THE TEXAS TAX LAWYER

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Practitioner's Corner:

CHAIR'S MESSAGE

Greetings and welcome to another busy year for the Section of Taxation of the State Bar of Texas. Things are already off to a fast start thanks to the hard work of my fellow officers Mary McNulty (Chair-Elect), Tina Green (Secretary), and Elizabeth Copeland (Treasurer), as well as the efforts of all of our Council members, Committee Chairs and Vice Chairs, and the many other members who volunteer, without whom our Section could not be a success.

Below is a bullet-point list of our ongoing and upcoming projects and events (more detailed descriptions of these items are available on our website: www.texastaxsection.org). There should be something of interest to every member of the tax section:

- Mark your calendars for our 13th Annual International Tax Symposium to be held at The Center for American & International Law, 5201 Democracy Drive, Plano, Texas on November 5th, 2010. For further information, view the brochure on our website or contact the head of the International Tax Committee, Andrius R. Kontrimas, at (713) 651-5482.

- We now have over 40 CLE programs available free of charge to our members through the Section's 24/7 webcast library, which includes over 40 hours of allowable CLE credit, over 3 of which count towards the ethics requirement. If you have any questions, please contact J. Michael Threet, the head of our CLE Committee, at (214) 969-2795.

- Our COGS program, which provides comments to governmental authorities on federal and state tax laws, is already geared up for an active year. Two of our section members, Mandi Matlock and Robert D. Probasco, have already been scheduled to provide Congressional testimony with respect to their work on a Circular 230 comment project (the Section seeks to encourage such testimony and funds the travel expenses for the Section's members). If you wish to get involved with on ongoing project or have ideas for leading one yourself, please contact the COGS Committee chair, Stephanie M. Schroepfer, at (713) 651-5591.

- Through the pro bono committee's programs, the Section serves people who cannot afford to pay for the services of a tax lawyer. Through the Tax Court Pro Bono Program, Section members advise pro se tax payers who appear at calendar calls of the United States Tax Court held in Texas cities. Through the VITA program, Section members help lower-income taxpayers in the preparation of their federal income tax returns, with a focus on helping qualified taxpayers take the earned income tax credit. If you wish to volunteer, please contact the chair of our Pro Bono Committee, Gerald Brantley, at (512) 637-1045.

- We continue to expand our law school outreach program and are looking for volunteer tax attorneys to serve as panelists in our effort to educate students about the exciting (or, at least, challenging) world of tax law. If you wish to serve as a panelist, please contact the head of our law school student outreach program, Abbey B. Garber, at (972) 308-7913.

And now please allow me to address a few housekeeping matters. First, I want to thank my predecessor, Tyree Collier, for all of his hard work—we've gotten off to a running start this year thanks to the groundwork he laid down last year. Also, congratulations to Andrea Marks for her winning entry in our student note award contest, Living the Dream: How I.R.C. § 195 can Jump-Start the American Economy, which you can read in this October 2010 issue of the Texas Tax Lawyer. Ms. Marks (University of Houston Law Center, Class of 2010) received a check for

$1,000 and a plaque that was presented to her at the September meeting of the Houston Bar Association Tax Section by the Section of Taxation Council Member Ron Adzgery.

I also want to again congratulate Charles O. Galvin, who in June became the seventh individual to receive the Outstanding Texas Tax Lawyer Award from the Section, the highest honor bestowed by the Section. This year's nomination form is on our website and is included in this October 2010 issue of the Texas Tax Lawyer. Nominations must be made by January 15, 2011. Please take a few minutes and consider nominating a worthy individual for this award.

On the subject of nominations, I have appointed the Section's nominating committee for 2010-2011. The nominating committee consists of Dan Micciche (fax 214-969-4343), Kevin Thomason (fax 214-999-9261), Tyree Collier (fax 214-999-1655), and me as an ex officio member. Nominations for Chair-Elect, Secretary, Treasurer, or an Elected Council Member position can be submitted to any member of the nominating committee or to any Officer of the Section at any time on or before March 1, 2011.

And now I'd like to give you a peek at some coming attractions. First, Andrius R. Kontrimas is working on a listserv project which we hope to roll out within the month that will provide section and committee members with a variety of email forums for sharing tips, concerns, referrals and other matters with their fellow members. We are trying to make this very user friendly without being disruptive to our busy schedules. You should receive an announcement shortly regarding this exciting initiative (if you have not already done so since this newsletter has gone to press). Also, thanks to the hard work of Bill Elliott, we have already committed a heavy hitter, Larry Gibbs, former IRS Commissioner, as our headline speaker at our annual meeting on June 24th as part of the State Bar's Annual Meeting. Bill has also agreed to produce a series of video interviews with Tax Legends which shall be posted on our website. I am very excited and honored that the tax section is able to underwrite this important project.

Finally, if you are not already involved in the Section's activities, I encourage you to get involved. Take a quick look at the Section's leadership roster in this issue of the Texas Tax Lawyer, identify a committee where you think you can help, and call or email the chair of that committee. If you are not sure who to contact, then call (512-536-5264) or email (podaniel@fulbright.com) me. You will not only help to build and maintain a stronger Section, but I think you will find that it is fun.

Thanks, and I look forward to working with all of you and to a great year.

Patrick L. O'Daniel, Chair

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STATE BAR *of* TEXAS
13th Annual
INTERNATIONAL TAX SYMPOSIUM
NOVEMBER 5, 2010

Registration Form

The Center for American & International Law ☆ 5201 Democracy Drive ☆ Plano, TX

Name |

Firm/Company |

Address |

Telephone |

E-mail Address |

Materials Delivery | Please specify whether you would prefer to receive the materials in an electronic or printed format.
☐ *electronic* ☐ *printed notebook*

Please complete this form and mail it along with your $200 check made payable to "Tax Section State Bar of Texas" to

Victoria Beard
Fulbright & Jaworski LLP
1301 McKinney, Suite 5100
Houston, TX 77010

Be sure to reference the name of the attendee

Questions? Please contact:
Victoria Beard @ 713-651-8442 or vbeard@fulbright.com

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2010-2011 CALENDAR

July 2010	
23	2010 SBOT New Chair and Treasurer Orientation – Houston
August 2010	
16	
25	Nuts & Bolts of Tax Workshop - Houston
26-27	28th Annual Advanced Tax Law Course – Houston
September 2010	
10	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Fulbright & Jaworski LLP 600 Congress Avenue, Suite 2400 Austin, Texas 78701 (512) 474-5201
23-25	ABA Section of Taxation 2010 Joint Fall CLE Meeting – Toronto
30	Deadline for submitting articles for the Fall 2010 issue of the *Texas Tax Lawyer*
October 2010	
18	Pro Bono Committee Calendar Call Assistance United States Tax court Dallas, Texas
18	Pro Bono Committee Calendar Call Assistance United States Tax court Lubbock, Texas
25	Pro Bono Committee Calendar Call Assistance United States Tax court Houston, Texas
31	Fall 2010 Issue of The Texas Tax Lawyer
November 2010	
1	Pro Bono Committee Calendar Call Assistance United States Tax court San Antonio, Texas
5	13th Annual International Tax Symposium The Center for American and International Law 5201 Democracy Drive Plano, Texas 75024

12	10:30 a.m. – 12:30 p.m. Council Meeting Fulbright & Jaworski LLP 600 Congress Avenue, Suite 2400 Austin, Texas 78701 (512) 474-5201
15	Pro Bono Committee Calendar Call Assistance United States Tax court Houston, Texas
December 2010	
6	Pro Bono Committee Calendar Call Assistance United States Tax court El Paso, Texas
January 2011	
20-22	ABA Section of Taxation 2011 Midyear Meeting – Boca Raton
21	Final Deadline for submitting articles for the Winter 2011 issue of the *Texas Tax Lawyer*
28	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting Fulbright & Jaworski LLP 600 Congress Avenue, Suite 2400 Austin, Texas 78701 (512) 474-5201
February 2011	
28	Winter 2011 Issue of The Texas Tax Lawyer
March 2011	
-	- - -
April 2011	
8	10:30 a.m. – 12:30 p.m. Council Meeting Fulbright & Jaworski LLP 600 Congress Avenue, Suite 2400 Austin, Texas 78701 (512) 474-5201
22	Deadline for submitting articles for the Spring 2011 issue of the *Texas Tax Lawyer*
May 2011	
5-7	ABA Section of Taxation 2011 May Meeting – Washington, DC
13	Spring 2011 Issue of The Texas Tax Lawyer
June 2011	
9-10	25th Annual Texas Federal Tax Institute – San Antonio
23-24	State Bar of Texas 2011 Annual Meeting – San Antonio
24	2011 Annual Members' Meeting - Section of Taxation of the State Bar of Texas – San Antonio

CALL FOR NOMINATIONS FOR OUTSTANDING TEXAS TAX LAWYER AWARD

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

Nominations can be filled out online and submitted to Patrick O'Daniel, either by email (podaniel@fulbright.com) or hardcopy (fax number (512) 536-4598) no later than January 15, 2011. The award will be presented at the 2011 Texas Federal Tax Institute in San Antonio on June 10, 2011.

NOMINATION FOR OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name:____

Mailing Address:____

____

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

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Additional pages may be attached if desired.

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

SECTION OF TAXATION OF THE STATE BAR OF TEXAS
2010-2011
LEADERSHIP ROSTER

Officers

Patrick O'Daniel (Chair)
Fulbright & Jaworski LLP
600 Congress Avenue, Suite 2400
Austin, Texas 78701
512-536-5264
512-536-4598 (fax)
podaniel@fulbright.com

Mary McNulty (Chair-Elect)
Thompson & Knight LLP
One Arts Plaza
1722 Routh Street, Suite 1500
Dallas, Texas 75201-2533
214-969-1187
214-880-3182 (fax)
mary.mcnulty@tklaw.com

Tina R. Green (Secretary)
Capshaw Green, PLLC
2801 Richmond Road #46
Texarkana, Texas 75503
903-223-9544
888-371-7863 (fax)
tgreen@capshawgreen.com

Elizabeth Copeland (Treasurer)
Oppenheimer Blend Harrison & Tate, Inc.
711 Navarro, Suite 600
San Antonio, Texas 78205-1796
210-224-2000
210-224-7540 (fax)
ecopeland@obht.com

Appointed Council Members

Stephanie M. Schroepfer
COGS Chair
Fulbright & Jaworski L.L.P.
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-5591
713-651-3246 (fax)
sschroepfer@fulbright.com

J. Michael Threet
CLE Chair
Akin Gump Strauss Hauer & Feld LLP
1700 Pacific Avenue, Suite 4100
Dallas, Texas 75201
214-969-2795
214-969-4343 (fax)
mthreet@akingump.com

Andrius Kontrimas
Newsletter Editor
Fulbright & Jaworski LLP
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-5151
613-651-5246 (fax)
akontrimas@fulbright.com

Gerald Brantley
Pro Bono Chair
Law Office of Gerald Brantley
9600 Great Hills Trail, Ste. 150W
Austin, Texas 78759
512-637-1045
512-637-1046 (fax)
gerald@geraldbrantley.com

Elected Council Members

J. Michael Threet
Term expires 2011
Akin Gump Strauss Hauer & Feld LLP
1700 Pacific Avenue, Suite 4100
Dallas, Texas 75201
214-969-2795
214-969-4343 (fax)
mthreet@akingump.com

Mark Richard Martin
Term expires 2011
Gardere Wynne Sewell LLP
1000 Louisiana, #3400
Houston, Texas 77002
713-276-5391
713-276-6391 (fax)
mmartin@gardere.com

David D. Colmenero
Term expires 2011
Meadows, Collier, Reed,
Cousins & Blau, LLP
901 Main Street, Suite 3700
Dallas, Texas 75202
214-744-3700
214-747-3732 (fax)
dcolmenero@meadowscollier.com

Alyson Outenreath
Term expires 2012
Thompson & Knight LLP
One Arts Plaza
1722 Routh Street, Suite 1500
Dallas, Texas 75201-2533
214-969-1741
214-880-3276 (fax)
alyson.outenreath@tklaw.com

Robert W. Phillpott, Jr.
Term expires 2012
Fulbright & Jaworski LLP
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-5151
713-651-5246 (fax)
rphillpott@fulbright.com

David C. D'Alessandro
Term expires 2012
Vinson & Elkins LLP
Trammell Crow Center
2001 Ross Avenue, Suite 3700
Dallas, Texas 75201-2975
214-220-7890
214-999-7890 (fax)
ddalessandro@velaw.com

Ronald W. Adzgery
Term expires 2013
Fulbright & Jaworski LLP
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-7704
713-651-5246 (fax)
radzgery@fulbright.com

Christi Mondrik
Term expires 2013
Mondrik & Associates
515 Congress Avenue, Suite 1850
Austin, Texas 78701
512-542-9300
512-542-9301 (fax)
cmondrik@mondriklaw.com

Ryan Gardner
Term expires 2013
Kent, Good, Anderson &
Bush, P.C.
Woodgate I, Suite 200
1121 E.S.E. Loop 323
Tyler, Texas 75701
903-579-7510
903-581-3701 (fax)
rgardner@tyler.net

Ex Officio Council Members

Tyree Collier
Immediate Past Chair
Thompson & Knight LLP
One Arts Plaza
1722 Routh Street, Suite 1500
Dallas, Texas 75201-2533
214-969-1409
214-999-1655 (fax)
tyree.collier@tklaw.com

Christopher H. Hanna
Law School Representative
SMU Dedman School of Law
3315 Daniel Avenue
Dallas, Texas 75205
214-768-4394
214-768-3142 (fax)
channa@mail.smu.edu

Lia Edwards
Comptroller Representative
Comptroller of Public Accounts
Tax Policy Division
P.O. Box 13528
Austin, Texas 78711-3528
512-475-0221
512-475-0900 (fax)
lia.edwards@cpa.state.tx.us

Abbey B. Garber
IRS Representative
Internal Revenue Service
MC 2000 NDAL
13th Floor
4050 Alpha Road
Dallas, TX 75244
972-308-7913
abbey.b.garber@irscounsel.treas.gov

Committee Chairs and Vice Chairs

	COMMITTEE	CHAIR	VICE CHAIR
1.	**Continuing Legal Education**	**Ronald W. Adzgery** Fulbright & Jaworski LLP 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-7704 713-651-5246 (fax) radzgery@fulbright.com	**J. Michael Threet** Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Suite 4100 Dallas, Texas 75201 214-969-2795 214-969-4343 (fax) mthreet@akingump.com
			Lawrence Ray Jones, Jr. Townsend & Jones LLP 8100 Lomo Alto, #238 Dallas, Texas 75225-6545 214-696-2661 214-764-3320 (fax) larry@tjtaxlaw.com
			Robert Maddox Kemp Smith P.C. 221 North Kansas, Suite 1700 El Paso, Texas 79901 915-533-4424 915-546-5360 (fax) bmad@kempsmith.com
2.	**Corporate Tax**	**Ryan Gardner** Kent, Good, Anderson & Bush, P.C. Woodgate I, Suite 200 1121 E.S.E. Loop 323 Tyler, Texas 75701 903-579-7510 903-581-3701 (fax) rgardner@tyler.net	**Jeffrey M. Blair** Hunton & Williams LLP 1445 Ross Avenue Suite 3700 Dallas, Texas 75202-2799 214-468-3306 214-468-3599 (fax) jblair@hunton.com
			Eric Larson Locke Lord Bissell & Liddell LLP 3400 JPMorgan Chase Tower 600 Travis Houston, Texas 77002 713-226-1343 713-229-2574 (fax) elarson@lockelord.com
3.	**Employee Benefits**	**Benny R. Valek** 904 Signal Ridge Place Rockwall, Texas 75032 972-878-1700 972-875-7979 (fax) bvalek@bvaleklaw.com	**Randy Fickel** J. C. Penney 6501 Legacy Drive Plano, Texas 75024 972-431-1235 rfickel@jcpenney.com

COMMITTEE	CHAIR	VICE CHAIR
		Susan A. Wetzel Haynes & Boone 2323 Victory Ave., Ste. 700 Dallas, Texas 75219 214-651-5389 214-200-0675 (fax) susan.wetzel@haynesboone.com
4. **Energy and Natural Resources Tax**	**Roger D. Aksamit** Thompson & Knight LLP 333 Clay Street, Suite 3300 Houston, Texas 77002 713-951-5885 832-397-8057 (fax) Roger.Aksamit@tklaw.com	**Brian Dethrow** Jackson Walker L.L.P. 901 Main Street, Suite 6000 Dallas, Texas 75202-3797 214-953-5794 214-661-6866 (fax) bdethrow@jw.com
5. **Estate and Gift Tax**	**Daniel H. McCarthy** The Blum Firm, P.C. 420 Throckmorton Street, Suite 650 Fort Worth, Texas 76102-3723 817-334-0066 817-334-0078 (fax) dmccarthy@theblumfirm.com	**Martin P. Adler** KPM Ventures, Ltd. P.O. Box 941428 Plano, Texas 75094 214-215-0696 214-317-4894 (fax) martin@kpmtexas.com **Jason Roy Flaherty** Bennett Flaherty LLP 3307 Northland Drive, Suite 470 Austin, Texas 78731 512-407-8888 512-407-8588 (fax) jflaherty@bfaustin.com
6. **General Tax Issues**	**Gene Wolf** Kemp Smith LLC 221 North Kansas, Suite 1700 El Paso, Texas 79901-1441 915-543-6441 915-204-8936 (fax) gwolf@kempsmith.com	**Julie C. Sassenrath** Winstead PC 5400 Renaissance Tower 1201 Elm Street Dallas, Texas 75270 214-745.5887 214-745.5390 (fax) jsassenrath@winstead.com
7. **International Tax**	**Andrius R. Kontrimas** Fulbright & Jaworski L.L.P. Fulbright Tower 1301 McKinney Houston, Texas 77010-3095 713-651-5482 713-651-5246 (fax) akontrimas@fulbright.com	**Mark Horowitz** Gardere Wynne Sewell LLP 1000 Louisiana, Suite 3400 Houston, Texas 77002 713-276-5467 713-276-6467 (fax) mhorowitz@gardere.com

COMMITTEE	CHAIR	VICE CHAIR
		Judith M. Blissard Vinson & Elkins LLP First City Tower 1001 Fannin Street, Ste. 2500 Houston, TX 77002-6760 713-758-2374 713-615-5807 (fax) jblissard@velaw.com
8. **Partnership and Real Estate**	**J.F "Jack" Howell III** Sprouse Shrader Smith P.C. 701 S. Taylor, Suite 500 Amarillo, Texas 79101 806-468-3345 806-373-3454 (fax) jack.howell@sprouselaw.com	**Jeffrey D. Wallace** Locke Lord Bissell & Liddell LLP 2200 Ross Avenue, Suite 2200 Dallas, Texas 75201 214-740-8784 214-740-8800 (fax) jwallace@lockelord.com
		W. Michael Snider Baker & McKenzie LLP 711 Louisiana, Ste. 3400 Houston, Texas 77002 713-427-5000 713-427-5099 (fax) michael.snider@bakermckenzie.com
9. **Property Tax**	**Matthew Tepper** McCreary, Veselka, Bragg & Allen, PC. 700 Jeffrey Way, Suite 100 Round Rock, Texas 78665 512-323-3200 512-323-3205 (fax) mtepper@mvbalaw.com	**Mary A. Van Kerrebrook** Van Kerrebrook & Assoc., P.C. 1125 Lyric Centre 440 Louisiana Houston, Texas 77002 713-425-7150 713-425-7159 (fax) Mary@vkalawyers.com
		Melinda Blackwell Brusniak Blackwell PC 17400 Dallas Parkway, Suite 112 Dallas, Texas 75287 972-407-6599 972-250-3559 (fax) Blackwell@txtax.com
10. **Solo and Small Firm**	**Catherine C. Scheid** 4301 Yoakum Blvd. Houston, Texas 77006 713-840-1840 713-840-1820 (fax) ccs@scheidlaw.com	**Christi Mondrik** Mondrik & Associates 515 Congress Avenue, Suite 1850 Austin, Texas 78701 512-542-9300 512-542-9301 (fax) cmondrik@mondriklaw.com

COMMITTEE	CHAIR	VICE CHAIR
11. **State and Local Tax**	**Matthew L. Larsen** Baker Botts LLP 2001 Ross Avenue Dallas, Texas 75201-2980 214-953-6673 214-661-4673 (fax) matthew.larsen@bakerbotts.com	**Alyson Outenreath** Thompson & Knight LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201-2533 214-969-1741 214-880-3276 (fax) alyson.outenreath@tklaw.com **Ira A. Lipstet** DuBois, Bryant & Campbell, LLP 700 Lavaca, Suite 1300 Austin, Texas 78701 512-381-8040 512-457-8008 (fax) ilipstet@dbcllp.com
12. **Tax Controversy**	**David E. Colmenero** Meadows, Collier, Reed, Cousins & Blau, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) dcolmenero@meadowscollier.com	**G. Thomas Rhodus** Looper, Reed & McGraw 1601 Elm Street, Suite 4100 Dallas, Texas 75201 214-954-4135 214-953-1332 (fax) trhodus@lrmlaw.com **Anthony P. Daddino** Meadows, Collier, Reed, Cousins & Blau, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) adaddino@meadowscollier.com
13. **Tax-Exempt Finance**	**W. Mark Scott** DAC Resources, LLP P.O. Box 32165 Washington, DC 20007 (202) 249-1090 mark@dacbond.com	**Victoria Ozimek** Vinson & Elkins LLP 2801 Via Fortuna, Ste. 100 Austin, Texas 78746 (512) 542-8856 vozimek@velaw.com

COMMITTEE	CHAIR	VICE CHAIR
14. **Tax-Exempt Organizations**	**Bruce E. Bernstien** Bruce E. Bernstien & Assoc. P.C. 10440 N. Central Expwy., Suite 1130 Lock Box 402 Dallas, Texas 75231 214-706-0837 214-706-0848 (fax) bbernstien@plusassociates.com	**Brian W. Crozier** Brorby, Crozier & Dobie PC 111 Congress Ave., Ste. 2250 Austin, Texas 78701 512-320-7040 512-320-7041 (fax) bcrozier@brorby.com **Ronald S. Webster** Fizer, Beck, Webster, Bentley & Scroggins 1330 Post Oak Boulevard, Suite 2900 Houston, Texas 77056 713-840-7710 713-963-8469 (fax) rwebster@fizerbeck.com **Albert Lin** Brown McCarroll L.L.P. 111 Congress Avenue, Suite 1400 Austin, Texas 78701-4093 512-472-5456 512-479-1101 (fax) alin@mailbmc.com **G. Philip Morehead** G. Philip Morehead, P.C. 500 Chestnut Street, Suite 1400 Abilene, Texas 79602-1457 325-676-7575 325-676-7878 (fax) phil@moreheadlaw.com
15. **Governmental Submissions**	**Dan G. Baucum** Shackelford, Melton & McKinley, LLP 3333 Lee Parkway, Tenth Floor Dallas, Texas 75219 214-780-1470 214-889-9770 (fax) dbaucum@shacklaw.net	**Stephanie M. Schroepfer** Fulbright & Jaworski LLP 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5591 713-651-5246 (fax) sschroepfer@fulbright.com

COMMITTEE	CHAIR	VICE CHAIR
16. Newsletter Editor	**Andrius R. Kontrimas** Fulbright & Jaworski L.L.P. Fulbright Tower 1301 McKinney Houston, Texas 77010-3095 713-651-5482 713-651-5246 (fax) akontrimas@fulbright.com	**Lisa Rossmiller** Fulbright & Jaworski L.L.P. Fulbright Tower 1301 McKinney Houston, Texas 77010-3095 713-651-5151 713-651-5246 (fax) lrossmiller@fulbright.com
17. Pro Bono	**Elizabeth Copeland** Oppenheimer Blend Harrison & Tate, Inc. 711 Navarro, Suite 600 San Antonio, Texas 78205-1796 210-299-2347 210-224-7540 (fax) ecopeland@obht.com	**Katherine E. David** Oppenheimer Blend Harrison & Tate, Inc. 711 Navarro, Suite 600 San Antonio, Texas 78205-1796 210-299-2355 210-224-7540 (fax) kdavid@obht.com **Vicki L. Rees** Pittman & Fink, P.C. 8000 Anderson Square, Suite 101 Austin, Texas 78757 (512) 499-0902 (512) 499-0952 (fax) vrees@pittmanfink.com **Gerald Brantley** Law Office of Gerald Brantley 9600 Great Hills Trail, Ste. 150W Austin, Texas 78759 (512) 637-1045 (512) 637-1046 (fax) gerald@geraldbrantley.com
18. Website	**Jason Roy Flaherty** Bennett Flaherty LLP 7800 North MoPac, Ste. 200 Austin, Texas 78759 512-407-8888 512-407-8588 (fax) jflaherty@bfaustin.com	

COMMITTEE CHAIRS AND VICE CHAIRS
2010-2011

	COMMITTEE	CHAIR	VICE CHAIR
1.	**Continuing Legal Education**	**J. Michael Threet** Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Suite 4100 Dallas, Texas 75201 214-969-2795 214-969-4343 (fax) mthreet@akingump.com	**Lawrence Ray Jones, Jr.** Townsend & Jones LLP 8100 Lomo Alto, #238 Dallas, Texas 75225-6545 214-696-2661 214-764-3320 (fax) larry@tjtaxlaw.com
			Robert Maddox Kemp Smith P.C. 221 North Kansas, Suite 1700 El Paso, Texas 79901 915-533-4424 915-546-5360 (fax) bmad@kempsmith.com
2.	**Corporate Tax**	**Jeffrey M. Blair** Hunton & Williams LLP 1445 Ross Avenue Suite 3700 Dallas, Texas 75202-2799 214-468-3306 214-468-3599 (fax) jblair@hunton.com	**Eric Larson** Locke Lord Bissell & Liddell LLP 3400 JPMorgan Chase Tower 600 Travis Houston, Texas 77002 713-226-1343 713-229-2574 (fax) elarson@lockelord.com
			David S. Peck Vinson & Elkins L.L.P. Trammell Crow Center 2001 Ross Avenue, Suite 3700 Dallas, Texas 75201 214-220-7937 214-999-7937 (fax) dpeck@velaw.com
3.	**Employee Benefits**	**Susan A. Wetzel** Haynes & Boone 2323 Victory Ave., Ste. 700 Dallas, Texas 75219 214-651-5389 214-200-0675 (fax) susan.wetzel@haynesboone.com	**Randy Fickel** J. C. Penney 6501 Legacy Drive Plano, Texas 75024 972-431-1235 rfickel@jcpenney.com
			Henry Talavera Hunton & Williams LLP 1445 Ross Avenue, Suite 3700 Dallas, Texas 75202 214-468-3386 214-468-3599 (fax) htalavera@hunton.com

	COMMITTEE	CHAIR	VICE CHAIR
4.	**Energy and Natural Resources Tax**	**Brian Dethrow** Jackson Walker L.L.P. 901 Main Street, Suite 6000 Dallas, Texas 75202-3797 214-953-5794 214-661-6866 (fax) bdethrow@jw.com	**Sean R. O'Brien** Jackson Walker L.L.P. 1401 McKinney Street, Suite 1900 Houston, Texas 77010 713-752-4544 713-752-4221 (fax) sobrien@jw.com
5.	**Estate and Gift Tax**	**Jason Roy Flaherty** Bennett Flaherty LLP 3307 Northland Drive, Suite 470 Austin, Texas 78731 512-407-8888 512-407-8588 (fax) jflaherty@bfaustin.com	**Martin P. Adler** KPM Ventures, Ltd. P.O. Box 941428 Plano, Texas 75094 214-215-0696 214-317-4894 (fax) martin@kpmtexas.com
6.	**General Tax Issues**	**Julie C. Sassenrath** Winstead PC 5400 Renaissance Tower 1201 Elm Street Dallas, Texas 75270 214-745-5887 214-745-5390 (fax) jsassenrath@winstead.com	**David C. Cole** Vinson & Elkins LLP First City Tower 1001 Fannin Street, Suite 2500 Houston, Texas 77002-6760 713-758-2543 713-615-5043 (fax) dcole@velaw.com
7.	**International Tax**	**Andrius R. Kontrimas** Fulbright & Jaworski L.L.P. Fulbright Tower 1301 McKinney Houston, Texas 77010-3095 713-651-5482 713-651-5246 (fax) akontrimas@fulbright.com	**Judith M. Blissard** Vinson & Elkins LLP First City Tower 1001 Fannin Street, Ste. 2500 Houston, TX 77002-6760 713-758-2374 713-615-5807 (fax) jblissard@velaw.com **Melinda R. Phelan** Baker & McKenzie LLP 711 Louisiana, Suite 3400 Houston, Texas 77002 713-427-5012 713-427-5099 (fax) melinda.phelan@bakermckenzie.com
8.	**Partnership and Real Estate**	**Dan G. Baucum** Shackelford, Melton & McKinley, LLP 3333 Lee Parkway, Tenth Floor Dallas, Texas 75219 214-780-1470 214-889-9770 (fax) dbaucum@shacklaw.net	**W. Michael Snider** Baker & McKenzie LLP 711 Louisiana, Ste. 3400 Houston, Texas 77002 713-427-5000 713-427-5099 (fax) michael.snider@bakermckenzie.com

