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CHAIR'S MESSAGE

Greetings Tax Section Members,

The fiscal year end is coming up in June, but before that happens, there are still two major Tax Section events for you to attend: the 27th Annual Texas Federal Tax Institute and the 2011 Tax Section Annual Membership and CLE Meeting.

First, there's the always popular Annual Texas Federal Tax Institute held this year at its usual location at the Hyatt Regency Hill Country Resort in San Antonio. The 27th Institute will occur on June 9 and 10 and will feature the movers and shakers in tax law who are unrivaled in their knowledge and experience. Session topics to be covered include:

- Contingent Liabilities in Corporate Transactions
- Evolving Issues regarding Tax Basis in Corporate Transactions
- Current Issues in Consolidated Returns
- The New Uncertain Tax Position Rules
- Executive Compensation Issues in Mergers and Acquisitions
- Structuring Corporate Transactions

This is the premiere federal tax conference between the coasts and is not to be missed. Hotel rooms are limited and book up quickly so be sure to register without delay. You can register online at https://www.clesolutions.com/store.aspx?categoryid=1. You can submit your hotel reservation information online now to reserve your spot at special conference rates at https://www.clesolutions.com/HotelRegistration.aspx. If you prefer, you can still use the printed registration form which you can mail in or fax and it may be printed out at http://www.clesolutions.com/portals/0/OrderForms/FedTax11_RegForm.pdf.

Next, the Tax Section's 2011 Annual Member Membership and CLE Meeting will be held as part of the State Bar of Texas Annual Meeting on Friday, June 24. The State Bar of Texas Annual Meeting runs from June 23 – 24, 2011 and will be held at the Grand Hyatt San Antonio and the Henry B. Gonzalez Convention Center. To receive CLE credit for attending the Tax Section's 2011 Annual Member Membership and CLE Meeting, you will need to register for the State Bar of Texas Annual Meeting at http://www.texasbar.com/AM/Template.cfm?Section=Annual_Meeting&Template=/CM/HTMLDisplay.cfm&ContentID=12733. I highly recommend attending this event for which our council member in charge of the meeting, Mark Martin, has put together perhaps the finest collection of CLE panels ever offered as part of this meeting. These panels are:

- *Offshore Financial Account Reporting: Risks & Penalties for Noncompliance and Other International Enforcement Initiatives.* Andrius Kontrimas, Moderator. Panelists: Elizabeth Copeland and Jack Townsend.
- *Handling an IRS Controversy: Practical Advice and Recent Developments.* Val Albright, Moderator. Panelists: Emily Parker and Victoria Sherlock.
- *Tax-Practice Management.* Catherine C. Scheid and Christi Mondrik.
- *Lunch with Texas Tax Legend, Larry Gibbs.* Moderator: Bill Elliott.

Let me say a word more about the luncheon. First, it is free to all attendees of the Tax Section's 2011 Annual Member Membership and CLE Meeting. Also, it is part of the continuing series of interviews that comprise the Texas Tax Legends project developed and headed by Bill Elliott. These interviews, conducted in a "Bill Moyers" style—only, if possible, with more research and, at least for tax lawyers, wit—comprise a unique historical undertaking to preserve the voices of the true legends of the Texas tax bar. The former Commissioner of the Internal Revenue Service, Larry Gibbs, certainly fits that description. This interview should be particularly enlightening in that it will cover not just his years as Commissioner when he faced the daunting task of steering the Service through the implementation of the 1986 Tax Reform Act and having James Baker as a boss, but also his earlier years as an Assistant Commissioner and Chief Counsel under Richard Nixon and his later years as a practicing attorney at the powerhouse Dallas law firm, Johnson & Gibbs. Thanks goes out to Bill Elliott for implementing this important project which, to my knowledge, is the first of its kind anywhere in the country.

