc.com

COMMITTEE	CHAIR	VICE CHAIR
12. State and Local Tax	**Sam Megally** K&L Gates, LLP 1717 Main Street, Suite 2800 Dallas, Texas 75201 214-939-5491 sam.megally@klgates.com	**Matt Hunsaker** Baker Botts, L.L.P. 2001 Ross Avenue Dallas, Texas 75201 214-953-6828 matt.hunsaker@bakerbotts.com **Kirk Lyda** Jones Day 2727 North Harwood Street Dallas, Texas 75201 214-969-5013 klyda@jonesday.com **Stephen Long** Baker & McKenzie LLP 2001 Ross Ave., Suite 2300 Dallas, Texas 75201 214-965-3086 stephen.w.long@bakernet.com
13. Tax Controversy	**Richard L. Hunn** Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010 713-651-5293 richard.hunn@nortonrosefulbright.com **Mike A. Villa** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-749-2405 mvilla@meadowscollier.com	**David C. Gair** Gray Reed & McGraw, P.C. 1601 Elm Street, Suite 4600 Dallas, Texas 75201 214-954-4135 dgair@grayreed.com

COMMITTEE	CHAIR	VICE CHAIR
14. Tax-Exempt Finance	**Peter D. Smith** Norton Rose Fulbright 98 San Jacinto Blvd., Suite 1100 Austin, Texas 78701 512-536-3090 peter.smith@nortonrosefulbright.com	**Irina Barahona** Kemp Smith 221 North Kansas, Suite 1700 El Paso, Texas 79901 915-546-5205 irina.barahona@kempsmith.com **Adam Harden** Norton Rose Fulbright 98 San Jacinto Blvd., Suite 1100 Austin, Texas 78701 512-536-3090 adam.harden@nortonrosefulbright.com
15. Tax-Exempt Organizations	**Terri Lynn Helge** Texas A&M University School of Law 1515 Commerce Street Fort Worth, Texas 76102-6509 817-429-8050 thelge@law.tamu.edu	**[Pending]**
16. Government Submissions	**Ira A. Lipstet** DuBois, Bryant & Campbell, LLP 303 Colorado, Suite 2300 Austin, Texas 78701 512-381-8040 ilipstet@dbcllp.com **Henry Talavera** Polsinelli PC 2501 N. Harwood, Suite 1900 Dallas, Texas 75201 214-661-5538 htalavera@polsinelli.com **Jason Freeman** Freeman Law, PLLC 2595 Dallas Parkway, Suite 420 Frisco, Texas 75034 214.984.3410 jason@freemanlaw-pllc.com	**Jeffry M. Blair** Hunton & Williams, LLP 1445 Ross Avenue, Suite 3700 Dallas, Texas 75202 214-468-3306 jblair@hunton.com

COMMITTEE	CHAIR	VICE CHAIR
17. Newsletter	**Michelle Spiegel** Mayer Brown, LLP 700 Louisiana St., Suite 3400 Houston, Texas 77002 713-238-3000 mspiegel@mayerbrown.com	
18. Tax Law in a Day	**Lora G. Davis** Davis Stephenson, PLLC 100 Crescent Court, Suite 440 Dallas, Texas 75201 214-396-8801 lora@davisstephenson.com	
19. Pro Bono	**Juan F. Vasquez, Jr.** Chamberlain, Hrdlicka, White, Williams & Aughtry, LLP 1200 Smith Street, 14th Floor Houston, Texas 78205 713-654-9679 juan.vasquez@chamberlainlaw.com	**Jaime Vasquez** Chamberlain, Hrdlicka, White, Williams & Aughtry, LLP 112 East Pecan Street, St 1450 San Antonio, Texas 78205 210-507-6508 jaime.vasquez@chamberlainlaw.com **Tiffany Hamil** Law office of Tiffany Hamil 6440 N. Central Expressway Turley Law Center 316 Dallas, TX 75206 214-369-0909 dfwtaxadvisor@gmail.com **Joseph Perera** Strasburger 2301 Broadway Street San Antonio, TX 78215 210-250-6119 joseph.perera@strasburger.com

COMMITTEE	CHAIR	VICE CHAIR
20. Leadership Academy	**Christi Mondrik** Mondrik & Associates 11044 Research Blvd., Suite B-400 Austin, Texas 78759 512-542-9300 cmondrik@mondriklaw.com **Robert C. Morris** Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010 713-651-8404 robert.morris@nortonrosefulbright.com	N/A (Planning Committee)