	COMMITTEE	CHAIR	VICE CHAIR
			Todd D. Keator Thompson & Knight LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201-2533 214-969-1797 214-880-3276 (fax) todd.keator@tklaw.com
9.	**Property Tax**	**Matthew Tepper** McCreary, Veselka, Bragg &Allen, PC. 700 Jeffrey Way, Suite 100 Round Rock, Texas 78665 512-323-3200 512-323-3205 (fax) mtepper@mvbalaw.com	**Mary A. Van Kerrebrook** Van Kerrebrook & Assoc., P.C. 1125 Lyric Centre 440 Louisiana Houston, Texas 77002 713-425-7150 713-425-7159 (fax) Mary@vkalawyers.com
			Melinda Blackwell Brusniak Blackwell PC 17400 Dallas Parkway, Suite 112 Dallas, Texas 75287 972-407-6599 972-250-3559 (fax) Blackwell@txtax.com
10.	**Solo and Small Firm**	**Catherine C. Scheid** 4301 Yoakum Blvd. Houston, Texas 77006 713-840-1840 713-840-1820 (fax) ccs@scheidlaw.com	**Christi Mondrik** Mondrik & Associates 515 Congress Avenue, Suite 1850 Austin, Texas 78701 512-542-9300 512-542-9301 (fax) cmondrik@mondriklaw.com
11.	**State and Local Tax**	**Matthew L. Larsen** Baker Botts LLP 2001 Ross Avenue Dallas, Texas 75201-2980 214-953-6673 214-661-4673 (fax) matthew.larsen@bakerbotts.com	**Alyson Outenreath** Thompson & Knight LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201-2533 214-969-1741 214-969-1751 (fax) alyson.outenreath@tklaw.com
			Ira A. Lipstet DuBois, Bryant & Campbell, LLP 700 Lavaca, Suite 1300 Austin, Texas 78701 512-381-8040 512-457-8008 (fax) ilipstet@dbcllp.com

	COMMITTEE	CHAIR	VICE CHAIR
			Charlotte F. Noel Jones Day 2727 North Harwood Street Dallas, Texas 75201-1515 214-969-4538 214-969-5100 (fax) cfnoel@jonesday.com
12.	**Tax Controversy**	**David E. Colmenero** Meadows, Collier, Reed, Cousins & Blau, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) dcolmenero@meadowscollier.com	**Anthony P. Daddino** Meadows, Collier, Reed, Cousins & Blau, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) adaddino@meadowscollier.com
			Robert D. Probasco Thompson & Knight LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201-2533 214-969-1503 214-999-9113 (fax) robert.probasco@tklaw.com
13.	**Tax-Exempt Finance**	**Victoria Ozimek** Vinson & Elkins LLP 2801 Via Fortuna, Ste. 100 Austin, Texas 78746 (512) 542-8856 vozimek@velaw.com	**Peter D. Smith** Fulbright & Jaworski LLP 600 Congress Avenue, Suite 2400 Austin, Texas 78701 512-536-3090 512-536-4598 (fax) pdsmith@fulbright.com
14.	**Tax-Exempt Organizations**	**Bruce E. Bernstien** Bruce E. Bernstien & Assoc. P.C. 10440 N. Central Expy, Suite 1130 Lock Box 402 Dallas, Texas 75231 214-706-0837 214-706-0848 (fax) bbernstien@plusassociates.com	**Ronald S. Webster** Fizer, Beck, Webster, Bentley & Scroggins 1330 Post Oak Boulevard, Suite 2900 Houston, Texas 77056 713-840-7710 713-963-8469 (fax) rwebster@fizerbeck.com
			Albert Lin Brown McCarroll L.L.P. 111 Congress Avenue, Suite 1400 Austin, Texas 78701-4093 512-472-5456 512-479-1101 (fax) alin@mailbmc.com

	COMMITTEE	CHAIR	VICE CHAIR
			G. Philip Morehead G. Philip Morehead, P.C. 500 Chestnut Street, Suite 1400 Abilene, Texas 79602-1457 325-676-7575 325-676-7878 (fax) phil@moreheadlaw.com
15.	**Governmental Submissions**	**Stephanie M. Schroepfer** Fulbright & Jaworski LLP 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5591 713-651-5246 (fax) sschroepfer@fulbright.com	**David C. D'Alessandro** Vinson & Elkins LLP Trammell Crow Center 2001 Ross Avenue, Suite 3700 Dallas, Texas 75201-2975 214-220-7890 214-999-7890 (fax) ddalessandro@velaw.com
16.	**Newsletter Editor**	**Andrius R. Kontrimas** Fulbright & Jaworski L.L.P. Fulbright Tower 1301 McKinney Houston, Texas 77010-3095 713-651-5482 713-651-5246 (fax) akontrimas@fulbright.com	**Lisa Rossmiller** Fulbright & Jaworski L.L.P. Fulbright Tower 1301 McKinney Houston, Texas 77010-3095 713-651-5151 713-651-5246 (fax) lrossmiller@fulbright.com
17.	**Pro Bono**	**Gerald Brantley** Law Office of Gerald Brantley 9600 Great Hills Trail, Ste. 150W Austin, Texas 78759 (512) 637-1045 (512) 637-1046 (fax) gerald@geraldbrantley.com	**Vicki L. Rees** Pittman & Fink, P.C. 8000 Anderson Square, Suite 101 Austin, Texas 78757 (512) 499-0902 (512) 499-0952 (fax) vrees@pittmanfink.com

REDETERMINATION PROCEEDINGS IN TEXAS STATE TAX CONTESTED CASES

By: *Ira A. Lipstet*[1]

A. OVERVIEW

The Texas Comptroller of Public Accounts ("Comptroller") is authorized to collect taxes imposed under Title 2 of the Texas Tax Code ("Tax Code"), except as otherwise provided.[2] Title 2 of the Tax Code pertains to essentially all types of Texas taxes except for property tax.[3] The Comptroller has the authority (among other powers) to: collect taxes or fees under the Tax Code or as otherwise specified;[4] conduct audits of entities doing business within Texas by examining records as necessary;[5] issue deficiency determinations for tax amounts claimed due;[6] and administer redetermination and refund claim proceedings for those taxpayers that disagree with Comptroller actions.[7]

B. DEFICIENCY DETERMINATIONS

If the Comptroller is not satisfied with a tax report or the amount of tax required to be submitted to the state by the person, the Comptroller may compute and determine the amount of tax due from information contained in the report or any other information available.[8] The deficiency statement (titled "Notice of Tax Due" or, if subsequent to an audit, "Texas Notification of Audit Results") will include tax, interest and/or penalty amounts claimed due from the taxpayer. The notice is to be given by mail or personal service,[9] and is served when deposited in the U.S. Mail.[10] A deficiency determination becomes final 30 days (20 days for a jeopardy determination) after the date on which the service of the notice of determination is completed unless a petition for redetermination is filed by the taxpayer prior to that time.[11] For cases involving deficiency determinations for cigarettes and other tobacco product matters, the time for filing a petition redetermination is also 30 days.[12] A deficiency determination (as opposed to a redetermination) is due and payable within 10 days of the time it becomes final; if not so paid, a 10% penalty of the amount of tax due is added.[13]

If there is a deficiency notice issued pursuant to a Comptroller's Decision in a redetermination hearing, the liability becomes due and payable 20 days after the redetermination becomes final. The redetermination becomes final 20 days after the Comptroller's Decision is final. Thus, a taxpayer has 40 days after the issuance of a Comptroller's Decision in a redetermination proceeding to pay the amount asserted due. If not paid by that time, a 10% penalty is added to the tax amount.[14] *Note:* No tax, interest or penalty is due from a taxpayer that has timely filed a Petition for Redetermination with the Comptroller in response to a deficiency determination unless and until there is a final Comptroller's Decision issued. Interest, however, does continue to run during the pendency of the administrative process unless a payment has been made.

C. THE REDETERMINATION PROCESS

Following a Comptroller determination, a dissatisfied taxpayer may, by statute, take one of the following actions: (1) file a petition for redetermination and obtain an administrative hearing before the Comptroller[15] and, if not resolved, a hearing before a State Office of Administrative Hearings ("SOAH") administrative law judge ("ALJ);[16] (2) pay the deficiency assessment under protest and sue the Comptroller and Texas Attorney General in Travis County District Court to recover the taxes without a prior administrative hearing;[17] or (3) post security for the deficiency and sue for an injunction.[18] In addition, if a taxpayer files an oath of inability to pay tax, penalties and interest, and if a court, after notice and hearing, finds that prepayment of the disputed amounts would constitute an unreasonable restraint on the party's right of access to the courts, the protesting party may file suit in state district court without making a payment of tax.[19] If a taxpayer discovers that a tax has been erroneously paid and no deficiency assessment has been made, the taxpayer can file a claim for refund and obtain an administrative hearing before the Comptroller.[20] Hearing procedures are essentially the same for redetermination petitions and refund claims. *Note*, however, that taxpayers may not contest a denial of a refund without first going through the administrative process.[21] Comptroller Hearing procedures are guided in general by the provisions of the Texas Administrative Procedures and Texas Register Act,[22] and in particular by the Comptroller Rules (hereafter "Rule") found at 34 Texas Administrative Code § 1.1 - 1.42.

If there is no resolution of the contested matter within the Comptroller's agency, the case is then transferred to SOAH where the matter is heard before a SOAH ALJ (or determined on written submissions).[23] A proposed decision is then sent from the SOAH ALJ to the Comptroller. The Comptroller may thereafter accept or reject the SOAH proposed decision. However, the Comptroller may change a finding of fact or conclusion of law of the SOAH ALJ only if the Comptroller determines that: 1) the ALJ did not properly apply or interpret applicable law, then existing Comptroller rules or policies, or prior administrative decisions; or 2) the ALJ issued a finding of fact that is not supported by a preponderance of the evidence, or 3) a Comptroller policy or a prior administrative decision on which the ALJ relied is incorrect.[24] If the Comptroller determines that the amount of tax due from a taxpayer has not been properly reported, the Comptroller may compute and determine the amount of tax to be paid from information contained in the report or any other information available to the Comptroller.[25] The person is then notified by way of a deficiency amount issued on a Notice of Tax Due.[26]

If a petition for redetermination is denied, the taxpayer may then pay the tax under protest and sue for a refund in district court,[27] or the taxpayer may pay the tax and file a claim for refund to obtain a second administrative hearing before the Comptroller.[28] If payment is made under protest (as opposed to denial of a refund claim), there is no requirement that the taxpayer exhaust administrative remedies prior to filing the suit for refunding the contested amount (*i.e.*, it is not necessary in payment under protest actions to file a refund claim with the Comptroller and have it denied).[29]

1. Initiating the Redetermination Process

The hearings process is initiated by filing a written request for redetermination within the time periods prescribed by statute.[30] These time periods are, in general, 30 days for deficiency determinations and 20 days for jeopardy determinations.[31] A Statement of Grounds must be included within the request for redetermination, or filed within the time limit allowed for the request for redetermination.[32] If the Statement of Grounds is not received within this time period or any permitted extensions, the request will be dismissed.[33] In this event, the taxpayer is required to pay the deficiency and file a claim for refund. A Statement of Grounds must be filed along with the claim for refund or the claim will be dismissed.[34]

In general, the statutory deadline for requesting a redetermination or refund cannot be waived. A request for extension of time to file a Statement of Grounds will be granted only in the case of emergency or extraordinary circumstances.[35] The Comptroller's office does not grant extensions based on delay in delivery by the postal service, messenger services, or other carriers. However, an extension of time to file a request for redetermination and Statement of Grounds can be requested and may be granted in certain circumstances.[36] The Comptroller has authority to require that any report, claim, or other document filed on behalf of a taxpayer by a taxpayer's representative be accompanied by express written authorization of the taxpayer.[37] Such a power of attorney will typically be required in connection with a refund request. Comptroller policy is otherwise somewhat inconsistent as to when a power of attorney is required in connection with representation of a taxpayer. There is no specific general power of attorney form required (or provided) by the Comptroller (although there is such a Comptroller form available for use in refund claims). An officer, director, or employee of the taxpayer whose duties include administering the taxpayer's rights and responsibilities with the Comptroller may sign the written authorization. The authorization must include the title and telephone number of the officer, director or employee who signs the authorization for verification by the Comptroller.[38]

2. Statement of Grounds

The Statement of Grounds is the pleading that states the reasons the taxpayer disagrees with the proposed audit deficiency or other determination actions. The Statement of Grounds should be specific in identifying disagreements with factual information contained in the audit and the legal theories on which the audit is based. The Statement of Grounds must contain the reasons the taxpayer disagrees with the action of the agency. The taxpayer must list and number the items or transactions, individually or by category, with which the taxpayer disagrees. For each contested item or category of items, the taxpayer must also state the factual and legal grounds why the tax should not be assessed or should be refunded.[39] If the taxpayer disagrees with the agency's interpretation of the law, specific legal authority must be cited in support of the taxpayer's arguments. If an item or transaction, or category thereof, is not listed in the Statement of Grounds, it may be barred from consideration in a hearing.[40] In the event the taxpayer's Statement of Grounds fails to list and number items or transactions, individually or by category, or fails to state the factual basis and legal grounds upon which relief is sought, the case may be dismissed.[41] If the taxpayer's Statement of Grounds raises issues that cannot be resolved from the material contained in the audit or Statement of Grounds, additional evidence may be obtained through a preliminary conference, discovery (per Rule § 1.33), written or oral requests for additional evidence, and an audit amendment.[42] The Statement of Grounds may be amended up to the time that a Reply to Position Letter is required. All evidence on which the proving party intends to rely must be filed with the proposed amendment.[43]

3. Submission of Evidence at Audit Conference

When a taxpayer timely requests a redetermination hearing, the agency may request in writing that the taxpayer produce documentary evidence for inspection that would support the taxpayer's Statement of Grounds. The request may specify that resale or exemption certificates to support tax free sales must be submitted from 60 days from the date of the request. Resale or exemption certificates that are not so submitted within the 60-day time limit will not be accepted as evidence during the administrative process to support a claim of tax free sales.[44] *Note:* The "60 day letters" are typically sent to taxpayers both as part of acknowledgement of receipt of the petition for determination, and as a notification to taxpayer of the request for additional documentary evidence.

4. <u>Resolution Prior to Issuance of a Position Letter</u>

If the taxpayer's contentions are fully accepted, or the parties otherwise agree on resolution of all contentions, the agency may elect to amend the determination, to issue an amended ruling, or to agree to a refund credit request rather than issue a Position Letter.[45]

If the determination or billing is amended, and a refund or credit is issued, the action will become final 20 days after notification. Unless otherwise indicated, the amended billing or determination is payable 20 days after it becomes final. Notification is presumed to occur on the third day after the date of mailing.[46]

5. <u>Informal Resolution</u>

If there has not been a resolution of the case at the audit level, the case will be sent to the administrative hearing section of the Comptroller, where the Comptroller is represented by assistant general counsel attorneys ("AGC"). The AGC assigned the case is required by Comptroller policy to seek an informal resolution of the issues via contact with the taxpayer prior to developing a Position Letter. This review by the AGC is required by policy to occur within 45 days of the AGC receiving the file.

6. <u>The Position Letter</u>

After the AGC receives the Statement of Grounds and any additional information requested (and assuming the informal communication with the taxpayer has not resulted in a resolution of the case), the AGC must draft a Position Letter stating the Comptroller's position regarding each issue raised by the taxpayer. The taxpayer's contentions may be accepted or rejected in whole or in part. The Position Letter sets forth what the AGC finds is properly subject to or exempt from taxation.[47]

In general, there is no authority allowing the hearings attorney to settle cases on the basis of expediency, hazards of litigation, nuisance value, or settlement when not authorized by law. Consequently, cases are not routinely resolved on that basis. There can be resolution, however, if the AGC can be persuaded the Comptroller will not prevail on particular issues.

The Position Letter must be accepted or rejected by the taxpayer within 45 days after the date of the letter.[48] An extension of time to submit a response to the Position Letter may be granted upon request made to the AGC.[49] A form is provided with the Position Letter that allows the taxpayer to accept or reject the Position Letter.

The selection form enclosed with the Position Letter offers the taxpayer two options: agree or disagree with the Position Letter.[50] If the taxpayer agrees, the tax refund or liability will be calculated accordingly, and a final billing will be generated.[51] In the event the billing is incorrect, a motion for rehearing may be filed within 20 days indicating disagreement with the computation.[52]

7. Reply to Position Letter

If the taxpayer disagrees with the Position Letter, in whole or in part, taxpayer may request that the contested issues be decided in a hearing. If the taxpayer chooses this option, the taxpayer must return the selection form along with two copies of its Reply to Position Letter setting forth all of the taxpayer's arguments in support of its position. In addition, by Rule, the taxpayer must include with its Reply to Position Letter all supportive documents, affidavits, and other evidence.[53] The Reply should also address all unresolved contentions and provide legal and factual support for the taxpayer's position. All factual allegations should be supported by sworn affidavits, certified business records, or otherwise admissible evidence.[54]

If the taxpayer fails to timely respond to the Position Letter, the Comptroller may dismiss the contested case. The proceeding would then be concluded unless the taxpayer notifies the agency within 20 days that he disagrees with the amount by filing a Motion for Rehearing.[55]

The Position Letter may be modified or supplemented by the AGC presumably at any time prior to submitting the case to SOAH.[56] *Caveat*: This means the AGC attorney may revoke a Position Letter previously favorable to a taxpayer. This should be carefully considered when making a determination of whether to proceed with a matter where a favorable result has been obtained with regard to the largest part of the case.

8. Response of Administrative Hearings Section

If the taxpayer presents additional facts or legal arguments in a Reply to Position Letter, the AGC is supposed to issue within 45 days a Response to Taxpayer's Reply stating the legal position of the tax division, as well as any factual disagreement on each issue or argument raised by the taxpayer.[57] If the AGC is unable to respond within 45 days, the taxpayer will be notified of the delay and informed of the revised response date.[58] *Note*: It is not unusual for taxpayers to receive notices stating the AGC response period will be extended.

If the taxpayer fails to submit a Reply to Position Letter, or if such Reply does not contain any additional legal arguments or facts, the AGC is not required to issue a response.[59]

All documents submitted with or after the Position Letter selection form must be filed with the AGC.[60] Specific technical service requirements must be followed in submitting the documentation.[61] The service requirements are set out with specificity in Comptroller rules, and have been substantially modified so that they are in compliance with the more technical requirements of SOAH proceedings.[62] Rules of service governing filing documents at SOAH can vary.[63]

9. Continuances

Prior to the time a case is brought within the jurisdiction of SOAH, a taxpayer can request an extension of time to meet a deadline. Such a request should be made in writing to an

AGC at least seven days prior to the deadline (although emergency requests might be considered within the seven day period).[64] The request must show good cause in order to be granted, and that it is not being made due to neglect, indifference, or lack of diligence.[65] An increase of a tax deficiency by the Tax Division at or before the time of hearing allows the taxpayer a continuance of 30 additional days to obtain evidence.[66] SOAH rules of practice will apply to continuances requested after a hearing is set by SOAH.[67]

10. Procedural Disputes Subsequent to Position Letter

If there is any sort of procedural dispute that arises after the issuance of the Position Letter, even if the case has not yet been transferred to SOAH, at taxpayer's request, or on its own motion, the Tax Division shall file a Request to Docket Cases form with SOAH.[68] SOAH Rules of Evidence will apply after that point.[69]

11. Mediation

At the time the ALJs and contested case proceedings were moved to SOAH, Comptroller policy was also modified to provide an opportunity for mediation in a further effort to try and resolve controversies.[70] Should the review and contact by the AGC not resolve the conflict, the taxpayer is able to request mediation before a case is referred to SOAH. Per Comptroller policy, the mediation would be conducted by a trained mediator who reports directly to the Comptroller General Counsel. Unless the mediation schedule dictates otherwise, the mediation would occur within 30 days of the time the taxpayer makes the request. The AGC and AGC's supervisor will represent the agency at the mediation. The supervisor is also supposed to consider issues such as detrimental reliance and penalty and interest waiver claims at the mediation.[71]

12. Requesting a SOAH Hearing

If, after reviewing all Position Letters, Replies, Responses, and other communications the parties are unable to resolve or settle all contested matters, the Tax Division will, at a taxpayer's request or on its own motion, file a Request to Docket Case form with SOAH.[72] The Request to Docket Case form will be filed promptly following a taxpayer's request, in no event more than 30 days after such request (unless the parties otherwise agree).[73] All pleadings (served on all parties) shall be filed by the Comptroller with SOAH.[74] The taxpayer will be given the option of an oral hearing or a written submission hearing before the SOAH ALJ.[75] If the taxpayer fails to make a selection, the case will be docketed as a written submission hearing (although the taxpayer may subsequently change to an oral hearing).[76] A hearing initially selected as an oral hearing may also be changed to a written submission hearing.[77] The Tax Division has the option of requesting an oral hearing in any case in which it has the burden of proof[78] (such as a case involving fraud penalty assertions, or a license suspension or revocation hearing).[79]

13. Administrative Hearings

Once a case has been transferred to SOAH, the SOAH Rules of Practice and Procedure will control the proceeding. These rules (which are quite voluminous and technical) can be found at 1 Tex. Admin. Code Chapters 155-163. SOAH Procedural Rules are set out in 1 TAC Chapter 155.[80]

The case will proceed and resolution will occur according to SOAH Rules.

> *Caveat*: Administrative procedure (including rules of evidence, submission of documents, examination of witnesses and other related matters) will be applicable to a much greater extent than was the case in proceedings previously heard by Comptroller ALJs. Comptroller oral hearings prior to the transfer of responsibility for such hearings to SOAH (effective January 1, 2007) tended to be somewhat informal, with evidentiary and rules of procedure requirements sometimes relaxed. That is unlikely to be the case in SOAH proceedings, which more closely resemble bench trials before a judge in state district court. Following legal procedural aspects of the case will be quite important. While taxpayer representatives in Comptroller SOAH proceedings do not have to be attorneys, those who proceed in these matters without legal counsel may be at a disadvantage.

Once the SOAH process has been concluded, the assigned SOAH ALJ will issue a proposal for decision in accordance with SOAH's Rules of Procedure.[81] Any parties may file exceptions and responses in accordance with the SOAH rules.[82]

14. The Comptroller's Decision

Upon receipt of the proposal for decision from the SOAH ALJ, and review of any exceptions filed by the taxpayer and AGC counsel, the Comptroller will issue a final decision. The Comptroller may then either accept or reject the SOAH proposed decision. However, the Comptroller may change a finding of fact or conclusion of law of the SOAH ALJ only if: 1) the ALJ did not properly apply or interpret applicable law, then existing Comptroller rules or policies, or prior administrative decisions, 2) the ALJ issued a finding of fact that is not supported by a preponderance of the evidence, or 3) it determines that a Comptroller policy or a prior administrative decision on which the ALJ relied is incorrect.[83]

Notification of the decision is to be sent to the taxpayer and the taxpayer's representative. Notice is presumed to have been received on the third day after the notice is mailed. The decision becomes final unless a motion for rehearing is filed by the taxpayer within 20 days from the date of notification. If the motion for rehearing is granted, the decision is vacated pending a subsequent decision upon rehearing. If overruled (whether by order or operation of law (i.e., 45 days)), the decision is final on the date overruled.[84]

The agency may issue a Comptroller's decisions without issuance of a proposal for decision if the parties agree to waive the proposed decision.[85] The agency may also issue a final Comptroller's decision if a hearing is dismissed for taxpayer's failure to respond to the Position Letter, for taxpayer's failure to state a claim upon which relief can be sought, or for want of prosecution.[86]

Should the taxpayer or claimant disagree with the Comptroller's Decision, further remedies include making payment under protest, followed by a taxpayer claim in State district court[87] or filing a claim for tax refund in State district court.[88]

[1] Ira A. Lipstet is a partner with the Austin law firm of DuBois, Bryant, & Campbell, LLP. He engages in a broad ranging tax and business practice. Mr. Lipstet's experience involves federal and state tax and business planning and controversy. He received his B.A. and M.B.A. from the University of Texas at Austin and his J.D. from the University of Houston. Mr. Lipstet is board certified in tax law by the Texas Board of Legal Specialization and a certified public accountant.
[2] Texas Tax Code Ann. ("Tax Code") § 111.001.
[3] *See* Title 1, Tax Code §§ 1.01 *et. seq.*
[4] Tax Code §§111.001, 111.0021.
[5] Tax Code § 111.004.
[6] Tax Code § 111.008.
[7] Tax Code §§ 111.009, 111.104, 111.105.
[8] Tax Code § 111.008(a).
[9] Tax Code § 111.008(b).
[10] Tax Code § 111.008(c).
[11] Tax Code §§ 111.009, 111.022; Rule § 1.5.
[12] Tax Code §§ 154.309, 155.186. *See also* Rule § 1.14.
[13] Tax Code § 111.0081(a).
[14] Tax Code § 111.0081(c).
[15] Tax Code § 111.009.
[16] Tax Code § 111.00455.
[17] Tax Code § 112.051 *et. seq*.
[18] Tax Code § 112.101 *et. seq*.
[19] Tax Code § 112.108; *see also R. Communications v. Sharp*, 875 S.W.2d 314 (Tex. 1994).
[20] Tax Code § 111.105.
[21] Tax Code § 112.151(a).
[22] Tex. Gov't Code § 2003, *et. seq.*
[23] For an extensive discussion of procedures and guidelines pertaining to tax cases at SOAH, see "Contested Tax Cases Before the State Office of Administrative Hearings" by Hon. Peter Brooks (SOAH administrative law judge), a paper delivered at the TSCPA Texas State Tax Conference, Houston, Texas, August 20, 2009.
[24] Tex. Gov't Code § 2003.101(e).
[25] Tax Code § 111.008(a).
[26] Tax Code § 111.008(b).
[27] Tax Code § 112.051, *et. seq*.
[28] Tax Code § 111.104.
[29] Tax Code § 112.051, *et. seq*.
[30] Rule § 1.5.
[31] Rule § 1.5(a).
[32] Rule § 1.5.
[33] Rule § 1.5(a).
[34] Rule § 1.5(c).
[35] Rule § 1.6.
[36] *Id.*
[37] Tax Code § 111.023.
[38] Tax Code § 111.023(b).
[39] Rule § 1.7.
[40] Rule § 1.7(b).
[41] Rule § 1.7(c).
[42] Rule § 1.7(d).
[43] Rule § 1.7(e).
[44] Rule § 1.5(b).
[45] Rule § 1.8(a).
[46] Rule § 1.8(b).
[47] Rule § 1.9.
[48] Rule § 1.10(a).
[49] *Id.*

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[50] Rule § 1.10(b)(1), (2).
[51] Rule § 1.10(b)(1).
[52] *Id.*
[53] Rule §§ 1.10(b)(2); 1.15(a).
[54] Rule § 1.15(b).
[55] Rule § 1.15(c).
[56] Rule § 1.11.
[57] Rule § 1.16(a).
[58] *Id.*
[59] Rule § 1.16(b).
[60] Rule § 1.18.
[61] Rule §§ 1.18; 1.32.
[62] *See* Rule § 1.32.
[63] Rule § 1.32; *see also* SOAH, Rules of Procedure, 1 TAC § 155.23.
[64] Rule § 1.20(a).
[65] Rule § 1.20(b).
[66] Rule § 1.20(c).
[67] Rule § 1.20(d).
[68] Rule § 1.20(e).
[69] *See*, *generally*, 1 Texas Administrative Code ("TAC") Chapters 155-163.
[70] *See* Rule § 1.22(b).
[71] *See* generally *Comptroller Tax Process Improvements* issued Feb. 7, 2007, Texas Comptroller website at www.window.state.tx.us/taxinfo/taxprocess.
[72] Tax Code § 111.00455.
[73] Rule § 1.22(b).
[74] Rule § 1.22(c).
[75] Rule § 1.22(d).
[76] Rule §§ 1.22(e),(f).
[77] Rule § 1.22(f).
[78] Rule § 1.22(g).
[79] *See* Rule § 1.40(l).
[80] 1 TAC §§ 155.1 – 155.59.
[81] Rule § 1.27; 1 TAC § 155.59.
[82] Rule § 1.27.
[83] Tex. Gov't. Code § 2003-101(e).
[84] Rule §§ 1.28(a); 1.29.
[85] Rule § 1.28(b).
[86] Rule § 1.28(c).
[87] Tax Code §§ 112.051-112.060.
[88] Tax Code §§ 112.151-112.156.