Finally, be sure to mark on your calendars the annual Advanced Tax Law Course, which is scheduled for August 18-19 at the Crowne Plaza Houston – River Oaks Hotel (preceded the day before by Tax Law 101 at the same location). This year's Advanced Tax Law Course features a number of great topics and speakers including:

- *Partnership Agreement Drafting Train Wrecks.* Terrence Floyd Cuff.
- *Disposition of Privately Held Businesses.* R. David Wheat.
- *Tax Controversy.* Daniel Price (IRS Office of Chief Counsel), Gordon Peter Sanz (IRS Office of Chief Counsel), Victoria J. Sherlock, Hon. Juan Flores Vasquez (United States Tax Court).
- *What Does it Mean to Exercise Due Diligence?* Karen Hawkins (Director, IRS Office of Professional Responsibility).
- *Current Estate Planning Developments, Including New Planning Paradigms Under the Tax Relief Act of 2010.* Stephen R. Akers.

You can get more information about this course at http://www.texasbarcle.com/materials/Programs/2377/Brochure.pdf. Also, you can register at http://www.texasbarcle.com/cle/AABuy0.asp?sProductType=EV&lID=10406.

On a more personal note, I want to thank the many members who have made this year such a wonderful year for the Section. First, my officers, Mary McNulty, Tina Green and Elizabeth Copeland have always been willing to pitch in and help when issues came up that needed a prompt response. Mary in particular has been a very hard working Chair Elect and will make an outstanding Chair (although she might not appreciate all of the unfinished projects I have left on her plate). The Section will definitely be in very good hands for many years to come.

As for my council members, almost all of them took on a substantial project and handled it with diligence and aplomb. In particular, I'd like to recognize Abbey Garber who again led our highly successful and appreciated law student outreach program. Also, I'd like to thank Stephanie Schroepfer, along with David D'Alessandro, for their yeomen's service in overseeing the very busy COGS committee this year. Stephanie, in particular, oversaw the publication of numerous COGS comments and also facilitated testimony by other members before Congress on two occasions (I also appreciate her leadership on running a tight ship through her monthly

COGS calls). J. Michael Threet did an outstanding job overseeing our CLE program this year (indeed most of this Chair's Message is a paean to his hard work). As mentioned earlier, Mark Martin has put together a fantastic 2011 Annual Member Membership and CLE Meeting (special thanks to Elizabeth Copeland for arranging the meet-and-greet social activities). Also, a special, heartfelt thanks to David Colmenero, assisted by Ryan Gardner, on overseeing the Leadership Academy Proposal. The Leadership Academy—although one of the biggest unfinished projects on Mary's plate—has the potential for making a lasting impact on the development of young tax attorneys and bringing meaningful value to our members. Alyson Outenreath I'd like to thank for her oversight regarding the tax app project (also a very exciting—but, alas, unfinished—project). Ronald Adzgery has done a great job promoting the Law Student Tax Paper Competition and soliciting notes from schools which have not participated in the competition in the past. Then there's Christi Mondrik who has been involved in all sorts of different projects including many of the projects already listed (in particular, I'd like to thank Christi for agreeing to serve on numerous Section CLE panels). Finally, a big thank you to Gerald Brantley for the smooth leadership transition he facilitated as head of the Pro Bono committee and in particular his hard work on continuing the high level of excellence associated with the Tax Court pro se representation project.

Regarding the committee chairs, I would first point out the hard work done by Dan Baucum as the chair of the Partnership and Real Estate committee. He shepherded through a wonderful Series LLC COGS project which received very favorable national press and heightened the profile of the section. He also has been very active in promoting his section's listserv list. I'd also like to thank Andrius Kontrimas as head of the International Tax committee who is also newsletter editor of the Texas Tax Lawyer and also oversaw the successful implementation of the listserv project (with the able assistance of the vice chair of the Communications committee, Brent Gardner). Andrius also ran the Section's very successful 13th Annual International Tax Symposium (and congratulations to Andrius on being elected as the next Treasurer to the Section). I'd also like to thank Matthew Larsen for all his hard work as chair of the State and Local Tax committee and for putting together two outstanding COGS projects. To the other chairs as well, thank you for all of your hard work.

Finally, the greatest benefit you can receive as a member of the Tax Section is to become involved with one or more of the Section's many activities. It's a great way to meet fellow tax professionals and make a lasting impact on the practice of tax law—both in Texas and nationally. Take a quick look at the Section's leadership roster on our website, identify a committee you are interested in joining, and call or email the committee chair. If you are not sure how to get involved, please contact me at (512) 536-5264 or at podaniel@fulbright.com. You will not only build and maintain a stronger Section but your personal practice will benefit as well. This is your Section but it is only as strong as the time and effort you are able to devote to it. Thanks, and I look forward to finishing out a strong year with your help.