TAX PROVISIONS OF THE 2010 SMALL BUSINESS JOBS ACT IMPACTING CORPORATIONS

By: *Jeffrey Blair*[1]

On September 27, 2010, President Obama signed into law the 2010 Small Business Jobs Act (the "2010 SB Act"). The 2010 SB Act includes various tax breaks aimed at small business and a broad array of revenue raising provisions. A brief summary of the provisions of the 2010 SB Act potentially impacting C corporations and S corporations follows.

1. BIG Tax Period for S corporations reduced to 5 years for 2011. A C corporation that converts to an S corporation must pay a corporate level tax on built-in gains that existed as of the date of the S corporation election if those gains are recognized during the ten year period immediately following the date of the S corporation election. This ten year recognition period was reduced for taxable years beginning in 2009 or 2010 to seven years. The 2010 SB Act reduces the recognition period to 5 years for taxable years beginning in 2011. Former C corporations that elected S corporation status within the last five to nine years and are planning a sale within the next few years may want to consider accelerating that future sale to take advantage of this benefit.

2. Increased carryback period and AMT relief on Eligible Small Business Tax Credits. General business tax credits under Section 38(a) of the Internal Revenue Code of 1986, as amended (the "Code") otherwise allowed for any tax year are subject to a limitation based on the taxpayer's tax liability for that tax year. Section 38(c) of the Code states that the tax credits allowed under Section 38(a) for any taxable year may not exceed the excess (if any) of the taxpayer's net income tax over the greater of: (a) the taxpayer's tentative minimum tax for the taxable year or (b) 25% of the taxpayer's net regular tax liability in excess of $25,000. A taxpayer's net income tax is the sum of the taxpayer's regular tax liability and alternative minimum tax reduced by certain tax credits. A taxpayer's tentative minimum tax is an amount equal to the taxpayer's alternative minimum taxable income in excess of an exemption amount times specified rates of tax). A taxpayer's alternative minimum tax is generally the excess of the taxpayer's tentative minimum tax over the taxpayer's regular tax reduced by the foreign tax credit and certain other amounts. A taxpayer generally can only offset its alternative minimum tax liability with certain general business credits (e.g., empowerment zone employment credits, New York Liberty Zone employment credits). General business tax credits that exceed the $25,000 limitation of Code Section 38(c) may be carried back one year and forward up to 20 years. The 2010 SB Act provides new benefits for small businesses with tax credits that are "eligible small business credits." Eligible small business credits are the sum of the of the general business tax credits for that tax year for a business that is an "eligible small business." An eligible small business is defined as business that (i) is either a corporation, the stock of which is not publicly traded, or a partnership and (ii) which has average annual gross receipts of not more than $50 million for the three-taxable years preceding the tax year. For tax years starting in 2010, the 2010 SB Act helps eligible small businesses in two ways. First, the 2010 SB Act extends the carryback period for eligible small business credits from one to five years. Second, the 2010 SB Act provides that the tentative minimum tax is treated as zero with respect to eligible small business credits. Since eligible small business credits can include any general business tax credits that meet the definition of eligible small business credits, this change,

effectively, will allow a taxpayer's eligible business credits to offset both that taxpayer's regular tax liability and alternative minimum tax liability. Both of these provisions are effective for taxable years beginning after December 31, 2009.

3. Temporary Exclusion of Gains on certain Qualified Small Business Stock. Prior to the 2010 SB Act, individuals could exclude from their regular taxable income 50% of the gain on the sale or exchange of "qualified small business stock" ("QSBS") held for more than five years. The excluded percentage was increased to 60% for certain empowerment zone businesses. In addition, the amount of the gain eligible for exclusion by an individual with respect to any corporation was the greater of (i) ten times the individual's tax basis in the stock or (ii) $10 million. The portion of the gain that was not excluded was subject to a maximum federal income tax rate of 28%. To meet the definition of qualified small business stock, the business must be a qualified small business and the stock must be acquired by the taxpayer at its original issue in exchange for money other property (not including stock) or as compensation for services provided to the corporation. To qualify as a qualified small business, the entity must be a domestic C corporation with gross assets that do not exceed $50 million. The corporation also must meet certain active trade or business requirements. For alternative minimum tax purposes, a percentage of the excluded gain was treated as a preference item and the portion of the gain included in alternative minimum taxable income was taxed at the alternative minimum tax rate of 28%. The 2010 SB Act increases the exclusion to 100% for both regular and alternative minimum tax purposes for QSBS acquired after the enactment date of the 2010 SB Act and before January 1, 2011. Therefore, any taxpayers wanting to take advantage of this measure will need to do so quickly because it will only apply with respect to QSBS issued during the three month period from the enactment date for the 2010 SB Act until December 31, 2010.

4. Temporary Expansion of Section 179 Expensing. Section 179 of the Internal Revenue Code of 1986, as amended (the "Code") permits a small business that satisfies limitations on annual investment to elect to deduct the cost of certain qualified property in the year of acquisition rather than capitalizing these costs and recovering them over time. For taxable years beginning after 2007 and before 2011, the maximum annual expensing limit was $250,000. This limit was reduced (but not below zero) by the amount by which the cost of all qualifying property placed in service in that taxable year exceeded $800,000. In general, property qualifying for expensing under Code section 179 was defined as depreciable tangible personal property purchased for use in the active conduct of a trade or business. Off-the shelf computer software placed in service before 2011 was treated as qualifying property. The 2010 SB Act increases the maximum annual expensing limit to from $250,000 to $500,000 and the phase-out threshold from $800,000 to $2,000,000 for taxable years beginning in 2010 or 2011. The 2010 SB Act also temporarily expands the definition of property qualifying for Section 179 expensing to include the following qualified real property: (i) qualified leasehold improvement property, (ii) qualified restaurant property, and (iii) qualified retail improvement property. With respect to qualified real property, the maximum amount that may be expensed is $250,000. Section 179 deductions attributable to qualified real property also are limited to the taxpayer's active trade or business In addition, if a taxpayer's Code section 179 deductions attributable to qualified real property for a taxable year beginning in 2010 exceed the $250,000 annual limit, the excess may be carried over to the taxpayer's taxable year beginning in 2011 with the carryover amount being treated as attributable to property first placed in service in 2011.

5. Extension of Bonus Depreciation. Additional first year depreciation ("bonus depreciation") allows a taxpayer to deduct an amount equal to 50% of the adjusted tax basis of certain qualifying property for the year the property is placed in service. The basis of the property and the remaining depreciation allowances are appropriately adjusted to reflect the additional first-year deduction. Bonus depreciation is allowed as a deduction for both regular and alternative minimum tax purposes. The amount of bonus depreciation is not affected by a short taxable year. In addition, taxpayers may elect out of the bonus depreciation for any class of property for any taxable year. Qualifying property for bonus depreciation must meet all of the following requirements. First, the property must be: (i) property to which the Modified Accelerated Cost Recovery System ("MACRS") applies with an applicable recovery period of 20 years or less, (ii) computer software other than computer software covered by Code section 197, (iii) water utility property or (iv) qualified leasehold improvement property (within the meaning of Code section 168(k)(3). Second, the original use of the property must commence with the taxpayer after December 31, 2007. Third, the taxpayer must purchase the property within the applicable time period. Lastly, the property must be placed in service after December 31, 2007 and before January 1, 2010. For certain transportation equipment, the placed in service date is extended to January 1, 2011. Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property. The 2010 SB Act extends the additional first year bonus depreciation for one year to apply to qualified property acquired or placed in service during 2010 (or placed in service in 2011 for certain long-lived property and transportation property). This provision is effective for property placed in service in taxable years after December 31, 2009.

6. Extension of Depreciation for Passenger Automobiles that are Qualified Property. Code section 280F limits the amount of depreciation deductions (including Code Section 179 deductions) with respect to "passenger vehicles." These limits are adjusted annually. In general, the adjusted first year limit for passenger automobiles placed in service in 2010 would be $3,060. For passenger automobiles built on a truck chassis (e.g., light trucks), the adjusted first year limit for such vehicles placed in service in 2010 would be $3,160. For any passenger car that is "qualified property" and which isn't subject to a taxpayer election to forgo the 50% bonus depreciation and alternative minimum tax depreciation relief otherwise available for "qualified property" under Code section 168(k), the applicable first year depreciation limit is increased by $8,000. The 2010 SB Act extends the $8,000 increase in annual depreciation for passenger automobiles that meet the above requirements to passenger automobiles placed-in-service in 2010. Under these rules, the maximum first year depreciation for a passenger car in 2010 would be $11,060 ($11,160 for light trucks). This provision is effective for property placed in service before January 1, 2011.

7. Increased Start-up Deduction Limits under Section 195. A taxpayer can elect to deduct up to $5,000 of start-up expenditures in the taxable year in which a trade or business begins. The $5,000 limit is reduced on a dollar-for-dollar basis to the extent the start-up expenditures exceed $50,000. Start-up expenditures that are not deducted in the first taxable year are capitalized and amortized on a straight-line basis over a 15-year period beginning with the month the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began, including amounts paid or incurred in connection with (i) investigating the creation or acquisition of an active trade or business, (ii) creating an active trade or business, or (iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in

anticipation of such activity becoming an active trade or business. For taxable years beginning in 2010, the 2010 SB Act increases the limit on the amount of start-up expenditures that a taxpayer can elect to deduct from $5,000 to $10,000. The 2010 SB Act also increases the deduction phase-out threshold limit from $50,000 to $60,000. This provision is effective for taxable years beginning after December 31, 2009. Interestingly, the 2010 SB Act did not similarly adjust the limits under Section 709 of the Internal Revenue Code for organization costs of partnerships.

8. Cell Phones. In general, a taxpayer may deduct ordinary and necessary business expenses of the taxpayer's trade or business (including the cost of and the monthly telecommunication charges with respect to cell phones). In the case of certain listed property (including any cellular telephone or other similar telecommunications equipment), no deduction is allowed unless the taxpayer meets certain additional substantiation requirements. The 2010 SB Act removes cell phones from the definition of listed property. Thus, for taxable years ending after December 31, 2009, the heightened substantiation requirements that apply to listed property will no longer apply to cell phones.

9. Increased Information Reporting. Code section 6041(a) requires information reporting to the Internal Revenue Service by all persons engaged in a trade or business who make certain payments of $600 in the course of that trade or business to another person. Payments subject to information reporting under Code Section 6041(a) are rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other fixed or determinable income. A taxpayer whose trade or business is a rental real estate activity, would be subject to these information reporting rules but a taxpayer whose rental real estate activity is not a trade or business would not be subject to these rules. The 2010 SB Act imposes information reporting on recipients of rental income from real estate, making these payments subject to these same information reporting rules as taxpayers engaged in a trade or business. This provision is effective for payments made after December 31, 2010.

10. Increase in Information Return Penalties. The Code provides for penalties for failing to file information returns. The penalty is tiered and capped. The maximum amount of the penalty varies depending on when the information return is filed and if the taxpayer is a qualified small business. The 2010 SB Act increases the penalty amounts and imposes new maximum penalty amounts. The 2010 SB Act also revises the penalty for failing to furnish a payee statement to provide tiers and caps similar to the tiers and caps for failing to file the information return. This provision is effective for information returns required to be filed on or after January 1, 2011.

11. Estimated Payments for Large Corporations. The 2010 SB Act increases the required payment of estimated tax by large corporations (i.e., corporations with assets of at least $1 billion) by thirty-six percent (36%) for July, August and September 2015. This provision was effective as of the enactment date of the 2010 SB Act.

[1] Jeffrey M. Blair is with Hunton & Williams LLP in Dallas and can be reached at jblair@hunton.com.

State Bar of Texas Tax Section's Annual Law Student Tax Paper Competition

The State Bar of Texas Tax Section's Annual Law Student Tax Paper Competition is designed to encourage and reward scholarly writings on legal subjects within the scope of the section. The State Bar of Texas Tax Section congratulates Andrea Marks from The University of Houston Law Center, the winner of its 2010 Annual Law Student Tax Paper Competition. Andrea Marks' winning article entitled "Living the Dream: How I.R.C. § 195 can Jump-Start the American Economy" is published below.

Numerous entries were received which were all impressive in their own right. The judging panel reviewed each paper anonymously, without knowing the students' names or their law school affiliations. The papers were judged on the following four criteria:

- Legal analysis
- Legal research
- Organization and writing style
- Originality and relevance of topic to current tax matters

Notably, the Annual Law Student Tax Paper Competition provides a $1,000 award to its winner and additional awards for second and third places in the judges' discretion. All J.D. and L.L.M. degree candidates attending accredited Texas law schools either on a part-time or full-time basis at the time the paper is written are eligible. Students can write on any federal or state tax topic. Papers must be sponsored by a law school faculty member and only one paper per student may be submitted. For additional information regarding the competition, please visit the section's website at http://www.texastaxsection.org/.

Living the Dream:

How I.R.C. § 195 can Jump-Start the American Economy

by Andrea Marks[1]

Living the Dream: How I.R.C. § 195 can Jump-Start the American Economy

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Living the Dream: How I.R.C. § 195 can Jump-Start the American Economy

> *"Over the years, the U.S. economy has shown a remarkable ability to absorb shocks of all kinds, to recover, and to continue to grow. Flexible and efficient markets for labor and capital, an entrepreneurial tradition, and a general willingness to tolerate and even embrace technological and economic change all contribute to this resiliency."*[2]
>
> *- Ben Bernanke*

I. Introduction

Entrepreneurship has always been an important part of American society.[3] Enterprising pioneers, including merchants, farmers and artisans opened the first American small businesses in the eighteenth and nineteenth centuries.[4] Many immigrants to the United States find economic success by starting their own business, generating $67 billion or 11.6% of the nation's total business income.[5] From 2004 to 2005, over 644,000 new businesses were started in the United States.[6] Entrepreneurs find that some of the benefits of starting a business include innovation, the flexibility to respond to an evolving market and enjoying the work.[7]

The government formally recognized the importance of start-up businesses when it established the Small Business Association ("SBA") in 1953.[8] The goal of the SBA was to:

> Aid, counsel, assist, and protect insofar as is possible the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts for supplies and services for the Government be placed with small-business enterprises, and to maintain and strengthen the overall economy of the Nation.[9]

Today, the SBA supports and tracks both employer and non-employer businesses.[10] In 2006, there were 26,790,682 small business firms in the United States.[11] Of these businesses, 99.59% have fewer than 100 employees and 99.9% have fewer than 500 employees[12], the SBA definition of a small business.[13] Of the 140.7 million total business employees in the United

States[14], 45.1% are employed by a business with less than 100 employees and 57.57% by a business with less than 500 employees.[15] Small business steadily contributes over 50% of the private non-farm gross domestic product.[16]

The 96th Congress acknowledged the economic importance of American small businesses when it enacted § 195 of the Internal Revenue Code ("I.R.C." or the "Code").[17] Section 195 details the tax treatment of start-up expenses incurred by owners prior to the operation of an active trade or business.[18] With § 195, Congress intended to decrease litigation surrounding the deductibility of certain expenses, encourage business formation and treat business and non-business taxpayers equally.[19] Subsequent revisions to the Code have strayed from the original intent of § 195, with current business owners receiving much larger tax incentives than those available to potential business owners.[20] These tax advantages lead to economies of scale for existing business owners and act as a barrier to entry for new businesses, making it more difficult for entrepreneurs to compete and succeed.[21]

The current version of § 195 will expire in July 2011.[22] Given the current economic environment, it is of paramount importance for Congress to not only extend but also modify § 195 to fulfill the intent of the 96th Congress.[23] If drafted appropriately, § 195 could encourage taxpayers to start businesses, reduce unemployment, spur economic growth and technological innovation and help the current economic recovery gain momentum.[24]

This comment discusses the history of § 195 and suggests how the section should be drafted to encourage start-up businesses. Part II examines Congress's intent regarding § 195's effect on small business formation and the section's original statutory construction.[25] Part III analyzes the initial case law affecting the assumptions underlying the provision.[26] Part IV looks at later case law and subsequent statutory and regulatory amendments affecting § 195's application.[27] Part V recommends changes to § 195 prior to its expiration in 2011[28], and Part VI concludes with a focus on the future and the importance of the provision.[29]

II: The Enactment of § 195

A. The Treatment of Start-Up Expenses Prior to 1980

The original version of the modern Code, the I.R.C. of 1954, contained no provision for the treatment of start-up expenses.[30] In general, the Code helps each taxpayer calculate their tax liability for a given year.[31] Implicit in this calculation is a determination of what is included in income and which deductions are allowed.[32] The Code attempts to temporally match expenses incurred with the income generated[33] and to create bright line rules between personal and business consumption.[34] Deductions for personal consumption are expressly disallowed, while business related expenditures may be deductible.[35]

Additionally, the Code does not allow deductions for capital expenditures.[36] A capital expenditure is "the cost incurred in the acquisition . . . of a capital asset"[37] with a useful life beyond one year.[38] In an attempt to match expenses with income, the cost of capital expenditures is distributed, or capitalized, over the life of the asset.[39] The Code achieves this through depreciation and amortization.[40] Losses, in contrast, may be deducted in the year of the loss under § 165.[41]

This basic framework sets the stage for the non-deductibility of start-up expenses. An entrepreneur incurs start-up costs for all activities undertaken prior to the operation as a trade or business.[42] As defined, these expenses did not qualify for a deduction under § 162, and were treated as personal consumption.[43] In Revenue Ruling 57-418, the IRS revoked a 1922 holding in which expenses associated with a failed business could be deducted as a loss in the year the business was abandoned.[44] Relying on *Parker v. Commissioner*[45], the IRS held the loss could only be deducted if the taxpayer engaged in and then abandoned an actual "transaction for profit".[46] The activities had to be "more than investigatory," thereby excluding all general start-up expenses.[47]

Revenue Ruling 77-254 subsequently clarified when expenses from a failed business could be deducted, and affirmed the holding in Revenue Ruling 57-418 regarding the non-deductibility of start-up expenses.[48] The IRS based its holding on *Seed v. Commissioner*[49]*,* in which the tax court allowed the expenses associated with the failure of a specific business acquisition to be deducted.[50] The ruling held that the costs associated with an unsuccessful acquisition were deductible as losses under § 165(c)(2).[51] Regarding start-up expenses, the IRS specifically held that "[t]he expenses for advertisements, travel to search for a new business, and the cost of audits . . . to help the individual decide whether to attempt an acquisition were [personal] investigatory expenses and are not deductible."[52] Subsequent case law supported this proposition, consistently holding that pre-opening, investigatory expenses were not deductible.[53]

B. The Miscellaneous Revenue Act of 1980

In 1980, the 96th Congress amended the Code to include I.R.C. § 195, allowing for the amortization of start-up expenses for both business and non-business taxpayers.[54]

1. Congressional Intent

Congress hoped § 195 would decrease the controversy regarding the classification of start-up expenditures.[55] The courts were often asked to classify or determine the deductibility of start-up expenses.[56] Congress hoped the addition of § 195 would clarify the definition and treatment of start-up expenditures, thereby reducing the strain on the courts.[57] Additionally, § 195 was viewed as a codification of the holding in *Briarcliff Candy Corp. v. Commissioner*[58] in which the taxpayer was allowed to deduct significant expansion costs.[59]

Congress also wanted to treat business and non-business taxpayers equally.[60] Under existing law, start-up costs were included in the business's basis and were only recoverable upon sale or abandonment.[61] Existing businesses were able to deduct or capitalize the start-up costs associated with expansion and acquisition, allowing them to more quickly recover their investment.[62] Congress hoped § 195 would correct this difference[63] and treat the similarly situated taxpayers equally, fulfilling the goal of horizontal equity.[64]

Lastly, Congress hoped to encourage new business development.[65] In the late 1970's, a worldwide recession fueled by high energy prices hurt big business.[66] Congress hoped small business, and its ability to respond quickly to new opportunities, would help the economy recover.[67] Under existing law, however, potential business owners were at a disadvantage.[68] The inability to deduct start-up expenses created a barrier to entry, and discouraged business development and innovation.[69] Section 195 was an attempt to remove the barrier and encourage growth.[70] While Section 195 may violate the neutrality principle, by encouraging behavior that may not have otherwise occurred[71], Congress often uses tax incentives to modify behavior, especially when the aggregate social gains from modification outweigh the total costs.[72]

2. The Text of § 195

The enactment of § 195 in 1980 allowed qualifying start-up expenses to be amortized over sixty months once the business began.[73] To qualify for amortization, the expenditure had to be paid or incurred in investigating the creation or acquisition of a trade or business[74] and deductible by an existing trade or business.[75] An additional requirement of successful operation was inferred by the tolling of the amortization period until the business began.[76] In application, § 195 served as a tool to defer expenses for those who eventually began a trade or business. It did not create a new class of deductions[77], but merely allowed entrepreneurs to amortize expenses current business owners were already able to deduct or amortize.[78]

In 1984, Congress enacted the Deficit Reduction Act, substantially revising § 195.[79] As revised, § 195 generally required capitalization of all start-up expenses except for specifically qualified expenses.[80] The definition of qualified expenses included expenses incurred by "any activity engaged in for profit and for the production of income" prior to achieving active trade or business status[81], and excluded expenses already covered by §§ 163(a), 164 or 174.[82]

III: Initial Application of § 195

A. General Application

Two early cases illustrate the limited application of § 195. In *Pino v. Commissioner*[83], the taxpayer attempted to deduct start-up expenses associated with an unsuccessful import-export business.[84] The expenses included consulting fees, travel, advertising and certain utilities, all of which Congress held to be eligible expenses under § 195.[85] The Court refused to allow a deduction under § 162[86] or to amortize the costs under § 195, finding that eventual participation in an active trade or business was required for § 195 amortization.[87]

In *Duecaster v. Commissioner*, the tax court was asked to more clearly define deductibility by an existing trade or business.[88] The taxpayer attempted to amortize the cost of his legal education under § 195.[89] In disallowing the amortization, the court determined the cost of legal education was not an otherwise allowable expense under § 162 and therefore was not deductible under § 195.[90]

B. Section 162's Impact on § 195

Pino and *Duecaster* illustrate § 195's reliance on § 162 in determining whether an expense qualifies for a current deduction.[91] Section 162 allows a deduction for "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[92] The legislative history and statutory construction of § 195 illustrate this dependency.[93] In this way, § 195 is similar to § 212, allowing a deduction for expenses associated with the production of income but not incurred by a trade or business.[94] Neither section creates a new class of deductions that are prohibited under § 162.[95] Both sections merely permit taxpayers to deduct or amortize expenses at previously unallowed stages of business development.[96] As a result, qualification of a § 195 expense is determined by what qualifies as an otherwise deductible expense under § 162.[97]

1. Lincoln Savings & Loan *and the "Separate and Distinct Asset" Test*

The first major case defining a § 162 expense was *Commissioner v. Lincoln Savings & Loan.*[98] The Supreme Court was asked to determine the character of a required premium payment made by Lincoln Savings to the Federal Savings and Loan Insurance Corporation.[99] In order to qualify as an allowable deduction under § 162, the Court noted that an item must be (i) an ordinary and necessary expense, (ii) paid or incurred during the taxable year, (iii) for the carrying on of a trade or business.[100] The tax court held that the premium did not qualify as an ordinary and necessary expense under § 162, therefore requiring capitalization.[101] The court of appeals reversed.[102]

The Supreme Court affirmed the tax court's classification of the expense as a capital expenditure, arguing that "what is important and controlling . . . is that the . . . payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense."[103] The Court noted that this was the correct inquiry because "many expenses concededly deductible have prospective effect beyond the taxable year." [104]

After *Lincoln Savings*, the "separate and distinct test" was almost universally applied to determine whether an expense was deductible under § 162 or required capitalization.[105] However, application of the test did not always result in capitalization.[106] In *Briarcliff Candy Corporation v. Commissioner*,[107] an established candy retailer incurred significant expansion costs associated with securing 159 franchise and distributor contracts with existing retailers.[108] The Commissioner argued that the contracts were capital assets with benefits lasting beyond the year in which they were made.[109] The Second Circuit, following *Lincoln Savings* and a long line of cases regarding the deductibility of self-preservation expenses[110], held that the expenses should be deductible.[111] The court interpreted the *Lincoln Savings* holding as requiring the creation of a new separate and distinct asset in order to capitalize the costs.[112]

In *NCNB Corporation v. United States*[113], the Fourth Circuit held that expenses associated with metro and feasibility studies and applications to the Comptroller were deductible.[114] Finding that the expenses did not create a separate asset[115], the court focused instead on the bank's need to analyze trends and market positions in order to stay competitive in their industry.[116] The court also noted the effect this holding had on the application of § 195, noting:

> Congress is thus under the impression that expenditures for market . . . and feasibility studies, as at issue here, are fully deductible if incurred by an existing business undergoing expansion. An interpretation by us to the contrary would render § 195 meaningless for it would obliterate the reference point in the statute – 'the expansion of an existing trade or business.'[117]

Not all courts, however, interpreted *Lincoln Savings* as requiring a separate, physical asset. In *Bilar Tool & Die Corporation v. Commissioner*[118], the Sixth Circuit held that the legal fees incurred in dividing a company required capitalization even though they did not create a separate asset.[119] The court found that the fee was "an expenditure to enhance capital which was calculated to benefit the taxpayer for much more than one year."[120]

After determining that a separate asset had been created, other issues still arose. In *Commissioner v. Idaho Power Company*[121], a utility company clearly created a separate asset when it constructed a new facility.[122] The issue was instead the correct period of time over which to depreciate the equipment used in the construction of the asset.[123] The Court held that the equipment should be depreciated over the life of the asset created, not the life of the equipment itself.[124] The Court noted that § 263 takes precedence over the current depreciation deductions allowed in § 167[125], in an attempt to "comport . . . accounting and taxation realities."[126] These inconsistencies in interpreting *Lincoln Savings* and the focus on matching expenses with income production led the Supreme Court to re-evaluate the "separate and distinct asset test" in 1992.[127]

2. INDOPCO and the "Future Benefit" Test

In *INDOPCO, Inc. v. Commissioner,*[128] the Supreme Court again looked at the issue of qualifying expenses under § 162.[129] In late 1977, Unilever, a customer of INDOPCO, expressed interest in acquiring INDOPCO in a friendly takeover.[130] INDOPCO shareholders approved the takeover and INDOPCO paid $2.2 million to investment bankers hired to facilitate the acquisition, which it later claimed as a § 162 deduction.[131] The IRS disallowed the deduction.[132]

Focusing on the long-term benefit INDOPCO received from the services, the tax court held that the fee was a capital expenditure and not deductible under § 162.[133] The Third Circuit Court of Appeals affirmed, holding that "both [INDOPCO]'s enormous resources and the possibility of synergy arising from the transaction served the long-term betterment of [INDOPCO]."[134] The Third Circuit rejected INDOPCO's argument that "because the disputed expenses did not 'create or enhance. . . a separate and distinct additional asset' they could not be capitalized and therefore were deductible under § 162(a)."[135]

The Supreme Court affirmed, holding that the expenses were not currently deductible.[136] Clarifying its original position in *Lincoln Savings*, the Court held that:

> *Lincoln Savings* stands for the simple proposition that a taxpayer's expenditure that 'serves to create or enhance . . . a separate and distinct' asset should be capitalized under § 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under § 263 . . . In short, *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure.[137]

Retreating from previous statements in *Lincoln Savings*[138], the Court also held that "[a]lthough the mere presence of an incidental future benefit–'some future aspect'–may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining . . . the appropriate tax treatment."[139] Finding that the merger created a substantial future benefit for both companies, extending well beyond the year in question, the Court held that the costs were correctly classified as capital expenditures.[140]

IV: Limits to the Application of *INDOPCO*

On its face, the *INDOPCO* holding had the potential to severely restrict the application of § 195.[141] If *INDOPCO* required capitalization of any expense that created a future benefit, the category of start-up costs eligible under § 195 would be limited to those that did not create a benefit beyond the taxable year.[142] Start-up costs, by definition, create future benefits or at least the potential for future benefits.[143] *INDOPCO's* replacement of the separate and distinct asset test, on which § 195 was loosely based[144], seemed to frustrate the intent behind the provision.[145] Upon closer inspection, however, *INDOPCO* arguably does not have such a far-reaching effect.[146]

A. Hostile Takeovers

In the aftermath of *INDOPCO*, many anticipated that the IRS would attempt to extend the *INDOPCO* holding to include the costs incurred defending against a hostile takeover.[147] The IRS's position regarding these costs had changed many times prior to the *INDOPCO* decision.[148] In reliance on the Third Circuit's holding in *National Starch*[149], the IRS had already issued TAM 91-44-042 which attempted to require the capitalization of costs associated with both friendly and hostile takeovers.[150]

The TAM held "that the nature of a proposed corporate takeover (i.e., whether it is friendly or hostile) is not determinative of the proper tax treatment . . . . Rather, the proper inquiry . . . is whether the target corporation obtained a long-term benefit as a result of making the expenditures."[151] The IRS placed the burden on the taxpayer to prove there was not a substantial future benefit[152] and assessed deficiencies against companies who had deducted the costs of defending a hostile takeover.[153]

The IRS took this position in *In re Federated Department Stores, Inc.*,[154] arguing that *INDOPCO* reversed the bankruptcy court's deduction decision and instead necessitated capitalization.[155] In an attempt to defend against an unsolicited takeover bid, Federated entered into 'white knight'[156] negotiations with Macy's, which included a break-up fee provision.[157] Federated eventually recommended the unsolicited takeover to its shareholders, paid Macy sixty million dollars under the break-up fee agreement and deducted the fee as a § 162 expense.[158] The district court affirmed the bankruptcy court's decision, finding that the expenses did not accrue a future benefit and should be classified under § 162.[159] In commenting on *INDOPCO*, the court found:

> INDOPCO . . . does not undermine . . . earlier decisions. It merely adds another criteria that courts should examine in ascertaining the tax classification of an expenditure–whether an expenditure creates a future benefit. INDOPCO does not stand for the principal that any expenditure that merely preserves the existing corporate structure or policy must be capitalized. The Court considers the expenses incurred in defending against a proxy fight as expenditures that protect the existing policies or structure of a business. Such expenditures are currently deductible and do not require capitalization.[160]

The Seventh Circuit also commented on hostile takeovers in *A.E. Staley Manufacturing Co. v. Commissioner*.[161] Staley Continental, Inc. incurred millions in banking fees as it attempted to resist a hostile takeover.[162] The tax court disallowed a deduction for the fees, concluding "that the hostile nature of the takeover did not distinguish the case from INDOPCO in any relevant sense."[163] The Seventh Circuit reversed, deferring to the "well-worn notion that expenses incurred in defending a business and its policies from attack are necessary and ordinary-and deductible-business expenses."[164] The court found that Staley was defending its business against attack,[165] which did not produce a benefit beyond the taxable year, thereby limiting the *INDOPCO* holding only to friendly acquisitions.[166]

B. The Realization v. the Expectation of Benefit

INDOPCO required capitalization due to the "taxpayer's realization of benefits beyond the year in which the expenditure is incurred."[167] In comparing *INDOPCO* to *Briarcliff Candy*[168], the expectation, rather than the realization, of the future benefit produced by the expenditure differentiates the two holdings.[169] In *Sun Microsystems v. Commissioner*,[170] the tax court focused on this distinction.[171] Sun Microsystems granted warrants to a strategic partner "as additional incentive for an ongoing business relationship."[172] The Commissioner argued that the costs incurred by Sun Microsystems associated with the exercise of the warrants should be capitalized under *INDOPCO*.[173] In allowing Sun to deduct the expenses, the court noted that "the anticipated long-term benefits to [Sun] from the relationship . . . were 'softer' and were speculative,"[174] qualifying them as "incidental future benefit[s]."[175]

In *FMR Corp v. Commissioner*, the tax court conducted a similar future benefit analysis.[176] FMR was a holding company for regulated investment companies ("RICs").[177] From 1985 to 1987, FMR established eighty-two RICs and deducted the associated expenses.[178] The Commissioner argued that these expenses should be capitalized, focusing on the expectation of future benefit analysis from *INDOPCO*.[179] While the tax court agreed these were capital expenses, it focused on the realization, not the expectation, of benefit. The court looked at the fee arrangement, the perpetual existence of the RIC's and the history of RIC success in determining that FMR actually received a future benefit from the contracts.[180] Additionally, the court distinguished *Briarcliff* from *INDOPCO* by "[e]mphasizing the importance of the realization of a significant future benefit in determining whether an expenditure should be capitalized."[181]

C. Other Limitations

The Third Circuit limited *INDOPCO's* application to loan origination costs in *PNC Bancorp, Inc. v. Commissioner*.[182] In spite of *INDOPCO* holding that "deductions are exception to the norm of capitalization"[183] and the Statement of Financial Standards ("SFAS") 91 requiring banks to separate loan origination costs from other expenses,[184] the tax court held that the costs should be capitalized over the life of the loan.[185] On appeal, the Third Circuit noted that "[h]istorically, the costs at issue have been deductible in the year that they are incurred."[186] Focusing on a line of pre-*INDOPCO* cases that permitted current deductions for loan creation costs and day-to-day bank operation expenses, the court reversed, allowing PNC to take the deduction.[187]

INDOPCO also had the potential to influence which expenses were considered to be associated with a substantial future benefit. *Wells Fargo v. Commissioner*[188] concerned in-house costs associated with a bank merger.[189] The bank deducted $150,000 in salaries paid to employees who assisted with the merger.[190] The Commissioner disallowed the deduction, claiming the employee's efforts contributed to the merger, creating a substantial future benefit and requiring capitalization.[191] The tax court agreed.[192] Using complex symbolic logic to interpret the *INDOPCO* decision[193], the Eighth Circuit reversed and allowed the deduction, holding that the indirect salaries associated with the merger were not comparable to the direct expenses in *INDOPCO*.[194]

D. What's Left of § 195?

In addition to the limitations above, the IRS has spoken directly on certain classes of expenses that specifically do not create a substantial future benefit. Revenue Ruling 92-80 stated that *INDOPCO* did not affect the deductibility of advertising expenses.[195] Revenue Ruling 94-12 confirmed pre-*INDOPCO* law by stating that incidental repair expenses are deductible expenses.[196] Revenue Ruling 96-62 held that training costs were also still deductible as business expenses post-*INDOPCO*.[197]

Most significantly for § 195 analysis, Revenue Ruling 2000-4 held that expenditures to expand an existing business do not necessarily result in a future benefit.[198] The IRS focused on the speculative and incidental nature of the benefits, noting "the mere ability to sell in new markets and to new customers, without more, does not result in significant future benefits."[199]

In an attempt to further clarify §195 qualification, Revenue Ruling 99-23 specifically discussed start-up expenditures.[200] The ruling differentiated between expenses incurred prior to making a "final decision" and those made afterwards.[201] Defining the final decision as "the point at which a taxpayer makes its decision whether to acquire a business and which business to acquire"[202], expenditures incurred prior to the final decision are classified as investigatory costs and eligible for amortization under § 195.[203] Costs incurred to acquire a specific business after the "whether and which" decision are not eligible under § 195.[204]

The ruling also succinctly described the relationship between §§ 162 and 195, stating "[t]hus, the expenditure must be an ordinary expense under § 162, and not a capital expenditure, to be a start-up expenditure under § 195."[205] Possible expenses that qualify for amortization include costs to survey potential markets, advertising, salaries, and travel expenses.[206]

The Treasury issued final regulations under § 263A in late 2003, attempting to simplify the interplay of §§ 195 and 263A.[207] Unfortunately, the regulations further complicated the relationship between the two sections.[208] For example, the final regulations do not allow for the amortization of start-up costs, although this is specifically allowed under § 195.[209] Another issue arises if costs were previously included as § 195 expenses but now require capitalization.[210]

In 2004, the 108th Congress passed the American Jobs Creation Act of 2004 (the "Act") in order to "make our manufacturing, service, and high-technology businesses and workers more competitive both at home and abroad."[211] The Act provided for consistent amortization of intangibles throughout the code, including in § 195, on a 180-month amortization schedule.[212] Most significantly, the Act allowed up to $5,000 of start-up expenditures to be immediately deductible.[213] Until 2004, § 195 only allowed for the amortization of expenditures once the business began.[214] While this change does not resolve the debate between §§ 162 and 263,[215] it encourages the formation of new businesses by giving an immediate deduction to potential business owners.[216]

INDOPCO re-stated the oft-quoted rule that "an income tax deduction is a matter of legislative grace."[217] While the Code may prefer capitalization in absence of a specific provision to the contrary, § 195 now specifically exempts start-up expenditures from the default requirement of automatic capitalization.[218] In fact, *INDOPCO* did not mention § 195, although it had been in the Code for over a decade.[219] In light of this, *INDOPCO* should not be read as prohibiting, or even substantially limiting, the application of § 195.[220]

V: Recommendations

Unless extended or amended, Section 195 will expire in July 2011.[221] The current iteration of the provision does not adequately meet Congress's stated goals – equal treatment of taxpayers, reduction in litigation and encouraging small business development and growth.[222] Each of these goals could be met by redrafting the statute.

A. Equal Treatment

Consider two taxpayers, each of whom spend $52,000 for technology infrastructure for their businesses, including hardware, software, networking and support.[223] Taxpayer A is currently engaged in an ongoing trade or business, and is therefore able to use § 162.[224] Additionally, Taxpayer A can also use §§ 168 and 179 to expense certain capital assets.[225] Taxpayer B is in the process of starting a business and therefore must rely only on § 195.[226] For the 2008 taxable year, Taxpayer A would be able to deduct the entire $52,000 cost of the technology.[227] Taxpayer B, however, would only be able to deduct $3,000 of the cost.[228] Had the total expenses been $60,000 instead, Taxpayer A still be able to deduct all $60,000 but Taxpayer B would not be able to deduct any of the expenses.[229]

This is inconsistent with Congress's intent for equal treatment of similar taxpayers and a problem for entrepreneurs hoping to use § 195.[230] In 2003, the SBA released a study on the costs associated with starting a business.[231] The average forecasted expenses associated with new business were $7,000 for solo entrepreneurs and $23,200 for teams of entrepreneurs.[232] Of the 830 entrepreneurs surveyed, 388 or 46.75% were solo entrepreneurs, making the expected value of expenses per entrepreneur $15,627.[233] The average actual investment is $8,026 with a standard deviation of $25,752 for solo entrepreneurs and $37,975 with a standard deviation of $182,201 for teams.[234] The 95% interval for self-investment by solo and team entrepreneurs is $0 to $59,530 and $0 to $402,377 respectively.[235] At this high level of expenditure, start-up business owners minimally benefit from the $5,000 deduction under § 195,[236] while ongoing business owners would be able to deduct most, if not all, of these expenses.[237]

Section 179 has a structure similar to § 195, although its benefits are only available to ongoing businesses.[238] Enacted in 1958, § 179 was intended to give small business owners a depreciation bonus for new assets.[239] Taxpayers could expense 20% of the cost of property placed in service during the taxable year.[240] Originally, the deduction was limited to $10,000, ensuring that only small businesses would benefit from the provision.[241] The deduction was changed to a dollar amount in 1981,[242] a reduction threshold was added in 1986[243] and an additional income limitation was added in 1988.[244] Since 1981, Congress has often updated the amount of the deduction under § 179(b)(1) as well as the phase-out limits.[245]

The limits under § 179 are much higher than those under § 195, allowing more taxpayers to use the incentives under the depreciation provision.[246] Section 195 should have similar limits, based on the amount of expenditures incurred by actual entrepreneurs. By increasing the deduction to $50,000 instead of $5,000, the percent of businesses able to take the maximum deduction increases from 45.22% to 94.84% for solo start-ups and 42.86% to 52.79% for team start-ups.[247] Increasing the threshold at which the deduction decreases from $50,000 under the current law to $400,000 would increase the percentage of start-ups able to use the provision from 96.56% to 100% for solo entrepreneurs and from 53.59% to 98.81% for teams.[248] These changes would allow the majority of start-up companies to use this incentive and would more closely align with horizontal equity.[249]

Start-up expenses alone do not insure long-term success. Twenty-five to thirty percent of new businesses fail within their first year and sixty to eighty percent fail within six years.[250] While team start-ups are initially more successful, the rate of success after six years of both types of start-ups is roughly equal.[251] One way to protect against failure is to have adequate financing in place prior to beginning the business.[252] Another is the development of a business plan, considered by many as the most critical step to ensuring the success of the business.[253] Giving start-up businesses the same tax incentives enjoyed by ongoing businesses will further serve Congress's stated legislative goals by giving entrepreneurs the time they need to develop business plans and secure funding, rather than feeling rushed to begin the business due to tax advantages.[254]

B. Reducing Litigation With Clear Statutory Construction

Revenue Ruling 99-23 differentiates between costs prior to the "whether and which" decisions and those after.[255] The legislative history of § 195 points to another span of time within which amortizable costs can occur–"subsequent to a decision to establish a particular business and prior to the time when the business begins."[256] The intent was for "ordinary and necessary expenses incurred before the business functions as a going concern fall within the proposed section. Section 162 applies to expenses incurred after the business begins functioning as a going concern."[257]

The use of the term "when the business begins"[258] and "active trade or business"[259] as opposed to "function as a going concern" is confusing.[260] Revenue Ruling 99-23 makes it clear that expenses incurred after the decision to enter a specific business are not included under § 195.[261] Under this interpretation, expenses incurred after this decision would be treated as capital expenditures and added to the basis of the business.[262] Congress's intent was for § 162 to take over as soon as § 195 was no longer applicable.[263] The inclusion of advertising and salaries as deductible start-up expenses would not make sense if all expenses incurred after the entry decision had to be capitalized.[264] Adjusting the terminology so it is consistent between the two provisions will simplify the application of § 195 and better fulfill Congress's intent.

C. Encouraging Small Business Growth

Formation of new business is at the heart of § 195's enactment.[265] Congress was concerned that the unequal treatment of taxpayers[266] was limiting small business development.[267] Specifically, in Revenue Ruling 99-23 the IRS concluded that:

> [t]his disparity in the tax treatment of investigatory expenses resulting from the carrying on a trade or business requirement discouraged taxpayers from investigating the creation or acquisition of new trades or business. Section 195 was enacted, in part, to minimize this disparity and *thereby encourage formation of new businesses by providing an amortization deduction for eligible investigatory expenses*.[268]

With the state of the current economy, small business optimism is at the lowest levels in recent history.[269] In 2006, non-employer firms increased only 1.85% from the previous year, as opposed to 4.45%, 4.69% and 5.65% the previous three years.[270] As companies freeze hiring and continue to lay off employees, unemployment numbers continue to grow and record numbers of people are looking for alternative employment.[271]

Noting that "start-ups that will create the high-wage, high-tech jobs of tomorrow," President Obama has pledged to help small business.[272] He plans to "improv[e] access to capital and invest in innovation and development."[273] The new administration's first attempt to follow through on this promise was the American Recovery and Reinvestment Act of 2009

("ARRA").[274] The much debated $787 billion stimulus package[275] intended to "provide investments needed to increase economic efficiency by spurring technological advances in science and health."[276] The ARRA includes tax incentives for businesses[277], and some provisions for small businesses in particular.[278]

None of these provisions, however, encourage the formation of new businesses.[279] The ARRA extends the favorable tax treatment under §§ 168(k)[280] and 179,[281] but these provisions are only available to ongoing businesses.[282] The ARRA also revises § 172 to allow net operating losses ("NOLs") to be carried back 5 years.[283] NOLs occur when tax deductions exceed gross income, for both business and non-business activities.[284] Non-business deductions are allowed to the extent of non-business net income.[285] Start-up activities are considered non-business deductions, and therefore would be included in this limitation.[286] To encourage small business formation, § 172 should be amended to exclude start-up activities from non-business activities and give entrepreneurs the same benefits as existing business owners.

President Obama hopes to also "eliminate all capital gains taxes on small and start-up businesses to encourage innovation and job creation."[287] Capital gains are paid on gains from capital assets by both business and non-business taxpayers.[288] While a taxpayer thinking of starting their own business may eventually benefit from this proposal, they will not receive any up-front benefits or incentives to begin the business.[289]

As the unsteady economic condition of the country continues, it has become increasing difficult to secure start-up capital, leading to severe cash flow and financing problems for small businesses.[290] This cash crunch is especially problematic for the economic recovery because it stalls technological growth and innovation.[291] Congress has tried to respond to this issue most recently by passing both House and Senate versions of the Small Business Jobs [and Credit] Act of 2010.[292] This Act, among various other provisions, amends § 195 for all taxable years beginning after December 31, 2009, increasing the deduction to $10,000 and the reduction threshold to $60,000.[293] Continuing to increase these limits even more will provide immediate, self-help incentives to entrepreneurs by giving them up-front deductions.[294] Changing § 172(d) to allow a carryover of NOLs due to start-up activities will make sure entrepreneurs can maximize this benefit.[295]

VI. Conclusion

Congress enacted § 195 with the hope of encouraging small business growth, reducing litigation and minimizing the varied tax treatment between similar taxpayers.[296] Over the past 30 years, small business has grown to produce more than half of the United States gross domestic product and employ over 99% of the workforce.[297] The role of small business in the future stability and "well being of the [United States] economy cannot be overstated."[298] With this in mind, as well as President Obama's own statements regarding start-up businesses, Congress should strive to ensure that § 195 remains part of the Code, while raising its deduction limits.[299]

Increasing the maximum deduction to $50,000 and the threshold limit to $400,000 will both encourage small business growth and minimize the discrepancy in tax treatment among business and non-business taxpayers.[300] Excluding start-up activities from the definition of non-business activity under § 172 will ensure that entrepreneurs receive the full benefit of their expenditures.[301] And using consistent language in § 195 and other related provisions, such as § 162, will simplify application and effectuate Congress's intent.[302]

The ARRA did not fulfill President Obama's promise to encourage start-up businesses, the creators of "high-wage, high-tech jobs" that will help the economy recover after the financial crisis.[303] The Small Business Jobs Act did not go as far as it could have to encourage small business growth. With the decrease in available capital, any increase in deductions available to entrepreneurs will lighten cash-flow issues and possibly help the businesses self-fund.[304] In light of this, Congress should make sure § 195 is as strong as possible to encourage start-up growth and economic development.

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[1] Andrea Marks earned her J.D. at the University of Houston Law Center in May 2010 and is currently associated with Crady, Jewett &McCulley LLP in Houston, Texas. Andrea can be reached via email at amarks@cjmlaw.com.

[2] Ben Bernanke, Governor, Fed. Reserve Board, Remarks at the National Economists Club in Washington, D.C. (Nov. 21, 2002) (transcript available at http://www.federalreserve.gov/ BOARDDOCS/SPEECHES/2002/20021121/default.htm).

[3] *See generally* Edwin J. Perkins, *The Entrepreneurial Spirit in Colonial America: The Foundations of Modern Business History*, 63 BUS. HISTORY REV. 160 (arguing that colonial businesses laid the foundation for current entrepreneurs).

[4] *See* MANSEL G. BLACKFORD, A HISTORY OF SMALL BUSINESS IN AMERICA 11-32 (2003) (describing the capitalist motives of early settlers, allowing for economic growth in the new country).

[5] Robert W. Fairlie, Small Business Administration Office of Advocacy, Estimating the Contribution of Immigrant Business Owners to the U.S. Economy (2008), http://www.sba.gov/advo/ research/rs334.pdf. *See also* Immigrant Business Owners Make Big Impact on US Economy, http://voices.washingtonpost.com/smallbusiness/2008/11 /immigrant_business_owners_make.html (Nov. 14, 2008, 13:55 EST) (noting that 12.5% of small businesses are owned by immigrants and immigrants are 30% more likely to start their own business); Elizabeth Kelleher, *Immigrants Fuel Small Business Growth in the United States*, America.gov, Mar. 7, 2008, http://www.america.gov/st/washfile english/2007/March/20070302160834berehellek0.7271845.html (noting that immigrant women are 57% more likely to start their own business than native-born women).

[6] *See* US Small Business Administration: Office of Advocacy, Firm Size Data, http://www.sba.gov/advo/research/data_uspdf.xls (last visited Mar. 1, 2009) [hereinafter SBA Data] Tab "dyn89_05" (noting 2006 firm deaths total 565,800 for a net increase of over 73,000 firms).

[7] *See* Ralph F. Wilson, *Small Business Benefits*, NETWORK SERVICES & CONSULTING CORP., 2002, http://www.enetsc.com/DoctorEbiz.htm (listing the benefits of small business).

[8] Small Business Act of 1953, Pub. L. No. 83-163, Title II, 67 Stat. 232 (1953).

[9] 67 Stat. at 232.

[10] US Small Business Administration: Office of Advocacy (2009), http://www.sba.gov/advo/research/data.html (last visited Mar. 1, 2009). Non-employer businesses only employ the owner, while employer businesses employ additional employees. *Id*.

[11] *See* SBA Data, *supra* note 6 at Tab "us88_06" (reporting 20,768,555 non-employer and 6,022,127 employer firms in 2006).

[12] *See* SBA Data, *supra* note 6 at Tab "dyn89_05" (detailing the number of employees per firm). Of the roughly 26.8 million firms, 26.68 and 26.77 million contain less than 100 and 500 employees respectively. *Id*.

[13] US Small Business Administration Office of Advocacy, Firm Size Data, http://www.sba.gov/advo/research/data.html (last visited Mar. 1, 2009) (defining a small business as "an independent business having fewer than 500 employees.")

[14] *See* SBA Data, *supra* note 6 at Tab us88_06 (noting the 119.917 million Americans employed by employer firms and the 20.769 million owners of non-employee firms).

[15] *See id*. (detailing employment statistics by size of the firm). Employees in firms with less than 100 people total 42,686,395. *Id*. Adding this to non-employer firms, total employment is 63,454,950. *Id*. Employment by firms with less than 500 employees is 60,223,740 in addition to the non-employer firms, for a total of 80,992,295. *Id*.

[16] *See* KATHERINE KOBE, U.S. SMALL BUSINESS ADMINISTRATION: OFFICE OF ADVOCACY, THE SMALL BUSINESS SHARE OF GDP 1998-2004 5, 11 (2007), http://www.sba.gov/advo/research/rs299tot.pdf (noting that only once since 1998 has the small business percentage been less than 50%).

[17] Miscellaneous Revenue Act of 1980, Pub. L. No. 96-905, Title I § 102(c), 94 Stat. 3522 (1980) (codified as I.R.C. § 195 (1982)). *See also* S. REP. NO. 96-1036 (1980) (outlining the intent behind the changes).

[18] I.R.C. § 195 (1982).

[19] *See* S. REP. NO. 96-1036, at 11 (1980) (noting that the intent is to "encourage formation of new business and decrease controversy . . . under present law"). *See also infra* Part II.B.l.

[20] *See, e.g.*, I.R.C. § 179 (2006) (allowing depreciation of qualified business property at an accelerated rate); I.R.C. § 168(k) (2006) (allowing additional depreciation of qualified property used by existing businesses). *See also* William G. Gale & Peter R. Orszag, *An Economic Assessment Of Tax Policy In The Bush Administration, 2001-2004*, 45 B. C. L. REV. 1157, 1170 (discussing the effects of the changes to § 179).

[21] KENNETH DESMOND GEORGE, CAROLINE JOLL & E. L. LYNK, INDUSTRIAL ORGANISATION: COMPETITION, GROWTH, AND STRUCTURAL CHANGE 259-60 (1992) (discussing the effect barriers to entry have on competition).

[22] Treas.. Reg. § 1.195-1T(e) (2008) (noting that the current provision will expire on July 6, 2011).

[23] *See, e.g.*, Bureau of Labor Statistics, Employment Situation Summary Jan. 2009, http://www.bls.gov/news.release/empsit.nr0 .htm (noting the unemployment rate in May 2009 increased from 8.9% to 9.4% with the economy losing 787,000 jobs); V. Dion Waynes, *Circuit City Shutting Down, Leaving 24,00 Out of Work*, WASH. POST, Jan. 17, 2009, at D1 (discussing the closing of all 567 Circuit City stores nationwide); Real Time Economics: First Quarter Layoffs – Selection of Job Cuts by Major Companies, http://blogs.wsj.com/economics/ (Jan. 8, 2009, 13:14 EST) (listing all first quarter layoffs by company, date of announcement and the number of jobs lost).

[24] *See* Morgan P. Miles & Spence L. Wise, *The Internal Revenue Service as a Stimulus to the Entrepreneurial Search Process*, BUS. FORUM, Spring 2001, *available at* http://www.entrepreneur.com/tradejournals/article/116186583_2.html (noting the potential for growth in the small business sector and the innovative successes derived from entrepreneurs).

[25] *See infra* Part II (focusing on the intent of the provision).

[26] *See infra* Part III (detailing case law that has effected the applicability of the provision).

[27] *See infra* Part IV (discussing the interpretation of *INDOPCO* and changes to tax law).

[28] *See infra* Part V (recommending changes for § 195).

[29] *See infra* Part VI (urging lawmakers to make the recommended changes).

[30] *See* Internal Revenue Code, Pub. L. No. 83-591, 68A Stat. 1 (1954) (excluding a specific provision for the treatment of start-up expenses). The 1954 Code replaced the 1939 version of the Code, which had only re-organized the existing tax law into volume 26 of the U.S. Code. *See* Internal Revenue Code, 53 Stat iii (1939) ("These statutes are codified without substantive change and with only such change of form as is required [for] consolidation.").

[31] *See* JOSEPH M. DODGE, J. CLIFTON FLEMING, JR., & DEBORAH A. GEIER, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY: TEXT, CASES, PROBLEMS 43-63 (3d. ed. 2004) (detailing the tax base under the current income tax code).

[32] *See id*. (discussing what is included and deducted to create the taxpayer's tax base).

[33] *See, e.g.*, INDOPCO v. Comm'r, 503 U.S. 79, 84 ("[T]he Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes).

[34] *Compare* I.R.C. § 162(a) (2006) ("There shall be allowed as a deduction all the ordinary and necessary expenses paid . . . in carrying on any trade or business") *with* I.R.C. § 262(a) (2006) ("[N]o deduction shall be allowed for personal, living or family expenses.").

[35] *See supra* note 34 (comparing §§ 162 and 262). *See also* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 57-58 (noting the limited classes of deductions and those expressly disallowed under the Code).

[36] *See* I.R.C. § 263(a) (2006) (disallowing deductions for a variety of expenditures).

[37] Woodward v. Comm'r, 397 U.S. 572, 573 (1970). The Code defines a capital asset as any taxpayer property excluding specifically listed assets. *See* I.R.C. § 1221(a) (2006) (excluding inventory, property subject to depreciation, property created by personal efforts, and clearly-identified hedging transactions, as capital assets).

[38] Treas. Reg. § 1.263(a)-2(a) (2008).

[39] *Id*.

[40] *See* I.R.C. § 167 (2006) (allowing depreciation for tangible business property); I.R.C. § 197 (2006) (allowing amortization for intangible business property).
[41] *See* I.R.C. § 165(c) (2006) (noting losses are deductible if incurred in a trade or business, in a for-profit transaction or from casualty or theft).
[42] *See, e.g.*, Fishman v. Comm'r, 837 F.2d 309, 311-12 (7th Cir. 1988) (describing start-up costs as pre-opening expenses, unable to be deducted).
[43] *See* I.R.C. § 162(a) (2006) (allowing deductions for expenses incurred while carrying on a trade or business); I.R.C. § 262(a) (2006) (disallowing personal consumption deductions).
[44] Rev. Rul. 57-418, 1957-2 C.B. 143. Revenue rulings are not binding, although the courts typically defer to on-point revenue rulings. DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 33.
[45] Parker v. Comm'r, 1 T.C. 709 (1943).
[46] Rev. Rul. 57-418.
[47] *Id*.
[48] Rev. Rul. 77-254, 1977-2 C.B. 63.
[49] Seed v. Comm'r, 52 T.C. 880 (1969).
[50] *See id*. at 885 ("Congress intended to grant a deduction for a loss which arose out of activities which constituted something less than . . . a trade or business. To hold otherwise would be to render [§] 165(c)(2) a nullity.")
[51] *Id*. *See also* I.R.C. § 165(c)(2) (2006) (allowing a deduction for "losses incurred in any transaction entered into for profit, though not connected with a trade or business.")
[52] Rev. Rul. 77-254.
[53] *See, e.g.*, Wimmer v. Comm'r, 25 T.C.M. (CCH) 951 (1966) ("It is, of course, well established that the expense one incurs in investigating and promoting a contemplated new business are not deductible under § 162."); Vanlandingham v. Department of Revenue, 9 Or. Tax 308 (1983) ("[Section] 162 allows a deduction for trade or business expenses only if incurred in connection with a trade or business, not if incurred in the preliminary investigation of a business"); Fishman v. Comm'r, 837 F.2d 309, 311 (7th Cir. 1988) (holding that rent paid for land prior to the generation of income was a start-up expense and not deductible under § 212).
[54] Miscellaneous Revenue Act of 1980, Pub. L. No. 96-905, Title I § 102(a), 94 Stat. 3521 (1980) (codified as I.R.C. § 195 (1982)).
[55] *See id.* (citing "decrease . . . litigation arising under present law with respect to the proper income tax classification of start-up expenditures" as one of the reasons for changing the law).
[56] *See supra* note 53 and accompanying text (noting cases dealing with the deductibility of start-up and investigatory expenses).
[57] *See* William C. Lathen and Robert L. Lathen, *The "Gap Period" Problem in Section 195*, 62 TAXES 416, 416 (1984) (noting the enactment was an attempt to "defuse the controversy arising over the tax treatment of start-up expenditures").
[58] Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775 (2nd Cir. 1973). *See also* George B. Javaras & Todd F. Maynes, *Do* Briarcliff Candy *and Code Section 195 Stiff National Starch?*, 49 TAX NOTES 1223, 1227 (Dec. 10, 1990) (discussing § 195 as the codification of the *Briarcliff* holding); John Paul LeBlanc, *The Supreme Court Attempt to "Iron Out" the Wrinkles in National Starch*, 54 LA. L. REV. 437, 462 (1993) ("That these expenses did not create an asset . . . was the impetus behind [§] 195 allowing the sixty-month amortization deduction.").
[59] *Briarcliff Candy*, 475 F.2d at 786. See *infra* notes 107-112 and accompanying text (discussing the *Briarcliff* decision).
[60] *See* Vanlandingham v. Dep't of Revenue, 9 Or. Tax 308, 310 (1983) ("The addition of I.R.C. § 195 was an attempt to equalize the treatment given corporate and non-corporate taxpayers in respect to finding a new business venture.").
[61] *See, e.g.*, Woodward v. Comm'r, 397 U.S. 572, 574-75 (1970) ("Such expenditures are added to the basis . . . and are taken into account . . . either through depreciation or by reducing the capital gain when the asset is sold."); Lathen & Lathen, *supra* note 57, at 416 ("[S]tart-up costs . . . were required to be capitalized and were recoverable only upon the sale or cessation of the business.").
[62] *See* Lathen & Lathen, *supra* note 57, at 416 (noting existing businesses ability to deduct these expenses under § 162(a) while new businesses could not).
[63] *See id*. (noting that § 195 was enacted to "treat these identical costs in a more consistent manner").
[64] *See* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 122 (discussing the equity norms guiding tax policy).
[65] S. REP. NO. 96-1036 at 11 (1980).