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S-CORPS: THE GOOD, THE BAD, AND THE STUDY

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PART I. INTRODUCTION

According to the United States Government Accountability Office ("GAO"), S-corporations have been one of the fastest growing business entity types in recent years.[1] Next to partnerships, S-corporations have displayed the second largest percentage increase among federal business types.[2] This outline explores the "good" and the "bad" of S-corporations and describes the GAO's findings in its study of S-corporation noncompliance.

Part II of this outline describes some of the unique benefits of S-corporations and planning opportunities that arise from the S-corporation form. Part III of this outline explains some of the challenges and drawbacks of S-corporation status and, where applicable, techniques to mitigate the negative consequences. Part IV of this outline summarizes the GAO's Report to the Committee on Finance, U.S. Senate entitled "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules" (the "GAO Report") and suggests actions taxpayers should consider in response to the GAO Report.

PART II. THE GOOD: UNIQUE BENEFITS OF S-CORPORATIONS AND PLANNING OPPORTUNITIES

A. Tax Benefits of S-Corporation Status

There are three significant tax-related reasons why a business owner should consider operating his business through an S-corporation: a single level of taxation; the ability to pass through business losses to shareholders; and calculating employment taxes on wages rather than net income.[3] S-corporations share each of these attributes with C-corporations, partnerships, or sole proprietorships, but the S-corporation is the only form that provides all three benefits. In addition, S-corporations are not subject to the I.R.C. §707(b)(2) ordinary income classification that applies to partnerships.

1. Single Level of Taxation

S-corporations generally are not subject to tax.[4] Items of income, loss, deduction, and credit pass through to the individual shareholders' income tax returns.[5] In contrast, C-corporations are taxed on net business income,[6] and individual shareholders are taxed on dividend income received from the business.[7] Because no tax is imposed at the entity level, S-corporations typically provide lower total taxes to their owners than similarly-profitable C-corporations.

2. Pass Through Business Losses

Because an S-corporation's items of deduction and loss pass through to its shareholders, shareholders can use these items to offset income on their individual returns. C-corporation shareholders cannot directly benefit from business losses, because those losses are taken at the entity level.

3. Employment Taxes on Wages

Under the Internal Revenue Code, two types of income are subject to employment tax: (1) wages, as defined in Section 3401(a), and (2) net earnings from self-employment as defined in Section 1402(a). Employees who receive a salary or other compensation from an employer have employment tax withheld from their compensation payments. Employers match the amounts withheld from the employees' compensation. Self-employed individuals are responsible for both the employer and employee portions of self-employment taxes and pay employment taxes on net income to the enterprise, not just on amounts distributed to them.[8]

For wages paid in 2010, the social security tax rate is 6.2 percent for both the employer and the employee. Because self-employed persons must pay the amount paid by the employee and the amount paid by the employer, the social security tax rate for a self-employed person is 12.4 percent of self-employment income received. In 2010, the social security tax is applied only to the first $106,800 of wages paid to an employee and to self-employment income received by a person who is self-employed.

The Medicare rate is 1.45 percent each for the employer and the employee on all wages, and 2.9 percent for self-employed individuals. This tax rate is applied to every dollar of wages paid to an employee and to every dollar of self-employment income received by a person who is self-employed.

A taxpayer who operates a business as a sole proprietorship or general partnership can reduce the amount of employment tax he pays by establishing an S-corporation and paying himself a wage. In that case, his employment tax liability will be based on wages, not on net business income.

4. Further Planning with S-Corporations: Avoiding Ordinary Income Under I.R.C. §707(b)(2)

Section 707(b)(2) provides special rules for sales of exchanges between partnerships and their majority (more than 50 percent) owners and between partnerships that have the same majority owner(s). Specifically, if property that is not a capital asset in the hands of the transferee is sold or exchanged between parties to which I.R.C. §707(b)(2) applies, any gain recognized by the transferor is considered ordinary income.

For example, assume a partnership holds an undeveloped parcel of land it would like to subdivide, develop, and sell. The land is valued at $100,000 and has a basis in the hands of the partnership of $50,000. Subdivision and development, at a cost of $50,000, will increase the parcels' aggregate value to $200,000 and the partnership's basis to $100,000. Pursuant to Section 1221, gain from the sale of these subdivided, developed parcels will be taxed as ordinary income, and the partners will recognize $100,000 of ordinary income among them. The partnership decides to sell the undivided parcel for market value to a related entity and to have the related entity subdivide and sell the land. The partners will recognize $50,000 of capital gain on the sale. After acquiring, subdividing, and developing the property, the related entity will take a $150,000 basis in the property, such that the subsequent sale generates only $50,000 of ordinary income. By selling the property to a related entity, the partnership shields $50,000 of proceeds from ordinary-income treatment.

Pursuant to I.R.C. §707(b)(2), if the partnership sells the property to a related partnership, the gain recognized from the sale shall be considered ordinary income. Section 707(b)(2) prevents the sort of income-shielding the transaction is designed to accomplish. S-corporations are not subject to I.R.C. §707(b)(2). If the "related party" is an S-corporation, and if the transaction is properly structured, the parties should be able to shield proceeds from ordinary income treatment.[9]

B. Non-Tax Benefits of S-Corporation Status

1. Liability Protection

An S-corporation typically is created by having an eligible state-law corporation file a Form 2553 *Election by a Small Business Corporation* electing S-corporation status. An S-corporation also can be formed by having an otherwise-eligible state-law entity elect to be classified as an association under Treas. Reg. §301.7701-3(c)(1)(i) by filing Form 8832 and then electing to be an S-corporation under I.R.C. §1362(a) by filing Form 2553.[10] In either case, the S-corporation's shareholders enjoy the liability protection afforded to the entity under state law.

2. Government Contracts

As the GAO Report notes, corporate status is an eligibility requirement for certain government contracts. An S-corporation can be a good choice for smaller businesses (or businesses for which pass-through status is desired) that want to compete for these contracts.[11]

3. Corporate Image

According to the GAO Report, stakeholder representatives who were interviewed as part of the study mentioned that corporations project a more professional image than other entity types.[12]

PART III. THE BAD: CHALLENGES AND DRAWBACKS OF S-CORPORATION STATUS

A. In General

Although the S-corporation is a popular business form, the rules affecting stock ownership and the type of stock that S-corporations may issue can make S-corporations a cumbersome and difficult form of business entity to use. Also, Subchapter S's failure to adopt an aggregate theory of taxation makes S-corporations less desirable than partnerships in many situations. This section describes some of the challenges and drawbacks of S-corporation status and offers some techniques to mitigate the negative consequences

1. Shareholders of an S-Corporation Must be Individuals.

In some circumstances, parties who are starting a business will know immediately that an S-corporation is not a formation option because it is required or desired that an entity own equity in the business. Often, however, one or more individuals starting a business opt for an S-corporation structure without considering that this form significantly limits flexibility with respect to future ownership.[13]

Example. Assume a client has a successful business operating as a limited partnership with multiple owners ("Client"). Client has a competitor in another market: an S-corporation owned in equal shares by two individuals ("Target"). One of the two individuals is ready to retire and the parties agree to terms whereby Client will buy out the retiring individual, and Target will be owned in equal shares by Client and the remaining individual. The problem, of course, is that because of the S-corporation restrictions, Client cannot be a shareholder of Target. A practitioner may address this problem by having Target and Client form a new LLC ("Newco") owned in equal shares by Target and Client. Target may contribute all of its operating assets (e.g., valued at $300,000) into Newco, in which case Client may contribute $150,000 of cash into Newco. Newco may then specially allocate to Target cash-flow in the amount of $150,000 to compensate Target for its disproportionate capital contribution. Target may use this cash to redeem the shares of the retiring owner. This example illustrates obstacles to future planning resulting from choosing an S-corporation. These obstacles would not have existed if Target had not been formed as an S-corporation.