[66] *See* BLACKFORD, *supra* note 4, at 166 (noting the depressed economy that lead to a decrease in employment among Fortune 500 companies).
[67] *Id*.
[68] *See supra* notes 61-64 and accompanying text (noting the differing treatment for pre-opening expenses under current law).
[69] *See* GEORGE, JOLL & LYNK, *supra* note 21, at 260 (defining barriers to entry as "costs that have to be borne by an entrant that are not borne by established firms").
[70] *See* S. REP. NO. 96-1036, at 11 (1980) (noting that Congress hoped to "encourage [the] formation of new businesses").
[71] *See* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 128 (arguing the tax system should not distort the free market by encouraging or discouraging particular economic activities relative to others). *See also* Matthew A. Melone**,** *Should The United States Tax Sovereign Wealth Funds?*, 26 B. U. INT'L L. J. 143, 218 (discussing the concept of tax neutrality).
[72] *See* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 131 (discussing the Kaldor-Hicks efficiency theory). The theory applies a cost-benefit analysis to determine if the tax incentive and its violation of the neutrality principle, both measured in terms of utility and not in nominal dollars, create an aggregate positive addition to the economy. *Id*. *See also* NICHOLAS MERCURO & STEVEN G. MEDEMA, ECONOMICS AND THE LAW: FROM POSNER TO POST-MODERNISM 45-50 (1998) (discussing the non-neutral efficiency theory)**.**
[73] *See* I.R.C. § 195(a) (1982) (allowing the taxpayer to amortize expenses "beginning with the month in which the business begins").
[74] I.R.C. § 195(b)(1) (1982). *See also* S. REP. NO. 96-1036, at 11 (describing the circumstances under which the expense must be incurred).
[75] I.R.C. § 195(b)(2) (1982). *See also* S. REP. NO. 96-1036, at 11 (requiring deductibility by a current business).
[76] *See* S. REP. NO. 96-1036, at 14 (detailing the length of the amortization period and when it begins). Using the phrase "business begins" confused Congress's intent. *See infra* notes 256-264 and accompanying text (discussing the frustration caused by poor word choice).
[77] *See* Vanlandingham v. Dep't of Revenue, 9 Or. Tax 308, 309 (1983) (discussing the treatment of expenditures under § 195); I.R.C. § 195(a) (1982) (allowing for the amortization once the business begins).
[78] *See infra* note 95 and accompanying text (discussing the § 162 requirement in §§ 195 and 212). *See also infra* Part III.B.
[79] Deficit Reduction Act of 1984, Pub. L. No. 98-369, Div A, Title I § 94, 98 Stat. 494, 614 (1984) (codified as I.R.C. § 195 (1988)).
[80] I.R.C. § 195(a) (1988).
[81] I.R.C. § 195(c)(1)(A)(iii) (1988). *See also* I.R.C. § 212 (2006) (using similar language to deduct expenses not associated with a trade or business).
[82] I.R.C. § 195(c) (1988). *See also* I.R.C. § 163(a) (1988) (detailing the deduction for interest payments); I.R.C. § 164 (1988) (detailing the deduction for taxes paid); I.R.C. § 174 (1988) (detailing the deduction for research and development expenses).
[83] Pino v. Comm'r, 52 T.C.M. (CCH) 1388 (1987).
[84] *Id*.
[85] *Id*. *See also* S. REP. NO. 96-1036, at 12 (listing examples of expenses eligible for amortization upon taxpayer election).
[86] *Pino*, 52 T.C.M. (CCH) 1388 (citing H. REP. NO. 96-1278, 1980-2 C.B. 709, 713-14 (1980)). While not discussed in the opinion, the taxpayer does have the option to include the expenses as a § 165(c)(2) loss. *See* Rev. Rul. 77-254 (allowing deductions for losses incurred which were not in connection with a trade or business).
[87] *Pino*, 52 T.C.M. (CCH) 1388.
[88] Duecaster v. Comm'r, 60 T.C.M. (CCH) 917 (1990). *See supra* note 75 and accompanying text (discussing the second requirement under § 195).
[89] *Duecaster*, 60 T.C.M. (CCH) 917.
[90] *Id*. *See* I.R.C. § 162(a) (2006) (describing the deductible ordinary and necessary expenses).
[91] *See* I.R.C. § 195(c)(1)(B) (1988) (defining a start-up expenditure as one which "if paid or incurred in connection with the operation of an existing active trade or business [in the same field…] would be allowable as a deduction for the taxable year").
[92] I.R.C. § 162(a) (2006).

[93] *See* S. REP. NO. 96-1036, at 11 (requiring deductibility by an ongoing trade or business in order to qualify as an expenditure eligible under § 195).
[94] *See* I.R.C. § 212 (2006) (allowing deductions in three additional situations).
[95] *See* Deucaster v. Comm'r, 60 T.C.M. (CCH) 917 (1990) ("Nothing in the statute or the legislative history suggests that [§] 195 was intended to create a deduction . . . which would not . . . have been deductible under prior law."). *See also* United States v. Gilmore, 372 U.S. 39, 46 (1963) (noting that the only deductible expenses under § 23(a)(2) [precursor to § 212] are those that meet the limitations set in § 24(a)(1) [precursor to § 162]).
[96] *See Gilmore*, 372 U.S. at 46
[97] *See, e.g.*, *Deucaster*, 60 T.C.M. at 917 ("The role of [§] 195 is comparable to that of [§]212 . . . . It has long been established that [§ 212] creates no deduction for an expenditure that would not have been deductible under [§] 162.").
[98] Comm'r v. Lincoln Savings & Loan, 403 U.S. 345 (1971).
[99] *Id*. at 347.
[100]*Id*. at 352 (citing Welch v. Helvering, 270 U.S. 111, 114-15 (1933) (defining ordinary expenses as those which are "normal, common and accepted by the business community"). *See also* Comm'r v. Tellier, 383 U.S. 687, 689 (1966) (deferring the taxpayers decision regarding necessary business expenses). 'Paid or incurred' refers to the taxpayer's method of accounting, either cash (paid) or accrual (incurred). *See* I.R.C. § 446 (2006) (discussing the rules regarding accounting methods). *See also* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 354-58 (discussing the different methods of accounting available to taxpayers).
[101] *Lincoln Savings & Loan*, 403 U.S. at 352. *See also* Lincoln Savings & Loan v. Comm'r, 51 T.C. 82 (1968) (describing the tax court's reasoning for capitalizing the expense); I.R.C. § 263(a) (2006) (requiring capitalization in the absence of a specific provision to the contrary).
[102] *Lincoln Savings & Loan*, 403 U.S. at 352. *See generally* Lincoln Savings & Loan v. Comm'r, 422 F.2d 90 (1970) (dismissing Revenue Ruling 66-49 and allowing the deduction).
[103] *Lincoln Savings & Loan*, 403 U.S. at 354.
[104] *Id*.
[105] *See e.g.*, NCNB Corp. v. United States, 684 F.2d 285, 289-90 (4th Cir. 1982) (holding that marketing expenses associated with a expansion were deductible because they did not create a separate asset); United States v. Miss. Chem. Corp., 405 U.S. 298, 309 (holding that new shares of a bank were a separate asset). *See also* Dion Mathewson, *Certain Business Expansion and Startup Expenses are Not Deductible as Ordinary and Necessary Expenses:* FMR Corp. v. Commissioner, 52 TAX LAW. 417, 418 n.18 (citing other cases that applied the separate and distinct test).
[106] *See, e.g.*, *NCNB Corp.*, 684 F.2d at 289-90 (using the separate and distinct test to determine that the expenses were currently deductible).
[107] Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775 (2nd Cir. 1973).
[108] *Id*. at 777-78. The company incurred substantial advertising costs, aimed at recruiting distributors, rather than end consumers. *Id*. at 777. The court held the distinction was insignificant and allowed the expensing of both advertising costs. *Id*. at 784. In so holding, the court stated, "This is plainly a most unjust and unequal interpretation of the law, unsupported by legislative, regulatory and judicial authority. All sellers, whether at a wholesale or retail level must be treated alike-in the absence of the acquisition of a capital asset, their expenses for advertising and promotion should be deductible under § 162." *Id*.
[109] *Briarcliff Candy Corp.*, 475 F.2d at 780, 785-86. *See generally* Briarcliff Candy Corp. v. Comm'r, 31 T.C.M. (CCH) 171 (finding the 159 distributor contracts to be capital assets).
[110] *See e.g.*, Allen v. Comm'r, 283 F.2d 785, 790-791 (7th Cir. 1960) ("Expenditures by a taxpayer to protect an established business are fully deductible as ordinary business expense[s]"); Lutz v. Comm'r, 282 F.2d 614, 617, 620 (5th Cir. 1960) (noting the ordinary and necessary requirement applies for business protection expenses); Comm'r v. Surface Combustion Corp., 181 F.2d 444, 447 (6th Cir. 1950) ("The payments were made to preserve an existing asset rather than to acquire a new one, and should not be capitalized").
[111] *Briarcliff Candy Corp.*, 475 F.2d at 786 ("The Supreme Court, however, in Lincoln Savings . . . held that the fact that an ensuing benefit may have some future aspect is not controlling."). The court went on to say that "what was important and controlling was that the expenditures served to create or enhance for the taxpayer what is essentially a separate and distinct additional asset." *Id*.
[112] *Id*. at 786 (noting that the contracts created "no property interest whatsoever"). *See also* James David Ruffner, *Corporate Reorganization Expenses: Overview of the Denial of Current Federal Tax Deductibility and Resulting*

Capitalization, 19 DAYTON L. REV. 197, 213-14 (1993) (interpreting "the existence of a separate and distinct asset as a prerequisite to the creation of a capital asset").
[113] NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982).
[114] *Id*. at 289, 293-94.
[115] *See NCNB Corp.*, 684 F.2d at 293 ("[T]he branch has no existence separate and apart from the parent bank.").
[116] *See id.* at 294 ("In order to maintain this network, NCNB must continually evaluate its market position"); Ruffner, *supra* note 112, at 216 (noting that the "court used the bank's needs as the rationale to characterize the costs as ordinary and necessary).
[117] *NCNB Corp.*, 684 F.2d at 291.
[118] Bilar Tool & Die Corp. v. Comm'r, 530 F.2d 708 (6th Cir. 1976).
[119] *See id*. at 713 (discussing what constituted ordinary and necessary under § 162).
[120] *Id*.
[121] Comm'r v. Idaho Power Co., 418 U.S. 1 (1974).
[122] *Id*. at 5.
[123] *Id*. at 5-6.
[124] *Id*. at 16-17.
[125] *Id*. This was in accord with § 263(a), whose purpose was "to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing." *Id*. at 16. *See also* Ruffner, *supra* note 112, at 215 ("[T]he purpose of I.R.C. § 263 is to match the amortization of an asset's cost with its income-producing years."). Ruffner additionally notes that the "priority-ordering directive of I.R.C. § 161" mandates capitalization over deductibility. *Id*.
[126] *Idaho Power Co.*, 418 U.S. at 10.
[127] *See* Brett M. Alexander, *An Analysis of INDOPCO, Inc. v. Commissioner*, 54 OHIO ST. L.J. 1505, 1507 (1993) (noting the split in the Circuit Courts following National Starch & Chemical Corp. v. Comm'r, 93 T.C. 67, 75 (1989), *aff'd* 918 F.2d 426, 432-33 (3rd Cir 1990)). *See also* Ruffner, *supra* note 112, at 215 (noting the "dogmatic adherence to the matching principle . . . set the stage" for *INDOPCO*).
[128] INDOPCO v. Comm'r, 503 U.S. 79 (1992). INDOPCO was formerly known as National Starch and was referred to as such in the lower court opinions. *See generally* National Starch & Chemical Corp. v. Comm'r, 93 T.C. 67 (1989) and National Starch & Chemical Corp. v. Comm'r, 918 F.2d 426 (3rd Cir. 1990) (tax court and Third Circuit Court opinions, respectively).
[129] *INDOPCO*, 503 U.S. at 82-83.
[130] *Id*. at 80.
[131] *Id.* at 81-82.
[132] *Id*. at 82.
[133] *Id*. *See also* National Starch & Chemical Corp. v. Comm'r, 93 T.C. 67 (1989) (detailing the tax court's decision disallowing the current deduction).
[134] *INDOPCO*, 503 U.S. at 82-83 (quoting National Starch & Chemical Corp. v. Comm'r, 918 F.2d 426, 432-33 (3rd Cir. 1990)).
[135] *INDOPCO,* 503 U.S. at 82 (quoting Comm'r v. Lincoln Savings & Loan, 403 US 345, 354 (1971)).
[136] *INDOPCO*, 503 U.S. at 90.
[137] *Id*. at 86-87.
[138] *Lincoln Savings*, 403 U.S. at 354 ("[T]he presence of an ensuing benefit that may have some future aspect is not controlling").
[139] *INDOPCO*, 503 U.S. at 87.
[140] *Id*. at 88.
[141] *See* Lee A. Sheppard, *The* INDOPCO *Case and Hostile Dense Expenses*, 54 TAX NOTES 1458, 1459 (1992) ("Read broadly, *INDOPCO* means that the taxpayer always loses"); Sarah R. Lyke, INDOPCO, Inc. v. Commissioner*: National Starch Decision Adds Wrinkles to Capital Expenditure Issue*, 88 NW. U. L. REV. 1239, 1265 (1994) (noting the limited application of § 195 post-*INDOPCO*); Ruffner, *supra* note 112, at 223-24 ("Such a position will defeat the purpose of I.R.C. § 195").
[142] *See* I.R.C. § 195(b)(2) (1988) (noting that inclusion under § 195 requires current deductibility or classification as an expense if incurred by an ongoing trade or business); LeBlanc, *supra* note 58, at 462 ("A literal application of *INDOPCO* would seem to result in the capitalization of these expenditures because, arguably, they generate a 'not

insignificant future benefit that is more than merely incidental'") (citing National Starch & Chemical Corp. v. Comm'r, 918 F.2d 426, 431 (1990)).
[143] W. Eugene Seago, *The Treatment of Start-Up Costs Under Section 195*, 66 J. TAX'N 362, 362 (1991).
[144] *See supra* notes 58-59, 107-112 and accompanying text (discussing *Briarcliff's* role in the enactment of § 195).
[145] *See* S. REP. NO. 96-1036, at 11 ("Eligible expenses [for amortization] also include start up costs").
[146] *See infra* Part IV (discussing the limitations to *INDOPCO*'s application).
[147] *See* Lyke, *supra* note 141, at 1257-58 (1994) (discussing the possible expansive interpretation of *INDOPCO*).
[148] *See id*. at 1257 n.138 (detailing the many Technical Advice Memos (TAMs) issued by the IRS regarding hostile takeover defense costs).
[149] National Starch and Chemical Corp. v. Comm'r, 918 F.2d 426, 434 (3rd Cir. 1990) (requiring capitalization of costs associated with a friendly takeover).
[150] *See* I.R.S. Tech. Adv. Mem. 91-44-042 (July 1, 1991) (extending capitalization from friendly takeovers, as in *INDOPCO*, to hostile takeovers). TAM's may not be cited as precedent, but are used to show the IRS's position. I.R.C. § 6110(k)(3) (2006). *See also* I.R.S. Internal Revenue Manual § 33.2.1, *available at* http://www.irs.gov/irm/index.html (last visited Mar. 1, 2009).
[151] I.R.S. Tech. Adv. Mem. 91-44-042 (July 1, 1991).
[152] *Id*. ("The burden is on the taxpayer to demonstrate that it did not obtain a long-term benefit . . . . Each case will turn on its own specific set of facts and circumstances.").
[153] *See* Lyke, *supra* note 141, at 1257 (noting that the IRS asserted tax deficiencies against companies who previously incurred expenses in defense of a hostile takeovers); Sheppard, *supra* note 141, at 1458 (discussing a number of companies in the oil and gas industry that had deficiencies assessed).
[154] In re Federated Dep't Stores, Inc., 135 B.R. 950 (Bankr. S.D. Ohio 1992), *aff'd* 171 B.R. 603 (S.D. Ohio, 1994).
[155] *See In re Federated Dep't Stores, Inc.*, 171 B.R. at 608 ("The IRS asserts that *INDOPCO* requires the bankruptcy court's decision to be overturned and the break-up fees capitalized rather than currently deducted").
[156] *See* BLACK'S LAW DICTIONARY (8th ed. 2004) (defining white knight as "a person or corporation that rescues the target of an unfriendly corporate takeover, especially by acquiring a controlling interest in the target corporation or by making a competing tender offer."). For a recent example of a white knight transaction, *see* Miles Costello, Suzy Jagger, Leo Lewis & Christine Seib, *Bear Stearns Seeks White Knight as Fed Steps in to Avert Collapse*, THE TIMES, Mar. 15, 2008 (discussing JP Morgan's role in the bailout of the storied investment bank).
[157] *In re Federated Dep't Stores, Inc.*, 171 B.R. at 606 (stating that "if Federated was acquired by someone other than Macy, Federated would pay all of Macy's expenses, up to $45 million, plus 25% of any excess consideration received by Federated's shareholders from the new acquirer").
[158] *Id*.
[159] *Id*. at 609.
[160] *Id*.
[161] A.E. Staley Manufacturing Co. v. Comm'r, 119 F.3d 482 (7th Cir. 1997).
[162] *Id*. at 485.
[163] *Id*.
[164] *Id*. at 487.
[165] *Id*. at 489.
[166] *Id*. at 490 n.6, 491-92.
[167] INDOPCO v. Comm'r, 503 U.S. 79, 87.
[168] *See supra* notes 107-112 and accompanying text (discussing *Briarcliff Candy's* facts and noting that the Second Circuit allowed the taxpayer to expense the costs). *Briarcliff* was not explicitly overruled by *INDOPCO* and the two holdings co-exist.
[169] *See* Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775, 784 ("It is not enough that it may have a favorable expectancy or that in the course of its use it increases sales and produces income"). Focusing on the expectation of benefit, the court goes on to say that the contracts "acquired little more than an expectation or hope of future sales . . . . [W]e do not believe this minor additional factor is sufficient to justify our concluding that [Briarcliff] purchased some intangible capital assets by these contracts." *Id*. at 786. *See also* W. Eugene Seago & D. Larry Crumbley, INDOPCO: *A Tiger, a Pussycat, or a Creature Somewhere in Between?*, 94 J. TAX'N 14, 18 (2001) (noting that *Briarcliff's* expenditures created "little more than an expectation or hope of future sales"). The *INDOPCO* court focused instead on the realization of the benefit, rather than the mere expectation. *See supra* notes 128-140 and accompanying text (discussing the *INDOPCO* holding).

[170] Sun Microsystems v. Comm'r, 66 T.C.M. (CCH) 997 (1993).
[171] *Id*. at 11-12.
[172] *Id*. at 4. A warrant is "an instrument granting the holder a long-term (usually a five- to ten-year) option to buy shares at a fixed price . . . commonly attached to preferred stocks or bonds." BLACK'S LAW DICTIONARY (8th ed. 2004).
[173] *Sun Microsystems*, 66 T.C.M. 997 at 8.
[174] *Id*. at 11.
[175] *Id*. at 12.
[176] FMR Corp. v. Comm'r, 110 T.C. 402 (1998).
[177] *Id*. at 404.
[178] *Id*. at 409, 413-14.
[179] *Id*. at 416.
[180] *See id*. at 417 ("A Massachusetts business trust . . . has perpetual existence . . . . No RIC managed by petitioner has ever exercised its right of termination or otherwise failed to renew a management contract with petitioner . . . . [P]etitioner expects to be awarded the initial contract to manage the new fund, as well as the annual renewals of that contract for as long as the RIC exists. Here, petitioner's expectations were in fact realized.").
[181] *Id*. at 424-25.
[182] PNC Bancorp, Inc. v. Comm'r, 212 F.3d 822 (3rd Cir. 2000), *rev'g* 110 T.C. 349 (1998).
[183] INDOPCO v. Comm'r, 503 U.S. 79, 84 (1992).
[184] *See PNC Bancorp*, 212 F.3d at 825 (noting that SFAS 91 was promulgated by the Financial Accounting Standards Board (FASB)). *See also* Jezabel Llorente, *Nothing Left of INDOPCO: Let's Keep it That Way!*, 29 FLA. ST. U. L. REV. 277, 285 (summarizing the IRS position in *PNC Bancorp*); Gary L. Maydew, *To Deduct or Capitalize: Courts and IRS Interpret INDOPCO*, 63 PRAC. TAX STRAT. 145, 149-50 (discussing the tax court's holding in *PNC Bancorp*).
[185] PNC Bancorp Inc. v. Comm'r, 110 T.C. 349 (1998).
[186] *PNC Bancorp*, 212 F.3d at 824-25.
[187] *Id.* at 830. *See e.g.*, Iowa-Des Moines National Bank, 68 TC 872 (1977), *aff'd* 592 F.2d 433 (8th Cir. 1979) (holding that the cost to investigate customer credit worthiness in connection with extending loans was ordinary and necessary and should be currently deducted).
[188] Wells Fargo v. Comm'r, 224 F.3d 874 (8th Cir. 2000).
[189] *Id*. at 879-80.
[190] *Id*. at 880.
[191] *Id*.
[192] *See* Norwest Corp. v. Comm'r, 112 T.C. 89 (1999) (holding in favor of the IRS).
[193] *See Wells Fargo*, 224 F.3d at 881-86 nn.3-18 (defining variables and using these throughout the *INDOPCO* analysis). *See also id*. at 885 ("The tax court is saying that C must result because of the presence of B. This is equivalent to 'if B then C,' which we have previously proven to be a false statement.").
[194] *Id*. at 886 ("The *INDOPCO* case addressed costs which were *directly* related to the acquisition, while the instant case involves costs which were only *indirectly* related to the acquisition"). The Eighth Circuit also discussed Rev. Rul. 99-23's applicability to this case and other § 162 expense-cases. *See infra* notes 200-206 and accompanying text (discussing Revenue Ruling 99-23's holding and its impact on § 195).
[195] Rev. Rul. 92-80, 1992-39 I.R.B. 7. *See also* LeBlanc *supra* note 58, at 460-61 (discussing *INDOPCO's* future benefit test with respect to advertising costs); Maydew, *supra* note 184, at 150 (noting that advertising expenses are still considered § 162(a) deductions).
[196] Rev. Rul. 94-12, 1994-1 C.B. 36. *See also* Peter L. Faber, *INDOPCO: The Still Unresolved Riddle*, 47 TAX LAW. 607, 625 (noting that the IRS's reading of *INDOPCO* makes its application proactive only).
[197] Rev. Rul. 96-62, 1996-2 C.B. 9
[198] Rev. Rul. 2000-4, 2000-1 C.B. 331.
[199] *Id*. *See also supra* Part IV.B (discussing the effect mere expectation, as opposed to actual realization, has on determining the correct tax treatment).
[200] Rev. Rul. 99-23, 1999-1 C.B. 998.
[201] *Id*. *See also* SEN. REP. 96-1036, at 11 ("prior to reaching a final decision to acquire or to enter that business").
[202] Rev. Rul. 99-23. This is also referred to the "whether and which" test. *See* RONALD W. BLASI, U.S. MASTER BANK TAX GUIDE 348 (2008) (discussing the IRS's position in Revenue Ruling 99-23).

[203] *Id*. *See also* James L. Musselman, *Amortization Of Start-Up Expenditures Under Section 195 Of The Internal Revenue Code And Revenue Ruling 99-23: A Classic Example Of Misinterpretation By The IRS*, 4 FLA. ST. U. B. REV. 139, 169 (noting that only investigatory expenses can be amortized under § 195).
[204] Rev. Rul. 99-23.
[205] *Id*.
[206] *Id*. *See also* SEN. REP. 96-1036, at 11-12 (listing examples of start-up costs). *See generally* BNA TAX MANAGEMENT PORTFOLIOS, NO. 534-3RD VI, DETERMINING WHICH EXPENDITURES ARE TREATED AS START-UP EXPENSES (2008) (discussing what qualifies as start-up expenditures under § 195).
[207] Carol Conjura, Timothy A. Zuber & Peter C. Beale, *To Capitalize or Not? The INDOPCO Era Ends With Final Regulations Under § 263(A)*, 100 J. TAX'N 215, 215.
[208] *Id*. at 225.
[209] *See* Treas. Reg. § 1.263(a)-5(a) (listing the ten transactions that require capitalization, of which start-up expenditures are not one).
[210] *See* Conjura, Zuber & Beale, *supra* note 207, at 225 (discussing the many conflicting issues between § 195 and the final § 263(a) regulations). *Compare* Wells Fargo v. Comm'r, 224 F.3d 874, 885-86 (holding that the merger expenses are deductible) *with* Treas. Reg. 1.263-5(a) (requiring capitalization for the costs associated with a merger).
[211] Pub. L. No. 108-357, Title VIII § 902, 118 Stat. 1418, 1418 (2004).
[212] *See* 118 Stat. 1651 (2004) (codified as I.R.C. § 195 (2006)).
[213] *Id*. at § 902(a)(1).
[214] *See* I.R.C. § 195 (1988) (noting the previous treatment under § 195).
[215] *See supra* Part III.B and Part IV (discussing the struggle between current expenses and capital expenditures).
[216] *See* I.R.C. § 195(b)(1)(A)(ii) (2006) (allowing a deduction of up to $5,000). Taxpayers prefer current deductions rather than capitalization due to the time-value of money. *See* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 23-28 (describing taxpayer preferences for current expensing).
[217] INDOPCO v. Comm'r, 503 U.S. 79, 84 (1992). *See also* Interstate Transit Lines v. Comm'r, 319 U.S. 590, 593 (1943) ("[W]e examine the argument in the light of the now familiar rule that an income tax deduction is a matter of legislative grace."); Deputy v. Du Pont, 308 U.S. 488, 493 (1940) ("It 'depends upon legislative grace; and only as there is clear provision therefore can any particular deduction be allowed.'"); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace.").
[218] *See* LeBlanc, *supra* note 58, at 462-63 (viewing § 195 as a matter of legislative grace).
[219] *See id*. (noting that the Court's failure to mention § 195 in their analysis). *See generally INDOPCO*, 503 U.S. 79 (1992) (failing to mention § 195 in any part of the opinion).
[220] Lyke, *supra* note 141, at 1266 (discussing Congress's mandate regarding the current deductibility of certain start-up costs).
[221] Treas.. Reg. § 1.195-1T(e) (2008).
[222] *See supra* notes 55-72 and accompanying text (discussing Congress' intent in enacting § 195). *See also* SEN. REP. 96-1036, at 11 (noting the reasons for changing the current law).
[223] *See, e.g.*, Angela Mueller, *Angels We Have Heard on High*, ST. LOUIS BUS. J., Dec. 21, 2007, at 1 (demonstrating the high costs that can be associated with technology-based start-up companies, with investments ranging from $4.73 million to $50,000) Technology infrastructure is a large but often necessary expenditure for most entrepreneurs. *See* Mark Henricks, Amanda Kooser, Gwen Moran & Chris Penttila, *75 Startup Secrets*, ENTREPRENEUR'S STARTUPS, Mar. 2006 (discussing the technology requirements for starting a business).
[224] *See* I.R.C. § 162(a) (2006) (noting the deductions allowed for those in an ongoing trade or business).
[225] *See* I.R.C. §§ 168(k), 179(a) (2006) (allowing business taxpayers to expense the costs of capital assets placed into service during the taxable year). To qualify for a deduction, the property must meet certain requirements. *See* § 179(d)(1) (2006) (stating that § 179 property must be tangible property or computer software, § 1245 property and used in an active trade or business); I.R.C. § 167 (2006) (defining depreciable property); I.R.C. § 168 (2006) (allowing for the depreciation of tangible property); I.R.C. § 197 (2006) (allowing for the amortization of intangibles); I.R.C. § 1245 (2006) (defining qualified property as any depreciable business personal property or other non-building property).
[226] I.R.C. § 195 (2006). Section 195 is not the exclusive remedy to an individual taxpayer in the process of starting their business. *See* Musselman, *supra* note 203, at 145 (noting which costs continue to be currently deductible).