2. Each Shareholder of an S-Corporation Must be a Resident or a Citizen of the United States.

As with the previous item, this restriction may not seem like a burden when one forms an S-corporation for two United States citizens or resident individuals. The problem arises later, when the company has an opportunity to expand with the investment of a third party who is neither a United States citizen nor a resident of the United States.[14]

This restriction is of particular importance in Texas, with our close ties to Mexico and, in some circumstances, because of our community property laws. If a shareholder's spouse is a nonresident alien who has a current ownership interest in the stock of a corporation by reason of applicable law, the corporation does not qualify as an S-corporation from the time the nonresident alien spouse acquires the interest in the stock.[15] Texas community property law (as well as foreign property law) may operate to give a nonresident alien a current ownership interest, thereby violating the restriction of I.R.C. §1361(b)(1)(C).

3. An S-Corporation May Have No More Than 100 Shareholders.

The limitation on the number of shareholders would pose burdensome restructuring issues for a company considering an I.P.O. or other broad-based equity strategies.[16] Admittedly, an S-corporation could convert to a C-corporation through a tax-free reorganization when it is ready to make a public offering. Though such reorganization would circumvent the 100-shareholder restriction, for all the complication and expense it would add to the I.P.O., it would not go so far as to provide the organization will all the benefits enjoyed by historic C-corporations. Section 1202 allows a seller of qualified small business stock to exclude from tax up to 60% of his or her gains from sale. Pursuant to I.R.C. §1202(c), small business stock must be issued by a C-corporation; stock issued by an S-corporation that later becomes a C-corporation is not eligible for this benefit. Neither the original owners nor any owner who acquires stock before the corporation becomes a C-corporation will be able to avoid tax on gain from the sale stock after the public offering. Eleventh-hour conversion to C-status for I.R.C. §1361 purposes is a shallow victory for S-corporation owners who could have avoided significant tax had they formed a C-corporation at the outset.

The limitation is also problematic in the realm of family businesses. The limitations on trusts serving as shareholders of S-corporations restricts the testamentary options available for family businesses structured as S-corporations.

4. An S-Corporation May Not Have More Than One Class of Stock.

It often becomes desirable to treat business owners differently from one another with respect to economic rights. The one-class-of-stock restriction prevents such treatment by requiring all shareholders to have identical rights to distribution and liquidation proceeds.[17] Differences in voting rights, buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded for purposes of the one-class-of-stock rule (unless a principal purpose of such agreements is to circumvent the one-class requirement and the agreement establishes a redemption or purchase price that, at the time the agreement is made, is significantly below or in excess of the stock's fair market value),[18] but the rule does prevent S-corporations from enjoying the economic flexibility of partnerships and LLC's.

Example. If an S-corporation makes a disproportionate distribution, such disproportionate distribution may be deemed a preference, which would violate the restriction that an S-corporation may not have more than one class of stock.

The one-class-of-stock rule restricts an S-corporation's access to venture capital and certain sophisticated types of financing. Private equity investors often demand some type of preferred return in exchange for putting their capital at risk. Such a structure would violate the one-class-of-stock rule. Furthermore, commercial lenders require equity-like payments in addition to fixed interest payments in consideration for their investment risk and may extend financing only if they are given the right to convert their debt into equity. This sort of hybrid equity/debt (reminiscent of preferred stock) violates the one-class-of-stock rule.

This restriction also becomes an issue in Texas if an S-corporation desires, for "passive entity" margin tax planning, to convert its form into a limited partnership and then to "check the box" to continue to be treated as an S-corporation for federal income tax purposes. This option presents unnecessary risks that the business's "S" election could be lost as a result of the Internal Revenue Service determining that the existence of limited partners and general partners constitutes the existence of more than one class of stock.

5. Special Allocations Are Disallowed.

Section 704(b) provides that partners in a partnership may agree to specially allocate items of income, gain, loss, deduction, or credit to particular partners, so long as the allocation has substantial economic effect. Subchapter S does not provide a similar opportunity to specially allocate items of income, gain, loss, deduction, or credit to its shareholders. Thus, all such items of an S-corporation must be allocated to the various shareholders according to their interests in the corporation.[19]

6. Formation and Admission of New Members May Be Taxable.

Section 1371(a) provides that unless a specific exception in the Internal Revenue Code exists, Subchapter C shall apply to S-corporations. This rule has the potential to create many unfavorable tax consequences that can be avoided in the partnership context. Subchapter S does not provide specific rules for the contribution of property or services to an S-corporation. Therefore, the rules of Subchapter C apply to such transactions. The application of Subchapter C can produce negative tax results to the shareholders of an S-corporation.