Section 195 specifically exempts deductions allowable under §§ 163(a), 164 and 174 from the definition of start-up expenditures. I.R.C. § 195(c)(1) (2006). *See also* note 82, (noting the deductions excluded from the definition of start-up expenses).
[227] I.R.C. § 179(b)(7) (2006). For 2008, taxpayers can deduct up to $250,000 for § 179 property placed into service during the year, with a limit of $800,000 before the deduction decreases. *Id*. The deduction and limits vary depending on the taxable year. *See, e.g.,* I.R.C. § 179(b)(1), (2) (2006) (noting that the limits for 2005 would be $25,000 and $200,000 respectively whereas limits for 2009 would be $125,000 and $500,000 respectively). The 2009 limits were changed with the passage of the American Recovery and Reinvestment Act of 2009. *See infra* notes 274-283 (discussing the effect of the 111th Congress's bailout bill); H.R. 1, 111th Cong. § 1202 (1st Sess. 2009) (extending the favorable 2008 depreciation deduction limits through 2009).
[228] *See* I.R.C. § 195(b)(1)(A)(ii) (2006) (detailing the allowable deduction). Under § 195, the deduction is reduced by the amount the expenditures exceed $50,000 for the year. *Id*. Therefore, the actual deduction is $5,000 – ($52,000 - $50,000) = $3,000. *Id*.
[229] *See supra* notes 224-225, 227 (noting the maximum deduction for current business owners). Taxpayer A is well under the 2008 limit for § 179 deductions and would be able to fully expense the costs. I.R.C. § 179(b)(7) (2006). Taxpayer B's expenses exceed the $50,000 limit by $10,000, reducing the current deduction from $5,000 to $0. I.R.C. § 195(b)(1)(A)(ii) (2006). $60,000 will instead be added to the basis of B's business once it begins and amortized over 180-months. I.R.C. § 195(b)(1)(B) (2006). If Taxpayer A's expenses were associated with an expansion project unrelated to their current business, the results may be more similar. *See* FMR Corp. v. Comm'r, 110 T.C. 402 (1998) (noting Congress's intent to differentiate between the expansion costs of an existing business and those "paid or incurred in the creation or acquisition of a new trade or business to which § 195 did apply."). *But see* Rev. Rul. 2000-4, 2000-1 C.B. 331 (noting that the classification of expansion costs depends on the speculative nature of the future benefit).
[230] *See supra* notes 60-64 and accompanying text (discussing Congress's intent to treat both business and non-business taxpayers equally).
[231] Small Business Association Office of Advocacy, Expected Costs of Startup Ventures [hereinafter SBA Startup Costs] 1 (2003), www.sba.gov/advo/research/rs232tot.pdf.
[232] *Id*. at 22, 28. Solo entrepreneurs estimated $6,000 in start-up expenses and an additional $1,000 operating cash for the first month of business. *Id.* at 22. Teams of entrepreneurs required $20,000 and $3,200 respectively. *Id*. at 28. *But see* KEVIN SCHEHRER, STARTUP! BEYOND THE MYTHS TO THE REALITY OF STARTING A COMPANY 178-80 (2002) (noting that entrepreneurs have a tendency to underestimate the time and money necessary to start a business); Gayle F. Santana, *Funding Your Business Venture*, THE GLOW PROJECT, Jan. 2009, at 40, 42 (noting that "the cost of getting started exceeded the [entrepreneurs] expectations" even after creating business plans).
[233] *See* PAUL NEWBOLD, STATISTICS OR BUSINESS & ECONOMICS, 4TH EDITION 135-137 (1995) (noting the formula for expected value [E(x)] is Σ xP(x) or the sum of each outcome multiplied by the probability of each outcome). Therefore, the total expected costs are [(388/830) * $7,000 + (442/830) * $23,200 = $15,626.5]. *See* SBA Startup Costs *supra* note 231, at 18, 20 (detailing the expected cost for each group of entrepreneurs).
[234] SBA Startup Costs *supra* note 231, at 24, 29. The high standard deviation indicates that the data is largely dispersed around the mean. *See* NEWBOLD, *supra* note 233, at 17-22 (discussing the use of standard deviation as a measurement of dispersion among sample data).
[235] *See* NEWBOLD, *supra* note 233 at 21 (approximating that 95% of a population lies within two standard deviations on each side of the normal distribution). This assumes that the distribution of costs is normal, which is common among large samples with random outcomes. *Id*. at 194-98.
[236] *See* I.R.C. § 195(b)(1)(A) (2006) (defining the maximum deduction at $5,000).
[237] *See* I.R.C. § 162(a) (2006) (allowing for ordinary and necessary business deductions). *But see* I.R.C. § 263(A) (2006) (requiring capitalization for capital expenditures with a useful life beyond one year).
[238] *See* I.R.C. § 179(d)(1)(C) (2006) (noting the "use in [an] active conduct of a trade or business" requirement)
[239] Pub. L. No. 85-866, Title II, § 204(a), 72 Stat. 1679 (1958) (codified as I.R.C. § 179 (1958)).
[240] I.R.C. § 179(a) (1958) (stating the general rule for qualified property).
[241] I.R.C. § 179(b) (1958) (limiting the deduction to assets under $10,000).
[242] Pub. L. No. 97-34, Title II, § 202(a), 95 Stat. 219 (1981) (codified as I.R.C. § 179(b) (1982)).
[243] Pub. L. No. 99-514, Title II, § 202(a), 100 Stat. 2142 (1986) (codified as I.R.C. § 179(b)(2) (1988)) (reducing the deduction if the assets placed in service during the year exceed $200,000).

[244] Pub. L. No. 100-647, Title I, § 1002(b)(1), 102 Stat. 3357 (1988) (codified as I.R.C. § 179(b)(1) (1988) (limiting the deduction to the taxpayers taxable income for the year).
[245] *See* I.R.C. § 179(b) (2006) (noting the current limits and the many amendments to the provision, increasing the allowable deduction). *See supra* note 227 (discussing the limits and reduction thresholds in recent years).
[246] *Compare* I.R.C. § 179(b)(7) (2006) (noting the 2008 deduction limit is $250,000 with the reduction beginning at $800,000) *with* I.R.C. § 195(b)(1)(A) (2006) (noting the deduction limit of $5,000 with the reduction beginning at $50,000).
[247] *See* SBA Startup Costs *supra* note 231, at 24, 29 (noting the mean and standard deviation of investment by solo and team start-ups). Using the z-statistic formula, $P(z) = (x - \mu) / \sigma$, the z-statistic of solo start-ups under the current law is -.12, which is used to determine the probability under the normal curve. *See id*. at 835 (finding the P(z =.12) = .5478). Subtract this number from 1 to get the actual probability for the negative z-statistic, .4522. *See id*. at 202 (noting treatment for negative z-statistics). Repeat this process for the teams and for the suggested deduction of $50,000 to calculate the other probabilities.
[248] *See supra* note 247 (discussing the method for calculating percentages based on the mean and standard deviation of a normally distributed sample). For this calculation x = 450,000, the level of expenditure above which start-ups would be unable to take any deduction. *See* I.R.C. § 195(b)(1)(A)(ii) (2006) (detailing the reduction of the deduction for expenditures above the threshold amount).
[249] *See* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 122-3 (discussing the idea that similarly-situated taxpayers should be taxed equally).
[250] MARC J. DOLLINGER, ENTREPRENEURSHIP: STRATEGIES AND RESOURCES, THIRD EDITION PG. (2003); SCOTT SHANE, ILLUSIONS OF ENTREPRENEURSHIP: THE COSTLY MYTHS THAT ENTREPRENEURS, INVESTORS, AND POLICY MAKERS LIVE BY 99 (2008).
[251] *See* Erik Stam & Veronique Schutjens, *The Fragile Success of Team Start-Ups* [hereinafter *Team Startups*] 7, 9 (Max Planck Institute for Research into Economic Systems Group Entrepreneurship, Growth and Public Policy, Paper No. 1705, *available at* ftp://papers.mpiew-jena.mpg.de/egp/discussion papers/2005-17.pdf) (noting the six-year success rate of solo start-ups is 37.5% compared with 35.5% for team start-ups).
[252] *See* Gwen Moran, *50 Steps to Startup Success*, Entrepreneur's Startups, Sept. 2008 ("The worst thing you could do is give them enough to get halfway there. Then they will need to devote resources to raising more money when they haven't really accomplished anything yet.").
[253] *See Team Startups*, *supra* note 251, at 10 (noting the negative growth of "unfocused" teams without business plans compared to the positive growth of "focused" teams with business plans); Tim Berry, *15 Reasons You Need a Business Plan*, Entrepreneur.com, Mar. 13, 2006, *available at* http://www.entrepreneur.com/startingabusiness/businessplans/businessplancoachtimberry/article83818.html (noting many reasons entrepreneurs should develop a business plan).
[254] *See* Joseph Anthony, *Business Startup Costs: Write Off!*, Startup Nation, 2005, *available at* http://www.startupnation.com /articles/1178/1/AT_How-to-Write-Off-Your-Startup-Costs.asp (telling entrepreneurs that "[o]nce you open your business and start generating revenues, you can write off many . . . initial business startup costs at tax time.").
[255] Rev. Rul. 99-23. *See supra* notes 200-206 and accompanying text (discussing the treatment of expenses prior to and after determining whether to enter or acquire a business and which one to enter or acquire).
[256] SEN. REP. 96-1036, at 12.
[257] Lathen & Lathen, *supra* note 57, at 419 (citing Daniel Sharp, *Tax Relief for New Businesses: Equitable Treatment of Start-Up Costs*, 57 TAXES 695, 699 (1979)).
[258] I.R.C. § 195(c)(2)(A) (2006).
[259] I.R.C. § 195(b)(1)(A)(i)-(iii) (2006).
[260] *See* Lathen & Lathen, *supra* note 57, at 417 (discussing the treatment of expenses in the "gap period"—after the business begins but before it becomes an ongoing concern).
[261] Rev. Rul. 99-23.
[262] *Id*.
[263] *See* SEN. REP. 96-1036, at 12 ("Eligible expenses also include startup costs…prior to the time when the business begins"); Lathen & Lathen, *supra* note 57, at 419 (explaining the original intent of the section by the sponsor of the Senate Report).

[264] SEN. REP. 96-1036 at 12 ("Startup costs include advertising, salaries and wages paid to employees who are being trained and their instructors, travel and other expenses incurred . . . "). *See also* Musselman, *supra* note 203, at 169-71 (discussing the problems with the IRS's interpretation of § 195).
[265] *See* SEN. REP. 96-1036, at 11 (discussing the reasons for changing the current treatment of start-up expenditures); Lathen & Lathen, *supra* note 57, at 417 (noting the relationship between parity in treatment and encouraging business formation in § 195); *See* Lyke, *supra* note 141, at 1264 (noting Congress' recognition of the unequal treatment of taxpayers and § 195 as the remedy to encourage small business).
[266] *See supra* notes 60-64 and accompanying text (noting Congress's concern regarding the treatment of start-up costs prior to § 195's enactment). *See also supra* Part V.A. (discussing the differing tax treatment for business and non-business taxpayers).
[267] *See supra* notes 65-72 and accompanying text (noting Congress's intent to spur small business growth).
[268] Rev. Rul. 99-23 (emphasis added).
[269] Mike Diegel, *Small Business Optimism at Recession Level*, NFIB, August 12, 2008, http://www.nfib.com/object/IO_38161.html.
[270] *See SBA Data*, *supra* note 6, at Tab "dyn89_05" (noting the number of non-employer firms per year).
[271] *See supra* note 23 (detailing the high current unemployment rate of 7.6%).
[272] Barak Obama, Acceptance Speech, Democratic National Convention (Aug. 28, 2008) (transcript available at http://www.demconvention.com/barack-obama/).
[273] Obama/Biden's Plan for Small Business (2008), *available at* www.barackobama.com/pdf/SmallBusinessFINAL.pdf.
[274] H.R. 1, 111th Cong. (1st Sess. 2009).
[275] *See, e.g.*, Paul Krugman, *Bad Faith Economics*, N. Y. TIMES, Jan. 26, 2009, at A23 (critiquing opponents of the stimulus bill); Michael Gleason, *A Bad, Necessary Bill*, WASH. POST., Feb. 18, 2009 at A13 (noting the good and bad of the stimulus plan).
[276] H.R. 1, 111th Cong. § 3(a)(3) (1st Sess. 2009).
[277] *Id*. at §§ 1201-62. *See, e.g.*, Mickey Meece*, Stimulus Law Aids Small Business, but Benefits Are Not Easy to Find*, N. Y. TIMES, Feb. 20, 2009, at B3 (discussing the limited benefits business owners hope to receive from the stimulus).
[278] H.R. 1, 111th Cong. §§ 1211-12 (1st Sess. 2009).
[279] *See id*. at §§ 1201-12 (providing incentives for businesses that meet the ongoing trade or business requirement).
[280] *Id*. at § 1201(a).
[281] *Id*. at § 1202(a).
[282] *See supra* notes 20, 225, 227, 238-246 and accompanying text (discussing the ongoing business requirement in §§ 168 and 179).
[283] *Id*. at § 1211(a). *See also* I.R.C. § 172 (2006) (allowing net operating losses to be carried back 2 years and forward 20 years). The stimulus allows the carry-back to extend to the past 5 years. H.R. 1, 111th Cong. § 1211(a).
[284] I.R.C. § 172(c) (2006). *See also* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 765 (noting the limitations to carrying operating losses forward).
[285] I.R.C. § 172(d) (2006).
[286] *Id*.
[287] Obama/Biden's Plan for Small Business 1 (2008), *available at* www.barackobama.com/pdf/SmallBusinessFINAL.pdf.
[288] *See* I.R.C. § 1(h) (2006) (detailing the capital gains rate structure). A start-up company, prior to becoming an ongoing trade or business, would most not have any capital gains upon which they would pay tax. *See* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 728-30 (discussing which assets qualify as capital gains and how these gains are incurred).
[289] *See supra* notes 250-251 (noting the low survival rate for start-up businesses).
[290] *See e.g.,* Eric Lipton & Ron Nixon, *In Michigan, Bank Lends Little of Its Bailout Funds*, N. Y. TIMES, Jan. 13, 2009 (noting banks reluctance to extend credit during the current economic crisis); Raymund Flaundez, *SBA Offers Aid to Cash-Strapped,* Wall St. J., June 20, 2009 (commenting on banks weariness to loan money despite the SBA's program to help existing business owners). *See also supra* notes 232-235 (discussing the costs associated with start-up companies).
[291] *See supra* note 276 and accompanying text (noting Congress's intent behind the stimulus bill).
[292] H.R. 5297, 111th Cong. (2nd Sess. 2009).

[293] *Id*. at § 2031.
[294] *See supra* notes 247-248 and accompanying text (discussing the suggested changes to the statute deductions and limitations). *See also* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 23-28 (discussing the time-value of money).
[295] *See* I.R.C. § 172(d) (2006) (discussing the limitations on non-business taxpayers to carry over net operating losses into future years). *See also* notes 284-286 and accompanying text (recommending an exclusion of start-up activities from non-business deductions).
[296] *See* SEN. REP. 96-1036, at 11 (discussing the reasons for changing the current start-up expenditure law); *See* DODGE, FLEMING, JR., & GEIER, *supra* note 31, at 121-23 (discussing horizontal equity among similarly situated taxpayers). *See also supra* Part II.B.1 (noting the Congressional intent behind § 195).
[297] *See* KATHERINE KOBE, US SMALL BUSINESS ADMINISTRATION OFFICE OF ADVOCACY, THE SMALL BUSINESS SHARE OF GDP 1998-2004 5, 11 (2007), http://www.sba.gov/advo/research/rs299tot.pdf (tracking the small business percentage of GDP); SBA Data, *supra* note 6 at Tab "us88_06" (reporting employer and non-employer statistics).
[298] Miles & Wise, *supra* note 24.
[299] Obama/Biden's Plan for Small Business (2008), *available at* www.barackobama.com/pdf/SmallBusinessFINAL.pdf.
[300] *See supra* Part V.A. and V.B.
[301] *See supra* Part V.C.
[302] *See supra* Part V.B.
[303] Barak Obama, Acceptance Speech, Democratic National Convention (Aug. 28, 2008) (transcript available at http://www.demconvention.com/barack-obama/).
[304] *See* Lipton & Nixon, *supra* note 290 (noting that banks have been unwilling to lend the funds they have received from the government).

WHEN IT LOOKS TOO GOOD TO BE TRUE… ROLLOVERS AS BUSINESS START-UPS (ROBS)

By*: Nellie Strong, Dallas, Texas*[1] *and James Williamson, Dallas, Texas*[2]

Starting a small business is a dream for many people, and the tepid job market has only encouraged would-be entrepreneurs to think about pursuing that dream. But starting a new business requires capital,[3] and in the current economic climate the search for capital can quickly turn the dream into a nightmare. Many traditional capital-raising options are either no longer feasible or are deeply unattractive. The criteria for conventional loans in the current credit market make large loans unobtainable for most people. For homeowners, a home equity loan can provide start-up capital, but falling housing prices have taken this option off the table for many people. A withdrawal from a 401(k) plan or individual retirement account (IRA) is another possibility. For people under age 59½, however, such a withdrawal will typically trigger a 10% early withdrawal penalty *in addition to* ordinary income tax on the amount of the withdrawal. A loan from a 401(k) plan is also a possibility, but the amount that can be borrowed is limited (one-half of the account balance or $50,000, if less) and typically has to be repaid within five years.

Into this funding void have stepped promoters of a funding mechanism that promises to allow people to access their 401(k) or IRA accounts to start a business without incurring tax or a penalty for early withdrawal. A quick Google search returns a list of promoters offering to help would-be entrepreneurs tap into their retirement savings. The business appears to be booming with promoters reportedly doing hundreds or thousands of these transactions each year.[4] One article dubbed the technique the “IRA Job Machine.”[5]

Perhaps not surprisingly, the Internal Revenue Service (IRS) has expressed some reservations about these transactions, which effectively allow tax-favored retirement funds to be used for purposes other than retirement. The IRS has dubbed these transactions “Rollovers as Business Start-ups,” giving us the unsettling acronym “ROBS.” In a 2008 newsletter, the IRS expressed its concern in an article titled “When ‘Too Good to Be True’ Very Well May Be: Funding Business Startups with Plan Assets.” The IRS is still concerned: In a teleconference on August 27, 2010, IRS officials said that ROBS transactions were among several potential abusive tax-avoidance transactions that are among the IRS’s top priorities in examinations. The Department of Labor has likewise expressed (unofficially) concern about ROBS transactions.

This article focuses on the tax issues that the IRS has identified in ROBS arrangements, the consequences of a ROBS transaction that does not comply with applicable tax law, and—for those who choose to proceed with a ROBS transaction—steps that may reduce the risk of adverse tax consequences.

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The Transaction

In a typical ROBS transaction, the process works as follows: first, the promoter assists the owner of an IRA or other retirement account (the would-be business owner) in incorporating a C-corporation. The corporation typically has no assets or employees, and may not have a contribution to capital. Next, the corporation adopts a (purportedly) qualified defined contribution plan (usually a pre-approved prototype 401(k) profit sharing plan provided by the ROBS transaction promoter). This pre-approved plan provides, or is amended to provide, that plan participants may invest their entire account in employer stock (*i.e.*, stock of the newly-created corporation). The owner of the IRA becomes the sole employee of the corporation and, with the help of the promoter, rolls over the proceeds from his IRA into this newly created plan.[6] The individual then directs that his new plan account be invested entirely in employer stock. Accordingly, the plan acquires the stock of the newly-established corporation using the rolled-over IRA assets. The rolled-over assets having been moved through the newly-established plan to the corporation, the individual, acting through the corporation, can now use the funds to pursue his business venture. In many cases, after this initial investment in employer stock, the plan is amended to prohibit further investments in employer stock. As a result, only the original individual benefits from this investment option. Often, a portion of the proceeds of the stock transaction is remitted (directly or indirectly) back to the promoter—who organizes the transaction—in the form of a fee.

Because all assets are moved from one tax-exempt vehicle (the IRA or 401(k) plan) to another tax-exempt vehicle (the newly-created plan), and then invested in company stock, all taxes that otherwise would have been applicable to a distribution are (apparently) avoided.

Tax Issues

According to a memorandum issued by the IRS on October 1, 2008 (the "ROBS Memorandum"), the IRS has examined a number of these transactions, and found significant defects in most. Below is a summary of the tax issues that, according to the IRS, are raised by ROBS arrangements:

<u>Potential Prohibited Transactions</u>

Section 4975(a) of the Internal Revenue Code of 1986, as amended (the "Code") imposes a tax on a "prohibited transaction" equal to 15% of the amount involved in the transaction. Code Section 4975(b) imposes a tax equal to 100% of the amount involved if the prohibited transaction is not corrected within the taxable period.[7]

The IRS has identified two potential prohibited transactions with respect to ROBS arrangements: (1) valuation of stock, and (2) promoter fees.

Valuation of Stock

Under Code Section 4975(c)(1)(A), a prohibited transaction occurs if there is a sale, exchange or lease of any property between a plan and a disqualified person. A disqualified person includes the employer, or an owner of 50% or more of the total value of shares of all classes of stock of the employer. An exchange of stock between the plan and its employer sponsor would generally be a prohibited transaction, except that there is an exception for acquisitions or sales of qualifying employer securities. However, for this exception to apply, the acquisition or sale of employer securities to the plan must be for "adequate consideration."

Because the company involved in a typical ROBS transaction is a newly-established corporation, it is difficult to value the company. Often times, the value of the stock in a ROBS transaction appears to be determined by the amount available to be rolled over. The IRS has indicated that while an appraisal may be created to substantiate this value, it is often devoid of supporting analysis. Thus, the company may not actually be worth the value of the tax-deferred assets for which it was exchanged. If the employer securities are not exchanged to the plan for adequate consideration, a prohibited transaction has occurred.

Promoter Fees

Under Code Section 4975(c)(1)(E), a prohibited transaction also occurs if a fiduciary deals with the assets of the plan in his own interest or his own account. A fiduciary is defined as any person who exercises any discretionary authority or control, renders investment advice for a fee or other compensation, or has discretionary authority or responsibility in the administration of the plan. "Investment advice" includes advice to the plan as to the value of securities or other property, and recommendations as to the advisability of investing in, purchasing, or selling securities or other property.

In many ROBS transactions, immediately after the plan purchases the stock of the company, the company pays professional fees to the promoter. If the promoter qualifies as a fiduciary by providing "investment advice" to the plan, such payment could constitute a prohibited transaction.

<u>Plan Disqualification</u>

A profit sharing plan established as part of a ROBS transaction may not satisfy the requirements to be a qualified plan under the Code. If a plan does not maintain its qualified plan status, the plan loses its tax benefits, such as the deductibility of employer contributions to the plan and the tax deferral of employee contributions to the plan.

Violation of Nondiscrimination Requirements

Generally, Code Section 401(a)(4) provides that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees (HCEs). In order to satisfy Code Section 401(a)(4), (a) either the contributions or the benefits under a plan must be nondiscriminatory in amount, (b) a plan's benefits, rights and features, such as a right to invest in employer securities, must be nondiscriminatory, and (c) the timing of plan amendments must not have the effect of discriminating significantly in favor of

HCEs. An HCE is an individual who either owns 5% of the company or receives compensation over $110,000 (as indexed for inflation).

Because ROBS transactions generally benefit only the individual involved with setting up the business, the plan may violate the anti-discrimination provisions of the Code. However, in most typical ROBS arrangements, the individual is not an HCE because he or she does not make over $110,000. Even if the individual is an HCE, in a typical ROBS transaction, there are no other employees, so there can be no discrimination in favor of the individual. Nonetheless, the IRS has still found issues under subsection (b) above—the requirement that a plan's benefits, rights and features be nondiscriminatory. Under Treasury Regulation 1.401(a)(4)-4(c), a benefit, right or feature must be effectively available to non-highly compensated employees (NHCEs). This determination requires consideration of factors or conditions precedent that must be satisfied in order to accrue a benefit, including timing elements and whether the transaction was structured to intentionally avoid testing issues. Because ROBS transactions are often designed in a manner that the right to invest in employer stock will never be available to NHCEs, the IRS has found that these arrangements may not satisfy the "effectively available" requirement and thus may not satisfy the requirements to be a qualified plan.

Permanency

Treasury Regulation 1.401-1(a)(2) defines a qualified profit sharing plan as a *definite* written program and arrangement which is communicated to the employees and which is established and maintained by an employer to enable employees or their beneficiaries to participate in the profits of the employer's trade or business. Accordingly, in order to maintain its qualified status under Code Section 401(a)(4), a plan must be permanent. If a plan is discontinued within a few years after its adoption, Treasury Regulation 1.401-1(b)(2) provides that there is a presumption that it was not intended as a permanent program from its inception, unless business necessity required the discontinuance.

Permanency is not an area where the IRS has aggressively challenged plan qualification, because business reasons, tax motivated or otherwise, are generally the reasons why a retirement arrangement is installed or terminated. Nonetheless, the IRS has indicated that, depending on the facts, a ROBS arrangement could fail to satisfy this permanency requirement. In such case, the plan would lose its qualified status.

Exclusive Benefit

Code Section 401(a)(2) provides that a plan is not qualified unless it is impossible for any part of the corpus or income to be used for or diverted to purposes other than for the exclusive benefit of employees or their beneficiaries.

Many ROBS arrangements involve direction of some amount of plan assets to the promoter in payment of professional fees for setting up the transaction. The ROBS Memorandum indicates that payment of these fees and other start-up costs generally will not violate the exclusive benefit rule. However, when the newly purchased business uses the money to buy personal assets for the promoter (*i.e.*, recreational vehicles), the IRS has found the plan violates the exclusive benefit. In these instances, the plan would lose its qualified status.

Plan Not Communicated to Employees

As stated previously, under Treasury Regulation 1.401-1(a)(2), to be a qualified plan, the plan must be a definite, written program *communicated to employees*. In the case of ROBS transactions, the plans established as conduits for the stock investment often are not communicated to people hired after the business is up and running. The individual starting the business does not view the plan as a part of the new business, and thus does not offer it to the employees he or she later hires. In such cases, the plans could lose their qualified status, and would thus lose the tax benefits of such status.

In a related point, the ROBS Memorandum notes that many of the plans established in ROBS transactions contain a cash or deferred arrangement (*i.e.*, a 401(k) feature), and that in examinations the IRS has often been informed that the 401(k) feature is "inactive." Where the 401(k) feature is provided under the plan but is not being offered to participating employees, the plan may be in violation of the Code's requirements by not permitting eligible employees to elect salary deferral contributions.

Steps to Reduce Risk of Tax Consequences

Although the IRS has not classified ROBS transactions as non-compliant *per se*, it has indicated that it is focusing on such arrangements and will scrutinize them on a case-by-case basis. In other words, funding a start-up business through a ROBS transaction may invite IRS scrutiny. There is also the potential that the Department of Labor will come forward officially with its own concerns about ROBS transactions. However, if an individual would like to pursue such an arrangement, the following actions, based on the ROBS Memorandum, may reduce (but not eliminate) the risk that such arrangement will result in plan disqualification or a prohibited transaction:

- Actually start a business: using the proceeds from the IRA or 401(k) account to purchase personal items (*e.g.*, a boat) rather than to start a business will certainly trigger adverse consequences. A start-up owner should also be wary of using those proceeds to pay himself a salary.

- Look for other capital too: the risk of a prohibited transaction is increased where the sole asset of the new corporation is the proceeds rolled over from the IRA or 401(k) account and used to acquire company stock.

- Hire an attorney to prepare or review the profit sharing plan, and then follow the terms of the plan.

- Obtain an independent appraisal of the value of the company's stock, backed by meaningful analysis, before exchanging the stock of the company for the proceeds of the rollover account.

- Ensure that all employees of the plan sponsor have the right to invest in company stock.

- Once other employees are hired, make sure to communicate the existence of and their eligibility to participate in the plan and, where applicable, their right to make elective deferrals.

- Give consideration to the ongoing administration of the plan after the transaction is completed.

- Consider requesting a private letter ruling from the IRS that the particular arrangement will not result in negative tax consequences or plan disqualification.

Conclusion

The IRS has stopped short of saying that ROBS transactions are *per se* abusive. But, the "ROBS" acronym, the ROBS Memorandum, and the IRS's subsequent pronouncements all indicate that the IRS views these transactions with skepticism and will target them on examination. Further, the ROBS Memorandum makes clear that in many instances plan sponsors are not properly administering plans after they are established. Finally, the IRS has indicated that it is coordinating with the Department of Labor to monitor to these types of plans.

Those considering ROBS transactions to fund a business start-up should give careful consideration to the pitfalls and risks associated with such transactions. Those who have already engaged in these transactions should consider retaining counsel to determine whether the transaction may have raised one of the tax issues raised above and, if so, what corrective steps can be taken.

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[1] Nellie Strong, Haynes and Boone, LLP, 2323 Victory Avenue, Suite 700, Dallas, TX 75219, nellie.strong@haynesboone.com.

[2] James Williamson, Haynes and Boone, LLP, 2323 Victory Avenue, Suite 700, Dallas, TX 75219, james.williamson@haynesboone.com.

[3] Many small business start-ups are franchises. The start-up costs associated with a fast food franchise can easily run into the hundreds of thousands of dollars.

[4] Richard C. Morais, "The IRA Job Machine," *Forbes.com* (April 8, 2009).

[5] *Id*.

[6] Because this is done as a direct rollover from to a qualified plan, it triggers no tax consequences.

[7] The taxable period is the period beginning on the date the transaction occurs and ending on the earliest of the date a notice of deficiency with respect to the tax imposed by Code Section 6212(a) is mailed, the date on which the tax imposed by Code Section 4975 is assessed, or the date on which correction of the prohibited transaction is completed.

TEN WAYS TAXES IMPACT LEGAL FEES

By Robert W. Wood[1]

No one likes paying legal fees, but tax deductions make them less painful. For example, if your combined state and federal tax rate is 40%, $10,000 in legal fees costs you only $6,000. Here are ten rules you need to know about taxes and legal fees.

1. **Contingent Lawyer's Fees are Income.**

Before addressing tax deductions, there's one big income worry. You may only consider deducting legal fees you pay yourself, as by writing a check. However you should also consider legal fees someone else pays your lawyer. Since a payment to your lawyer discharges your obligation, you must consider the income side of the equation.

Suppose you are a plaintiff in a lawsuit and recover $1 million, and your contingent fee lawyer keeps 40%. You might assume your largest tax problem will be $600,000 of income. How could you possibly have to pay tax on the full $1 million?

Answer: the Internal Revenue Code is not always logical. The U.S. Supreme Court ruled in 2005[2] that "as a general rule" you've got income when your lawyer is paid, even if you never touched the money and it was paid by a third-party (like the defendant). That means you need to worry about how to deduct the fees.

2. **You Can't Deduct Personal Legal Fees.**

The least desirable legal expenses are those of a purely personal nature. The best legal fees are business expenses. As you review the other categories of legal fees below, you may start to think that nothing is purely personal, but you'd be wrong. If you incur legal expenses to get divorced or because you insult a family member who sues you for slander, the legal fees you pay would generally be regarded as purely personal and therefore non-deductible.

But distinguish between purely personal expenses and investment expenses. For example, suppose you are a local businessman and coach a little league team. You defame one of the parents at the game. You pay $25,000 in legal fees to resolve the case. Can you deduct it?

Even though the expense arose out of a personal activity, you'll argue you had to incur the expense because of your business and reputation. That could make it a business expense, or at least an investment expense (for the difference, see below). You may succeed, but the IRS wins many such cases.

3. <u>Legal Fees in Personal Physical Injury Cases are Tax-Free.</u>

If a client hires a contingent fee lawyer in a pure personal physical injury case (say an auto accident or a slip-and-fall), both the legal fees and the net recovery are tax-free to the plaintiff. Put another way, if the recovery is tax-free, it doesn't matter whether you consider the gross recovery including legal fees or the net after legal fees.

Unfortunately, there is often confusion about what is and is not tax-free. The basic rule is that recoveries for personal physical injuries and physical sickness are tax-free, but punitive damages are taxable, as is interest (even in a physical injury case). So a settlement or judgment may be part tax-free and part taxable.

4. <u>Legal Fees in Employment Cases Are Fully Deductible.</u>

Most employment lawsuit recoveries are taxable income. They may be wages (subject to withholding and employment taxes), or they may simply represent non-wage income (typically reported on an IRS Form 1099). Even in an employment case, payment for physical injuries or sickness is tax-free, but in most employment cases the monies are simply split between wages and other income. In an employment case, if the client receives 60% and the lawyer receives 40%, the client is still treated as receiving 100%.

But fortunately, due to a 2004 change to the Internal Revenue Code, the client can deduct the legal fees "above-the-line." The client includes the 40% legal fee in gross income, but then subtracts it before reaching adjusted gross income. That means the client isn't paying any tax — no regular tax and no AMT — on the legal fees. (See 7 below for more about AMT.) Still, people often foul this up on their tax returns, so be careful.

5. Business Legal Fees are Fully Deductible.

Legal feels incurred in running a trade or business are fully deductible by corporations, LLC, partnerships and proprietorships. Proprietorships report federal income tax on Schedule C to their IRS Form 1040. Schedule C tallies up income and expenses and arrives at net profit or loss from the business. That net profit or loss then goes on the face of the Form 1040. The legal fees on Schedule C operate like an above-the-line deduction, so the client pays no tax (no regular tax and no AMT) on the lawyer fees.

6. Investment Legal Fees Are Miscellaneous Itemized Deductions.

If the lawsuit does not involve personal physical injury or employment, and does not arise in a trade or business, the client has a tax problem. The client can deduct the legal fees only as a miscellaneous itemized deduction on Schedule A of the client's Form 1040. That triggers numerous limitations.

First, the legal expenses are deductible only in excess of 2% of the client's adjusted gross income. Second, clients with higher incomes have their miscellaneous itemized deductions and personal exemptions phased out. Then there's the dreaded AMT!

7. AMT Liabilities Can Be Big.

If you claim legal fees as miscellaneous itemized deductions, they are non-deductible for purposes of the Alternative Minimum Tax, or AMT. The tax applies at a 28% rate, and can effectively tax most or all your legal fees. When people talk about "paying tax on the lawyer fees," this is invariably what they mean.

It is easy to see that taxpayers have an incentive to try to net their legal fees. Some people file a Schedule C, claiming to be a proprietor. A recent example is Purdy, Inc.[3] Purdy was an employee and received a Form W-2. After an employment dispute, he received an award of wages, and then paid his lawyer $120,000.

Notably, this occurred in 2003, prior to the enactment of the above-the-line deduction for employment claims. Because of that, Purdy put the lawyer's expense on his Schedule C, claiming he could report income and expense as a proprietor. The Tax Court easily concluded that Purdy was an employee so he could not deduct legal fees on Schedule C. He could only deduct them as miscellaneous itemized deduction, so he paid AMT.

8. You Must Capitalize Some Legal Fees.

Another big category of legal expenses are those that must be capitalized. If a legal expense relates to your investments or to your business watch out for capitalization. In either event, to deduct the legal fees currently you need to be able to show that the fees relate to your current business operations or to the ongoing maintenance of your investment property, and not to something fundamental.

For example, if you are trying to sell your business and spend $50,000 in legal fees, can you deduct it against other income, or must you add it to your basis in your company? Usually, the latter. Similarly, suppose you incur legal expenses to resolve a lot line dispute between your house and your neighbor's. Is that purely personal, or is it investment-related, since your house is arguably an investment? Probably the latter.

Yet even though these legal expenses should qualify as investment-related rather than purely personal, you can't deduct them. Instead, you must capitalize them, adding them to your cost, just as you would handle the costs of a kitchen remodel. You only get a tax benefit later if you sell the house, when the legal expense can shield additional sales proceeds from tax.

9. **Legal Fees for Tax Advice are Deductible.**

Legal fees for tax advice are in a separate category and are always deductible (that means paying your tax lawyer is never as painful as paying other lawyers!). The rule covers legal fees for all taxes, income, estate, gift, property, even excise tax or sales and use tax. The taxes may be personal or business too. The advice may involve tax planning or tax controversies.

But there's a downside. Fees for tax advice deducted by individuals are only miscellaneous itemized expenses. That means you incur the same limitations and the same AMT trap discussed above. If the tax advice relates to your business, you are better off treating the legal fees as business expenses (fully deductible) rather than as tax fees (miscellaneous itemized).

On the other hand, sometimes you can deduct purely personal legal fees as tax advice. Divorce is personal, but the portion of your divorce legal fees related to tax advice is still deductible. A miscellaneous itemized deduction is better than nothing.

10. Allocate Fees in Combined Cases.

If you receive tax-free and taxable damages, you'll generally need to bifurcate your attorney fees too. Some of the legal fees in a contingent fee case will be income, so you want to find a way to deduct them. Punitive damages and interest often raise this problem.

Employment cases also often involve multiple types of recoveries and multiple types of attorney fees. A case may involve some deductible legal fees and some that must be capitalized. Even divorce cases can involve hybrids.

Conclusion

Clients can be forgiven for not wanting to pay legal fees without deducting them, for tax deductions alleviate some of the pain. The tax analysis can be sophisticated, and you'll often find that the facts are ambiguous and that you may incur legal fees that fall into more than one category. Fortunately, there are often several ways of allocating fees, so planning can pay off.

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[1] Robert W. Wood is a tax lawyer with a nationwide practice (www.woodporter.com). The author of more than 30 books including *Taxation of Damage Awards & Settlement Payments* (4th ed. 2009 www.taxinstitute.com), he can be reached at wood@woodporter.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.
[2] *Commissioner v. Banks*, 543 U.S. 426 (2005).
[3] T.C. Summary Opinion 2010-26

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SECTION OF TAXATION

State Bar of Texas

October 6, 2010

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

Internal Revenue Service
CC:PA:LPD:PR (REG-138637-07)
Room 5205
PO Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: Comments on proposed amendments to Treasury Circular 230 (REG-138637-07)

Dear Commissioner Shulman:

On August 19, 2010, the Internal Revenue Service (the "IRS" or "Service") and the Department of the Treasury ("Treasury") released REG-138637-07, proposed regulations that would amend 31 Code of Federal Regulations, Subtitle A, Part 10, Regulations Governing Practice Before the Internal Revenue Service ("Treasury Circular 230" or "Circular 230"). In REG-138637-07, the Service and Treasury requested comments on the proposed regulations by October 7, 2010. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments on the proposed regulations.

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

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

We commend the Service for the time and thought that has been put into preparing the proposal, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Patrick O'Daniel
Chair, Section of Taxation
The State Bar of Texas

cc: Karen L. Hawkins
Director
Office of Professional Responsibility
Internal Revenue Service

COMMENTS ON PROPOSED AMENDMENTS TO TREASURY CIRCULAR 230, AS PUBLISHED IN THE FEDERAL REGISTER ON AUGUST 23, 2010

Principal responsibility for drafting these comments was exercised by David Colmenero, Mandi L. Matlock, and Robert D. Probasco. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Gene Wolf, past Chair of the Section of Taxation of the State Bar of Texas, reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, the Chair of COGS, also reviewed the comments on behalf of COGS.

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

Contact Persons

David Colmenero
dcolmenero@meadowscollier.com
(214) 749-2462

Mandi L. Matlock
mmatlock@trla.org
(512) 374-2743

Robert D. Probasco
Robert.Probasco@tklaw.com
(214) 969-1503

Date: October 6, 2010

I. EXECUTIVE SUMMARY

We agree with the Service's proposed amendments to Circular 230 but respectfully suggest that the Service consider:

- Exempting nonsigning tax return preparers, if working in CPA or law firms under the direct supervision of CPAs or attorneys, from the competency testing and continuing education requirements for registered tax return preparers.
- Restricting the scope of practice of registered tax return preparers, with limited exceptions, to preparing tax returns for which they have passed competency examinations specific to that type of return.
- Publicizing the limited scope of practice for registered tax return preparers.
- Making competency examinations required for registered tax return preparers as comprehensive and rigorous as training and assessments commonly required by CPA and law firms for their unlicensed staff who serve as nonsigning tax return preparers.
- Automatically certifying as qualified continuing education programs those programs accepted by state licensing bodies for CPE/CLE credit.
- Issuing registered tax return preparers only enrollment or registration cards and not anything designated as, or having the appearance of, a "certificate."
- With respect to standards for tax return positions:
    - Establishing a "reasonable basis" standard, applicable other than for reportable transactions and "tax shelters";
    - Either
        - Restricting the higher standard to reportable transactions and not tax shelters, or
        - Providing an appropriate definition of "significant purpose" for evaluating whether a transaction qualifies as a tax shelter;
    - Including appropriate language in section 10.34(a)[1] allowing tax practitioners to advise their clients to take a tax return position contrary to rules and regulations based on a good faith challenge to those rules or regulations; and
    - Clarifying that the "not frivolous" standard for submitting "documents, affidavits, and other papers" does not apply to tax returns.

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[1] Unless otherwise indicated, all "section" references are to Circular 230 and may reference either the current provisions of Circular 230 or those included in the proposed amendments, depending on the context. References to sections of the Internal Revenue Code or the Treasury Regulations are so indicated.

- With respect to sanctions:
  - Establishing appropriate definitions of "willfully," "recklessly," and "gross incompetence";
  - Establishing a reasonable cause defense;
  - Exempting from sanctions any reporting position that the practitioner reasonably expected would not produce any tax benefits; and
  - Limiting any sanctions for violations of section 10.34(a) to only one tax return preparer for the tax return and tax position in question.

II. BACKGROUND

The vast majority of federal individual income tax returns are prepared by paid tax return preparers or by taxpayers using consumer tax preparation software. Circular 230 governs practice before the Service by attorneys, certified public accountants, enrolled agents, enrolled actuaries, and enrolled retirement plan agents (collectively, "practitioners"). Circular 230, however, has not applied to paid tax return preparers who did not fall within any of the categories of practitioners. Various observers, including the National Taxpayer Advocate and consumer advocacy groups, have expressed significant concerns about the lack of regulation of such unenrolled tax return preparers. In June 2009, Commissioner Shulman launched a review to help accomplish the Service's goal of ensuring that all tax practitioners and tax return preparers adhere to professional standards. The results of that review are described in Publication 4832 (Rev. 12-2009), Return Preparer Review.

As a result of the review, the Service has now proposed amendments to Circular 230 to regulate tax return preparers not previously subject to Circular 230's requirements. The proposed amendments identify "registered tax return preparers" as a new category of practitioners governed by Circular 230. Registered tax return preparers are required to pass appropriate competency examinations and satisfy continuing education requirements. The examination and continuing education requirements do not apply to CPAs and attorneys. The proposed amendments also establish standards for positions taken on tax returns that are applicable to all practitioners.

III. COMMENTS

We share the Service's goal of effective tax administration and concerns about the effect of unregulated tax return preparers on that goal. We commend the Service for the time and thought that has been put into preparing the proposed amendments. We also appreciate the opportunity to comment on the proposed amendments and hope that our comments prove to be helpful.

We agree with the approach taken by the Service to limit the new competency examinations and continuing education requirements to registered tax return preparers and concur that these new provisions should not be applied to CPAs and attorneys. CPAs and attorneys are licensed professionals who are already subject to substantial external regulation. State licensing authorities (state bars and boards of accountancy) impose rigorous licensing exams and annual continuing education requirements, establish ethical standards and guidelines, and review complaints from the public and disciplinary actions by the Service. Violation of their high professional and ethical standards can lead to serious sanctions, including suspension or termination not only of the right to practice before the Service but also of the professional license. Applicable professional organizations (both at the national and state level) can also sanction members for violation of professional and ethical standards.

A. NONSIGNING TAX RETURN PREPARERS

The proposed regulations would apply not only to signing tax return preparers but also to nonsigning tax return preparers. We suggest that the Service consider providing an exemption for nonsigning tax return preparers who work in professional firms under the supervision of licensed CPAs and attorneys from the additional testing and continuing education requirements.

Proposed section 10.2(a)(8) defines a tax return preparer as "any individual within the meaning of section 7701(a)(36) and 26 CFR 301.7701-15." Section 7701(a)(36)(A) of the Internal Revenue Code, as amended, (the "Code") defines a tax return preparer as

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

Section 301.7701-15 of the Treasury Regulations (the "Regulations") identifies two categories of tax return preparers. A signing tax return preparer, defined in Regulations section 301.7701-15(b)(1), "is the individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund." A nonsigning tax return preparer, defined in Regulations section 301.7701-15(b)(2)(i), (3), "is any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund," including not only the physical preparation of the return or claim for refund but also the rendering of tax advice "with respect to events that have occurred at the time the advice is rendered." The IRS website also indicates that "tax return preparer" under the proposed definition would include, for example, interns who prepared returns for very simple tax situations even when subject to careful review by the signing tax return preparer.[2] Thus, "tax return preparer" is construed broadly for purposes of Circular 230, subject to certain exceptions set forth in Code section 7701(a)(36)(B) and Regulations section 301.7701-15(f).

In News Release 2010-99 (September 28, 2010), the Service explained that CPAs, attorneys, and enrolled agents would be required to obtain a preparer tax identification number (PTIN) if they wished to prepare returns within the above definitions but would not be subject to the additional testing or continuing education requirements. The Service went on to note that it "has under serious consideration extending similar treatment to a discrete category of people who engage in return preparation under the supervision of someone else – for example, some employees who prepare all or substantially all of the return and work in certain professional firms under the supervision of one of the above individuals who signs the return."

We believe that this would be an appropriate change to the proposed regulations, commend the Service for its consideration of this change, and provide the following comments.

CPA and law firms often employ paraprofessionals, interns, and other staff, rather than licensed professionals, as nonsigning tax return preparers in order to provide cost-efficient services to their clients. These unlicensed professionals work under the supervision of licensed professionals subject to Circular

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[2] *See* http://www.irs.gov/taxpros/article/0,,id=218611,00.html#scenarios (visited September 30, 2010), Scenario 3.

230[3] and are not permitted to sign returns or to represent taxpayers before the IRS. In addition to the requirements set forth in Circular 230, many state licensing authorities and professional organizations have established high standards of accountability for CPAs and attorneys in supervising the work of subordinates. For example, Rule 5.03 of the Texas Disciplinary Rules of Professional Conduct states:

> A lawyer shall be subject to discipline for the conduct of a nonlawyer employed by, retained by, or affiliated with a lawyer or law firm that would be a violation of these Rules if engaged in by a lawyer, if:
>
> (a) the lawyer has direct supervisory authority over the nonlawyer and fails to make reasonable efforts to ensure that the nonlawyer's conduct is compatible with the lawyer's professional obligations;
>
> (b) the lawyer orders, encourages, or knowingly permits the conduct involved; or
>
> (c) the lawyer:
>
> > (1) has managerial authority in the law firm that has retained, employed, or affiliated the nonlawyer, or has direct supervisory authority over such nonlawyer; and
> >
> > (2) with knowledge of such misconduct by the nonlawyer knowingly fails to make reasonable remedial action within the scope of the lawyer's authority to avoid or mitigate the consequences of that nonlawyer's misconduct.[4]

These professional standards, combined with oversight by state licensing authorities and professional organizations,[5] establish a level of accountability for nonsigning tax return preparers not found elsewhere in the tax return preparation industry. If a nonsigning preparer makes an error in a return, the signing CPA or attorney would be fully responsible and subject to sanctions, potentially including not only suspension or loss of the right to practice before the Service but also even suspension or loss of

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3 Circular 230 imposes accountability for the practitioner with principal authority and responsibility for the firm's tax practice. Proposed section 10.36(b) states:

> Any practitioner who has (or practitioners who have or share) principal authority and responsibility for overseeing a firm's practice of preparing tax returns, claims for refunds, or other documents for submission to the Internal Revenue Service must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with Circular 230. Any practitioner who has (or practitioners who have or share) this principal authority will be subject to discipline for failing to comply with the requirement.

However, CPAs and attorneys are subject to strong accountability standards, beyond the requirements of Circular 230, for conduct of unlicensed staff whom they supervise.

4 There are comparable requirements for CPAs. For example, according to the American Institute of Certified Public Accountants ("AICPA") Code of Professional Conduct, ET section 201 (General Standards), AICPA members shall "adequately plan and supervise the performance of professional services." AICPA Interpretation 201-1 explains that: "Competence to perform professional services involves both the technical qualifications of the member and the member's staff and the ability to supervise and evaluate the quality of the work performed." This is similar to Texas State Board of Public Accountancy ("TSBPA") Rule 501.74(c). The AICPA has also issued Statements on Standards for Tax Services, establishing high standards of professional conduct on CPAs signing returns.

5 The oversight by state licensing authorities and professional organizations results in additional resources, beyond those available to the Office of Professional Responsibility, to identify and address violations of professional and ethical standards.

professional license. This accountability by licensed professionals provides stronger assurance of effective tax compliance than the new proposed requirements. To require unlicensed employees of CPA and law firms to take examinations and attend continuing education courses would add little benefit but would add to the firms' costs to comply with the regulations, which likely would be passed through in higher fees to taxpayers. As discussed below,[6] the examination requirement might also significantly restrict the extent of tax return preparation services offered by CPA and law firms, to the detriment of taxpayers.

Finally, exempting from these requirements nonsigning preparers who work at CPA or law firms under the supervision of licensed professionals would be consistent with the current approach to the return preparer penalty of Code section 6694. Regulations section 1.6694-1(b)(1) provides that "no more than one individual associated with a firm (for example, as a partner or employee) is treated as a preparer with respect to the same return or claim for refund." This "one preparer per position per firm" rule demonstrates the common-sense approach that holding one individual accountable is sufficient.

B. COMPETENCY EXAMINATIONS AND SCOPE OF PRACTICE

The proposed definition of practice before the Service, as set forth in section 10.2(a)(4), appears to include the preparation of any tax return that is filed with the Service. Any individual who does not otherwise qualify as a practitioner under existing provisions of Circular 230 must now become a registered tax return preparer (as defined in proposed section 10.3(f)) in order to practice before the Service. Proposed section 10.4(c) requires applicants, among other things, to "demonstrate[] competence in Federal tax return preparation matters by written examination administered by, or administered under the oversight of, the Internal Revenue Service." Thus, anyone who prepares a federal tax return without having passed the Service's competency examination would be in violation of Circular 230 and subject to sanctions.

The notice of proposed rulemaking, in its discussion of eligibility to become a registered tax return preparer, describes two examinations concerning Form 1040, including one for wage and nonbusiness income and one for wage and small business income. In the "Regulatory Assessment Under E.O. 12866," however, the notice says that the scope of the proposed regulations is considerably broader than individual tax returns, encompassing as well returns for corporations, large partnerships, excise taxes, and estate taxes, among others.

The notice requests "comments on whether a tax return preparer who solely prepares tax returns other than Form 1040 series returns (for example, Form 941, Employer's Quarterly Federal Tax Return, or Form 706, U.S. Estate Tax Return) should be permitted to prepare these other tax returns without successfully completing any examination." In the Regulatory Assessment, the notice states:

> The IRS and the Treasury Department believe that the expansion of these regulations to currently unenrolled tax return preparers may impact individual taxpayers more than large corporate taxpayers because the IRS and the Treasury Department believe that large corporate taxpayers more likely employ the services of those who are currently regulated than those who are currently unenrolled to prepare their tax returns. The IRS and the Treasury Department are seeking comments on the types of returns (for example: individual versus corporate tax returns) currently being prepared by currently unenrolled tax return preparers.

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6 *See infra* note 7 and accompanying text.

We cannot speak authoritatively to what types of returns are currently prepared by currently unenrolled tax return preparers. We do, however, suggest that the Service carefully consider the typical complexity of tax returns before permitting registered tax return preparers to prepare such returns without completing any competency examination.

Some tax returns may be fairly straightforward and less likely to lead to the frequency of errors that the Service found in its Return Preparer Review. For example:

- Form 720, Quarterly Federal Excise Tax Return
- Form 940, Employer's Annual Federal Unemployment Tax Return
- Form 941, Employer's Quarterly Federal Tax Return

Other tax returns, however, can be as complex as, if not more complex than, Form 1040. For example:

- Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return
- Form 709, U.S. Gift (and Generation-Skipping Transfer) Tax Return
- Form 990, Return of Organization Exempt From Tax
- Form 1041, U.S. Income Tax Return for Estates and Trusts
- Form 1065, U.S. Return of Partnership Income
- Form 1120, U.S. Corporation Income Tax Return
- Form 1120-S, U.S. Income Tax Return for an S Corporation
- Form 5500, Annual Return/Report of Employee Benefit Plan

The knowledge and expertise that are required to prepare business income tax returns effectively are significantly more than required for most individual income tax returns. Although large corporations and partnerships may mostly employ currently regulated practitioners for their returns, some business income tax returns are filed by significantly smaller businesses. It is possible that some taxpayers use currently unenrolled tax return preparers for such returns.

We are concerned that allowing registered tax return preparers to prepare many of the above tax returns, without first passing an appropriate competency examination, could hinder effective tax administration. Treating those returns differently from Form 1040 might also raise concerns about the effectiveness of the preparer registration initiative and confuse the public concerning the qualifications of registered tax return preparers. Accordingly, we suggest that the Service carefully consider the ramifications before permitting registered tax return preparers to prepare tax returns for which they have not passed competency exams specific to that type of return.[7]

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[7] As discussed above, the proposed amendments to Circular 230 currently would require certain unlicensed employees of CPA and law firms to apply to become registered tax return preparers. If, as we suggest, registered tax return preparers can only prepare tax returns after passing competency exams specific to that type of return, but the Service does not develop appropriate competency examinations, only CPAs, attorneys, and enrolled agents could prepare returns other than Form 1040. If CPA and law firms cannot use unlicensed staff to prepare such returns,

We also encourage the Service to make the competency examinations comprehensive and rigorous, to ensure that applicants who pass really are qualified. Many of the tax return preparers included in the Service's Return Preparer Review compliance testing likely had training and examinations before they began working, but still made many errors in preparing returns. The equivalent tax preparers who work for CPA and law firms (paraprofessionals, interns, and unlicensed degreed professionals) typically are given intensive training and assessment, as well as ongoing supervision. We believe registered tax return preparers should be subjected to comparable testing regimes to ensure comparable performance.

Finally, we suggest that the Service consider making clear – in the proposed regulations and by a public relations campaign to educate the public – the restricted scope of practice and limitations of registered tax return preparers. For example, the language in proposed section 10.30(a)(1), "designated as a registered tax return preparer with the Internal Revenue Service," does not contain any qualifier to signal that the registered tax return preparer has only passed a qualifying examination for individual income tax returns. The broad, unqualified language may mislead the public into believing that registered tax return preparers are qualified to prepare all tax returns, rather than only those for which they have passed competency exams. The Service may wish to consider adding appropriate qualifications to the designation of these practitioners, such as "registered individual income tax return preparer" or "registered tax return preparer – Form 1040."

C. QUALIFYING CONTINUING EDUCATION PROGRAMS

Proposed section 10.9(a)(1) states that a continuing education provider must be either: (a) an accredited educational institution; (b) recognized for continuing education purposes by the licensing body [presumably for public accountancy or law] of any State, territory, or possession of the United States, including a Commonwealth; or the District of Columbia; or (c) recognized by the Director of the Office of Professional Responsibility ("OPR") as one who offers a qualified continuing education program. Proposed section 10.9(a)(2), (3) then addresses the qualification and approval of each individual program by the Director of OPR. The specific requirements for qualifying continuing education programs in proposed sections 10.6(f)(3) and 10.9(a)(3) are similar to the standards of the National Association of State Boards of Accountancy (NASBA) for approving continuing professional education (CPE) courses for CPAs and to the standards of the State Bar for many states for approving continuing legal education (CLE) courses. These include qualified instructors, quality educational materials, attendance records, suitable testing and so forth.

Although CPAs and attorneys will not be subject to the new proposed continuing education requirements for enrolled agents, enrolled retirement plan agents, and registered tax return preparers, we believe that existing CPE and CLE courses would often be useful to these practitioners. These existing courses would also help absorb the increased demand for continuing education resulting from a significant increase in the number of practitioners other than CPAs and attorneys. Certification by OPR of thousands of existing CPE and CLE courses, however, would be tremendously time-consuming and expensive. We therefore suggest that the Service consider relying on state licensing bodies not only for the qualification of continuing education providers but also for the qualification of individual CPE/CLE programs.

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they would not be able to serve these taxpayers on a cost-efficient basis. This potential problem is a further argument in favor of excluding those unlicensed employees of professional firms from regulation under Circular 230, as the Service is currently considering.

D. DESIGNATION AND SOLICITATION

While the rule in proposed section 10.30(a)(1) prohibits the use of the term "certified" by registered tax return preparers, proposed section 10.6(b) provides that OPR will issue "an enrollment or registration card or certificate" for these individuals. This may confuse the public by giving the unwarranted appearance of a degree or professional certification. We suggest, therefore, that the Service consider changing section 10.6(b) to provide only for enrollment cards. If a certificate is issued, we suggest that it simply state that the recipient is registered and authorized with the IRS as an individual income tax return preparer. Any such certificate should be limited in size and not resemble a university degree or professional certification and should not bear diploma-type adornments, such as ribbons, seals, and signatures.

The designation of these practitioners also may be confusing to the public. "Registered tax return preparer" implies a much broader qualification than, for example, "registered individual income tax return preparer" or "registered tax return preparer – Form 1040" would. As discussed above, we suggest that the Service conduct a public relations campaign to educate the public about the restricted scope of practice and limitations of registered tax return preparers and consider adding appropriate qualifications to that designation. In addition, OPR should impose appropriate sanctions for registered tax return preparers who misrepresent their qualifications to taxpayers.

E. STANDARDS FOR TAX RETURN POSITIONS

We believe that the standards for tax return positions in proposed section 10.34(a) include some inconsistencies or ambiguities. Further, in some instances, we believe it may be appropriate to revise some of these standards. We recognize that the Service and Treasury have traditionally attempted to establish a consistent and uniform standard for tax return preparers, with similar standards applying to both Circular 230 and the return preparer penalty of Code section 6694. While consistency and uniformity are important, section 10.34(a) and Code section 6694 have different purposes, which may justify different standards. As an attorney-adviser in Treasury's Office of Tax Legislative Counsel observed in a January 23, 2010, speech at a meeting of the American Bar Association Section of Taxation, Circular 230 is an ethical standard and violations are subject not to "a civil penalty, but a fairly severe sanction, such as suspension from practice."[8] Not all Code section 6694 violations will rise to the level of an ethical violation.

Base Standard

Proposed section 10.34(a)(1)(i)(A), (ii)(A) suggests that a practitioner may sign a tax return or claim for refund containing, or advise a client to take, a position for which there is a reasonable basis. However, proposed section 10.34(a)(1)(i)(B), (ii)(B) references the "unreasonable position" provision of Code section 6694(a)(2). Code section 6694(a)(2)(A), (B) establishes a standard of either: (a) substantial authority, if not adequately disclosed; or (b) reasonable basis, if adequately disclosed. Incorporation of this standard by reference would essentially eliminate the reasonable basis (regardless of disclosure) standard of proposed section 10.34(a)(1)(i)(A), (ii)(A).

As discussed in the notice of proposed rulemaking, the Service deliberately aligned the standards in section 10.34 and Code section 6694. We believe, however, that a reasonable basis standard is appropriate for Circular 230, due to the magnitude of potential sanctions, rather than the higher standards in Code section 6694(a)(2)(A), (B). Suspension or disbarment has a much greater impact on a practitioner than a monetary penalty. We believe that Circular 230 should focus only on the smaller group of

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8 *See* 2010 TNT 16-3.

violations involving positions for which the taxpayer does not even have a reasonable basis. Accordingly, we suggest that the Service reconsider modifying section 10.34(a)(1)(i)(B), (ii)(B) to refer only to Code section 6694(a)(2)(C). (We also suggest below that the Service consider limiting the scope of section 10.34(a)(1)(i)(B), (ii)(B) even further.)

Reportable Transactions and Tax Shelters

Proposed section 10.34(a)(1)(i)(B), (ii)(B) incorporates by reference Code section 6694(a)(2)(C), which imposes a higher standard of certainty with respect to reportable transactions or "tax shelters." A position with respect to a reportable transaction or a tax shelter is "unreasonable" unless it is reasonable to believe that the position would more likely than not be sustained on the merits. A "tax shelter" is defined by reference to Code section 6662(d)(2)(C)(ii), which describes a tax shelter as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a "significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax."

The terms "tax shelter" and "significant purpose" appear in various sections of the Code and Circular 230. Code sections 6662(d)(2)(C) and 6694(a)(2)(C) apply different standards to understatements when they are attributable to tax shelters. Circular 230 section 10.35 categorizes some written advice as a "covered opinion," subject to more stringent requirements than those set forth in section 10.37, for certain entities, plans, or arrangements "a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code." Those provisions, however, contain no definition of "significant purpose," and no guidance has been issued with respect to that term.

"Significant purpose" is defined in Regulations section 301.6111-2(b). Those regulations were promulgated in 2003, replacing temporary regulations issued in 2000 to address the requirement under Code section 6111 (as then in effect) that "organizers" register "tax shelters" before selling interests in the shelter to taxpayers. The American Jobs Creation Act of 2004 ("AJCA") changed that regulatory regime to one in which taxpayers and their "material advisors" disclose "reportable transactions." Because the entire approach has been revised, it is not at all clear whether the definition in Regulations section 301.6111-2(b) would apply in the context of Circular 230 section 10.34.

We are also concerned about the interpretation of that definition. Regulations section 301.6111-2(b) states that a transaction has a significant purpose of avoidance or evasion of Federal income tax it is a listed transaction or "has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction." The definition is later limited in Regulations section 301.6111-2(b)(3) to transactions that the tax shelter promoter expects to present to multiple potential participants, and is also subject to a few exceptions in Regulations section 301.6111-2(b)(3)(i), (ii) and (4), including ordinary business transactions. It is entirely possible, however, that OPR and an administrative law judge would interpret "significant purpose" based solely on the part of the definition quoted above.

We believe such an interpretation, without all the restrictions, is more broad than would be appropriate in the context of section 10.34(a)(1)(i)(B), (ii)(B). There are countless situations where taxpayers legitimately structure their transactions to minimize tax liability.[9] Minimizing tax liabilities is almost always important. The lack of a clear definition requires practitioners to guess whether a particular transaction or arrangement constitutes a tax shelter subjecting the practitioner to a heightened standard of certainty under Circular 230 section 10.34(a)(1)(i)(B), (ii)(B). Moreover, failure to define the term "significant purpose" could leave Circular 230 provisions subject to challenge as unconstitutionally

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9 *See United States v. Carlton*, 512 U.S. 26, 35 (Justice O'Connor concurring) (noting that all taxpayers are entitled to structure their affairs to comply with the tax laws while minimizing liability).

vague, particularly where the Service seeks to impose sanctions for violations of section 10.34. Federal due process requires that a statute contain a reasonable degree of certainty so that individuals are not forced to guess what it means.[10]

For the above reasons, and because of the severe sanctions to which practitioners might be subjected for violations of section 10.34, we suggest the Service consider implementing one of the three following options:

- Modify proposed section 10.34(a)(1)(i)(B), (ii)(B) and the cross-reference to Code section 6694(b)(2)(C) to exclude "tax shelters" and require a heightened degree of certainty only for reportable transactions. This would align the standards for tax return positions in Circular 230 section 10.34 with the new regulatory regime for disclosure of reportable transactions rather than the old regime that was eliminated by AJCA. Further, we believe that the vast majority of transactions that would constitute "tax shelters" under the old regulatory regime would probably qualify today for one or more of the categories of reportable transactions.
- Specifically adopt, for purposes of Circular 230 section 10.34, the definition of "significant purpose" in Regulations section 301.6111-2(b) including all the limitations and exceptions therein.
- Provide other guidance as to the meaning of "significant purpose." We recognize the difficulty of addressing this issue, because of its impact on not only Code sections 6662 and 6694 but also Circular 230 sections 10.34 and 10.35. That impact makes it more difficult, but also more important, to address this issue in regulations or published guidance.

Good Faith Challenge to Rules or Regulations

Proposed section 10.34(a)(1)(i)(C), (ii)(C) suggests that practitioners may not knowingly sign a tax return containing, or advise a client to take, a tax position that intentionally disregards rules or regulations. We assume that this is not what the Service actually intends. There are clearly instances where tax practitioners should be permitted to advise their clients, without fear of penalty, to make a good faith challenge to the validity of the Service's rules or regulations. Indeed, the existence of Form 8275-R, Regulation Disclosure Statement, demonstrates that it is acceptable to take a return position contrary to regulations, although penalties might apply if it is not disclosed. We therefore suggest that the Service consider including appropriate language in section 10.34(a) allowing tax practitioners to advise their clients to take a tax return position contrary to rules and regulations based on a good faith challenge to those rules or regulations

Documents, Affidavits, and Other Papers

Proposed section 10.34(a) is labeled "Tax returns" and addresses the standards of care for signing a return containing, or advising a client to take on a return, certain tax positions. Section 10.34(b) is titled

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10 *See generally Pringle v. Wolfe*, 668 N.E.2d 1376,1382 (Ct. App. NY 1996) ("Due process requires that a civil statute contain a 'reasonable degree of certainty so that individuals of ordinary intelligence are not forced to guess at the meaning of statutory terms.'"); *State v. Glas*, 54 P.3d 147, 153 (Wash. 2002) ("A statute is void for vagueness if persons of common intelligence must necessarily guess at its meaning and differ as to its application."); *State v. Krahwinkel*, 656 N.W.2d 451, 466 (S.D. 2002) ("A statute which either forbids or requires the doing of an act in terms so vague that [people] of common intelligence must necessarily guess at its meaning and differ as to its application violates the first essential of due process.").

"Documents, affidavits and other papers" and establishes a lower, "not frivolous" standard for submitting documents, affidavits and other papers to the Service. Section 10.34(a) primarily applies to tax compliance while section 10.34(b) would include advocacy on behalf of a client, for example, during an audit or appeal. While a higher standard of certainty may be appropriate when filing a return, advocacy traditionally has been seen as a role for which more latitude is warranted. In disputes between the Service and a taxpayer, zealous advocacy on both sides is important in achieving the right resolution. Zealous advocacy requires more latitude in the standard of certainty required to espouse a position. A "not frivolous" standard seems appropriate for advocacy.

The scope of section 10.34(b) is not entirely clear, however. "Documents" and "other papers" might be interpreted as applying to tax returns as well. We suggest that the Service consider modifying section 10.34(b) to make clear that it does not apply to tax returns. We believe it is appropriate to maintain two separate categories of practice with different standards of certainty.

F. SANCTIONS

Section 10.50 establishes sanctions for violations of Circular 230. Section 10.52 specifies that a practitioner may be sanctioned if the practitioner: (a) willfully violates any part of Circular 230 other than section 10.33; or (b) recklessly or through gross incompetence violates sections 10.34 through 10.37. Sections 10.60 through 10.82 provide rules applicable to disciplinary proceedings.

Willfully

As noted above, there is significant ambiguity about the interpretation of section 10.34(a). Further, the number of individuals subject to Circular 230 will be expanded dramatically by the preparer registration initiative. These two factors substantially increase the potential for disciplinary proceedings against practitioners for alleged violations of section 10.34. Accordingly, we believe that it is critical to clarify the standards of care applicable to such violations. In particular, we are concerned about the lack of an adequate definition of the "willfully, recklessly, or through gross incompetence" standard in section 10.34. Section 10.52 uses a similar standard and also does not define it.

Disciplinary proceedings under section 10.52 have traditionally used a definition of "willful" from *Cheek v. United States*, 498 U.S. 192 (1991). *Cheek*, a criminal tax evasion case, defined willful as the voluntary, intentional violation of a known duty. The Court reached this decision "largely due to the complexity of the tax laws." *Id.* at 200. Recently, however, the Service has called into question this definition of "willful." In *Director, Office of Professional Responsibility v. Gonzales*, No. 2007-28 (Decision on Appeal, Dec. 9, 2009)(2010 TNT 21-17) and *Director, Office of Professional Responsibility v. Kilduff*, No. 2008-12 (Decision on Appeal, Jan. 20, 2010)(2010 TNT 27-5), the Appellate Authority in the Office of Chief Counsel questioned whether the *Cheek* standard was appropriate. He noted that a Circular 230 disciplinary hearing was a civil, rather than criminal, proceeding and invited the parties in future cases to brief the appropriate definition of willfulness. Because both cases involved the failure to timely file the practitioners' own tax returns, the *Cheek* standard was easily met. This suggests that the discussion of the definition of willfulness, unnecessary to those decisions, may be the first step in the IRS taking a more aggressive stance generally in disciplinary proceedings.

We believe that the standard of care required to avoid sanctions under Circular 230 should be relatively high. Section 10.50 authorizes the Secretary, after giving notice and an opportunity for a proceeding, to censure, suspend, or disbar practitioners from practice before the IRS. Although those sanctions are civil rather than criminal in nature, they also have the potential to take away the practitioner's livelihood, which is much worse than a monetary penalty.

Whatever standard of care is appropriate, however, we suggest that the Service consider clearly defining it in regulations or published guidance.[11] Without a clear definition, practitioners will not have appropriate notice and OPR and administrative law judges will not have appropriate guidance. Most states, for example, define such terms in their penal statutes. It is equally important in this context. We also suggest that the definitions of "willfully," "recklessly," and "through gross incompetence" could be applied to relevant penalty provisions of the Code, such as sections 6662, 6662A, and 6694.

Any definitions of these terms should also take into account the type of violation to which they are applied. *Gonzales* and *Kilduff* involved a fairly simple and straight-forward requirement – timely filing of the practitioner's own tax returns. In that context, a determination that the conduct was willful was easy. Any alleged violations of section 10.34, however, involve much more subjectivity and judgment. What is the proper application of the Code in the relevant circumstances? Did the practitioner have reasonable basis (or substantial authority) for the position taken on the return or claim for refund? Was the transaction "substantially similar" to a listed transaction and therefore subject to an even higher standard of certainty? The definition of "willfully," "recklessly," and "through gross incompetence" should take into account that subjectivity and judgment. An error in applying convoluted provisions of the Code to complex transactions is much more understandable and much less blameworthy than an error in determining the filing date for the practitioner's own tax returns. The IRS understandably wants practitioners to prepare returns or claims for refund accurately, and the State Bar of Texas Section of Taxation fully agrees with this goal. An occasional inadvertent error, however, should not subject a practitioner to the burden of a disciplinary proceeding under Circular 230. Section 10.34(a)(2) states: "A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross incompetence." We suggest that the Service consider defining the standard of care such that a pattern of conduct is *required* to institute disciplinary proceedings for alleged violations of section 10.34.

Reasonable Cause

Section 10.34 does not include a reasonable cause defense. The notice of proposed rulemaking states that this was a deliberate decision by the Service, relying instead "on the requirement that a practitioner must have acted willfully, recklessly, or through gross incompetence to ensure that sanctions are not imposed on a practitioner who acts reasonably and in good faith. We understand the Service's position but believe an explicit reasonable cause defense would provide more appropriate protection, particularly given concerns about the definition of "willfully, recklessly, or through gross incompetence." Accordingly, we suggest that the Service reconsider this decision.

No Expected Tax Benefits

The notice of proposed rulemaking states that the Service deliberately determined that section 10.34(a) would apply even if there is a final determination that there is no understatement of tax. This differs from Code section 6694(d). Thus, a practitioner could still be subject to discipline under Circular 230 "even if other positions on the same tax return or claim for refund eliminate the understatement of liability."

We understand the Service's rationale for this decision but believe a modification might be appropriate to avoid potential conflicts of interest between practitioners and their clients. In some instances, disallowance of a return position may not result in an understatement even disregarding other positions. For example, a taxpayer may want to avoid applying a particular accounting methodology that

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11 In conjunction with providing a definition of "willfully," the Service might also reconsider the definition of "recklessly or through gross incompetence" in section 10.51(a)(13) along the same lines.

would be cost-prohibitive to implement in favor of another methodology. As long as the other methodology does not result in an understatement of tax, the taxpayer could do this without fear of any penalties. However, Circular 230 would prohibit a tax practitioner from advising a taxpayer from taking this position if it contradicts a prescribed methodology set forth in IRS rules or regulations. This has the effect of precluding a practitioner from advising a client from taking an approach that may be in the best interest of the client, for fear of being penalized under Circular 230.

We therefore suggest that the Service consider amending Circular 230 to exempt from sanctions any reporting position that the practitioner reasonably expected would not produce any tax benefits.

Stacking

The Service has generally avoided "stacking" penalties with respect to the same error. For example, the "one preparer per position per firm" rule of Regulations section 1.6694-1(b)(1) limits the return preparer penalty of Code section 6694. An error on a tax return would not lead to the imposition of penalties on both the signing tax return preparer and a nonsigning tax return preparer. As discussed in section III.A above, we agree that an exemption of nonsigning tax return preparers who work in professional firms under the supervision of licensed practitioners, such as CPAs and attorneys, from the additional testing and continuing education requirements is appropriate. We similarly suggest that the Service consider exempting from sanctions pertaining to section 10.34(a) any such nonsigning tax return preparers under the supervision of a signing tax return preparer. Where no one in a particular CPA or law firm is a signing tax return preparer, because the CPAs or attorneys are tax return preparers only by virtue of advising their clients as to tax positions, we suggest that the Service consider limiting any sanctions for violations of section 10.34(a) with respect to a particular tax return to one practitioner in the firm.

A PRACTICAL LOOK AT ADVANCED DIRECTIVES IN THIS TOUGH ECONOMY

By Catherine C. Scheid[i]

Advanced Directives are those other documents that estate planning attorneys like to discuss with their clients after the wills and trusts discussion is over. Advanced Directives are emergency documents, and I present them as such to clients.

I refer to Advanced Directives as emergency documents because no one expects to be in a car accident on the way home from work and no one expects to fall off the ladder while washing the garage windows over the weekend. You unexpectedly find yourself in a crumpled car with the jaws of life screaming at you or on the grass in your backyard in pain wishing you had hired a handy man to wash those windows. On the other hand, Advanced Directives are also those documents which help as the inevitable aging process takes place, and we are along for the ride whether we want to be or not.

As lawyers we are either trying to solve the problem at hand or trying to do some preparation for an inevitable problem. Advanced Directives would be those documents to consider in preparation of the inevitable problem or unforseen emergency that we all experience at one time or another.

Everyone, including our clients, is worried during this tough economy and even less interested than ever to be in our offices and paying our bills. Therefore, more and more clients are asking me what is the minimum that they can do with Advanced Directives to prepare for the inevitable aging process or unforeseen emergency. In this situation, I recommend the following four documents:

1. *Statutory Durable Power of Attorney* - Tex. Prob. Code § 490 (2010);

2. *Medical Power of Attorney Designation of Health Care Agent* - Tex. Health & Safety Code § 166.164 (2010);

3. *Directive to Physicians and Family or Surrogates* - Tex. Health & Safety Code §166.033 (2010); and

4. *The Authorization for Use and Disclosure of Protected Health Information*.

In addition to the above referenced documents, if a client has minor children, I strongly suggest that they allow me to prepare a *Declaration of Appointment of Guardian for my Children in the Event of my Death or Incapacity*. Tex. Prob. Code §677A (2010).

When explaining these documents to my clients, I begin the discussion with the *Statutory Durable Power of Attorney* (Statutory POA). By executing a Statutory POA, the client is designating a helper when the inevitable aging or emergency occurs, which is a good thing. By executing a Statutory POA, a guardianship of the client's estate may be avoided, which is always a good thing. On the other hand, by executing a Statutory POA*,* the client is also exposing his or her assets to theft by the agent. To help clients understand this, I always refer to the Statutory POA as the "money document" because the client is basically handing the agent his or her checkbook. This idea may be difficult for a client to accept, but if the client is incapacitated and the mortgage still needs to be paid, then the client will need his agent's help. When I am speaking to clients about their choice of agent, I stress that the most important characteristics of an agent are honesty and integrity.

Along with choosing an agent, clients may also find it scary to decide when the Statutory POA should become effective. A client has to choose if the Statutory POA becomes effective when it is executed or when a medical doctor declares in writing that the client is incapacitated. My clients are usually all over the map on this choice and fortunately it is the client's decision and not ours as their lawyers. Lastly, when the choice has been made, I instruct the client to write a line through the option they have not chosen and initial next to the line. I do this because I have seen litigators try and make an issue out of the lack of an outward and visible choice on Advanced Directives.

Following the discussion when the Statutory POA becomes effective, I always address with the client whether he or she would like to grant the agent the power to give a gift to a certain class of people, usually the client's descendants. The gift power is limited to Federal Gift Tax Exclusion which is currently $13,000.[ii]

With this gift power in mind, I add to the special instructions section of the Statutory POA a definition of the descendants. Per a client's instructions, I have gone as far as expanding the definition of descendants to include step-children and step-grandchildren. When a client knows real property will eventually need to be sold by the agent, I use the special instructions section to define, in detail, the legal description of real property as to avoid controversy in the future.

I like the Statutory POA and advocate it to my clients. In my own family the Statutory POA avoided a guardianship of my grandmother when she became incapacitated. In addition, when my parents' health declined, I was the agent for both of them and it afforded me the opportunity to keep their households running. I explain this to my clients, in the hopes that they will understand that the pros definitely outweigh the cons of the Statutory POA.

Following the Statutory POA discussion, I explain the *Medical Power of Attorney Designation of Health Care Agent* (Medical POA). The Medical POA is the "health care helper" and I advocate it as such to my clients. The Medical POA is a bit different from the Statutory POA in that it does not spring into action unless the client cannot make a medical decision for himself or herself. I have found that clients do not hesitate in executing the Medical POA because they understand it does not become effective until the client is either unconscious or incapacitated.

Additionally, I explain to the client that the agent for the Medical POA does not have to be the same as the agent in the Statutory POA. I have found that clients appreciate this option and on many occasions the clients have chosen different agents for the Statutory POA and the Medical POA.

I basically use the same form that is set out in the Health and Safety Code. When my parents' health declined, I never had any trouble with their doctors or nurses when I had to make medical decisions for them using this form.

The discussion of the *Directive to Physicians and Family or Surrogates* (Directive) is generally more difficult for the clients to hear and for me to deliver. The choices on the Directive are always an ugly encounter with the grim reaper and difficult for any of us to consider. First, the client must decide if he or she wants life sustaining treatment when he or she has a terminal condition from which he or she is expected to die within 6 months. Second, the client must decide if he or she wants life sustaining treatment if he or she has an irreversible condition, cannot care for himself or herself and is expected to die without life-sustaining treatment.

As sobering as the words "6 months to live" and "terminal condition" are in the Directive I do not alter the document from the way the Texas Legislature drafted the form. The reason I do not alter the Directive from the Legislature's form is because it is what the hospitals, doctors and nurses are accustomed to seeing. Since the Texas hospitals, doctors and nurses are accustomed to seeing the Legislature's form, it takes less time to start a substantive conversation with them at the time of the emergency or crucial decision.

I have had some clients express concern with the idea of executing the Directive because the clients have this idea that "the plug" might be pulled prematurely and they could still have had a chance to live. When both of my parents died, the hospitals, doctors and nurses could not have been more proactive and positive in making sure my parents were comfortable and alive. It was not until after numerous tests were conducted and conversations were had that life support was discontinued, per my parents' Directives. I found that while following through with the Directive was very difficult, I was also honoring my parents last wish. I did not find that the hospital, doctors or nurses pushed me to "pull the plug" prematurely at all. They instead searched all avenues for helping my parents instead of hurting them.

There is a section in the Directive for additional requests over which clients always stumble. I have only had three clients ever write something in that space. The three different statements that have been written in that additional space are as follows:

1. "If I have not regained conscientiousness after 7 days and 7 nights then let me go please." (These words were written by a client that decided that God had created the world in 7 days and that was a good enough time frame for him to regain consciousness or he was ready to meet the "Big Guy" in person);

2. “Dialysis treatments shall not be administered to me if I am in hospice.” (This was written by a client that was under going dialysis treatment three times a week and had been approved for a kidney transplant); and

3. “I direct that pain killing medication be administered to me even if it hastens the moment of death” (These words were used by clients that moved to Texas from California and those same words had been in their California Directive.)

I have inserted the above words for your consideration in your practice for use in the section regarding additional requests.

When I discuss *The Authorization for Use and Disclosure of Protected Health Information* (HIPAA Document) with my clients, I tell them the document is not perfect but has worked for me during my parents’ final illnesses. My HIPAA Document is one that has been pieced together from different forms that I have read over the years. I have attached a sample HIPAA Document to this article for your consideration. I know the HIPAA Document is not perfect but I feel compelled to do what I can for my clients to help them scale the privacy wall during these emergency type situations. The last thing a family needs is to be kept in the dark about a parent’s terminal medical condition or for precious time to be wasted about the decision of surgery or other necessary medical procedures.

I used the HIPAA Document for both my parents during their final illnesses. Neither one of my parents went gently into that good night and I was in and out of doctors offices, hospitals, emergency rooms and hospice facilities and never had a problem. I would show up at the emergency room door, introduce myself to a person that had never met me or my parents and would simply present copies of the Medical POA, the Directive, the HIPAA Document and my Texas driver’s license and was always allowed to complete any and all paperwork, look at any medical file of either of my parents and talk to all the doctors and nurses. The HIPAA Document may not be perfect but it got me up and over the privacy wall when I needed to scale it.

The last critical Advanced Directive would be the *Declaration of Appointment of Guardian for my Children in the Event of my Death or Incapacity* (Declaration of Guardian). If a couple has minor children, then I encourage them to execute a Declaration of Guardian even if they will not allow me to prepare the Statutory POA, Medical POA or Directive for them. In my opinion, the most important decision a parent can make is who will care for their children if they are no long able to do so themselves. I realize that Texas Probate Code Section 676 provides a list of probable people to be guardians of the orphaned children, but I truly believe that the judgment made by a probate judge or county court judge, no matter how sound, is no substitute for a parent’s judgment. Therefore, I urge my clients with minor children to complete this document at the very least.

Advanced Directives may be the runner up to wills and trusts, but a few good Advanced Directives can give your client some peace of mind. I hope that by sharing my thoughts, opinions, and personal experiences with you, I have helped you determine what is best for your clients when trying to prepare Advanced Directives and how to accommodate your clients during these tough times.

I never do anything by myself, and therefore thank my associate, Beth Hearn Owens, and my paralegal, Merari E. Zambrano for their assistance in writing this article.

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[i] Catherine C. Scheid, Law Offices of Catherine C. Scheid, can be reach at ccs@scheidlaw.com.

[ii] I.R.C. Section 2503(b).

AUTHORIZATION FOR USE AND DISCLOSURE OF PROTECTED HEALTH INFORMATION

I REVOKE ANY PRIOR AUTHORIZATION FOR USE AND DISCLOSURE OF PROTECTED HEALTH INFORMATION

1. I, **[insert name of client]**, authorize all health care providers, including physicians, nurses, and all other persons (including entities) who may have provided, or may be providing, me with any type of health care, to disclose [all of my protected health information] [protected health information that relates directly or indirectly to my capacity to act rationally and prudently in my own best interests and to manage my financial affairs] [protected health information that relates directly or indirectly to my capacity to make rational and reasonable decisions regarding my health care] which is protected under the Health Insurance Portability and Accountability Act of 1996 (HIPAA), P.L. 104-191; 42 USC ''1320d-1320d-8 and the applicable Regulations under 45 CFR Parts 160, 162, and 164 and any amendments thereto:

(a) to an agent designated under a durable power of attorney signed by me when asked by my agent to do so for the purpose of determining my capacity as defined in the power of attorney or by governing law,

(b) to the trustee, or a designated successor trustee, of any trust of which I am a beneficiary or a trustee when asked to do so for the purpose of determining my capacity as defined in the trust,

(c) to any partner of any partnership of which I am a member for the purpose of determining my capacity as defined in the partnership agreement,

(d) to a guardian ad litem, if one is appointed for me, for the purpose of determining whether, and to what extent, a guardianship or other protective proceedings for me is necessary or desirable, and

(e) to **[insert name of any persons client would like information released to and their relation]**.

2. This authorization is intended to provide my health care providers with the authorization necessary to allow each of them to disclose protected health information regarding me to the persons described in (a)-(e) above for the purpose of allowing each of them to make the specified determinations regarding my capacity or need for protective proceedings.

3. Information disclosed by a health care provider pursuant to this authorization is subject to redisclosure and may no longer be protected by the privacy rules of 45 CFR ' 164.

4. This authorization may be revoked by a writing signed by me or by my personal representative.

5. This authorization shall expire __6__ years after my death unless validly revoked prior to that date.

SIGNED on this the _____ day of ____________________, 2010.

____
[insert name of client]

THE STATE OF TEXAS '
'
COUNTY OF HARRIS '

This document was acknowledged before me on this _____ day of __________________, 2010, by **[insert name of client]**, Principal.

____
Notary Public in and for
The State of _______________