7. Distributions of Property May Be Taxable at the Corporate Level.

Subchapter S does not protect the corporation from gain on the distribution of assets from the corporation. Because Subchapter S is silent, Subchapter C applies to such situations. Sections 311(b)(1) (distributions not in complete liquidation) and 336(a)(distributions in complete liquidation)of Subchapter C provide that a corporation recognizes gain on the distribution of appreciated property.

Example. If Red Corp., an S-corporation, distributes land worth $100,000 with a $30,000 basis to one of its two equal shareholders, Red Corp. will recognize $70,000 of gain on the distribution. (This distribution also may violate the single-class-of-stock rule.) That $70,000 of gain will be allocated equally between the two shareholders. Shareholders avoid this result when the entity making a distribution is a partnership instead of an S-corporation. Section 731(a)(1) provides that no gain or loss will be recognized by a partner on the distribution of appreciated property. Section 731(b) provides that no gain or loss shall be recognized to a partnership on the distribution of property to a partner. In the partnership context, the main concern is avoiding the disguised sale rules under Section 707 and avoiding the anti-mixing-bowl rules under Sections 704(c) and 737 on the distribution of property from a partnership. Those provisions may require gain recognition if previously contributed property is distributed to a partner other than the contributee partner.

Business owners often realize the weakness and disadvantage of using an S-corporation when it comes time to dispose of corporate assets and liquidate the corporation. One common example is a situation in which shareholders agree to sell the property of an S-corporation but have different objectives regarding the sale proceeds. For example, it is not unusual for corporations owning real property to have one shareholder desire to use the proceeds from the sale of such property to reinvest in other like-kind property in an exchange that qualifies for I.R.C. §1031 nonrecognition treatment. The other shareholder often desires to receive cash on the disposition. If the corporation simply sells the property, uses one half the proceeds to reinvest in other like-kind property and receives half the proceeds in the form of cash, the corporation will recognize gain that will flow-through to the shareholders in proportion to their ownership interests in the corporation. Thus, the shareholder desiring to obtain I.R.C. §1031 nonrecognition treatment will recognize a portion of the gain resulting from the disposition of the property. In the alternative, shareholders may desire to distribute the property to the shareholders and allow each to dispose of an undivided interest in the property separately allowing each to reinvest the proceeds according to their objectives. If the property has appreciated, I.R.C. §311 requires the corporation to recognize gain on the distribution and the gain will flow through to each of the shareholders. Therefore, a subsequent disposition of the property as part of an I.R.C. §1031 exchange will produce no tax benefit to the shareholder desiring nonrecognition treatment.

If the entity is set up as a partnership, however, the partners may be able to agree to specially allocate any gain to the partner desiring to receive cash. Assuming the allocation has substantial economic effect, the partner desiring to obtain nonrecognition treatment should recognize no gain on the transaction. Alternatively, the partnership may be able to distribute the property to the partners tax free, following which each partner may dispose of his interest in the property pursuant to his personal objectives.

8. No Internal Step-Up in Corporate Assets Allowed.

Section 754 provides a significant benefit to members of a partnership. That section provides that in the case of certain distributions and certain dispositions, the partnership may file an election to step up the basis of the assets of the partnership. The same opportunity is not available to S-corporations. Consider the consequence of stepping up the basis of partnership assets.

(i) Death

Section 743(b) provides that upon the death of a partner, the basis of partnership property may be increased if an I.R.C. §754 election is in effect. An example demonstrates the significant benefit of this provision.

<u>Example</u>. Assume Green Partnership is owned equally by Ann and Mary. The partnership has a single asset, land, with a fair market value of $100,000 and a basis of $50,000. Ann and Mary each have a $25,000 basis in their interests in Green Partnership. Assume Green Partnership has a I.R.C. §754 election in effect on the day Ann dies, passing her interest in Green Partnership to David. If Ann's interest in Green Partnership were worth $50,000, David would take that interest with a $50,000 basis under I.R.C. §1014. Thus, if David immediately sold that interest, he would recognize no gain on the disposition. Because the I.R.C. §754 election is in effect, the partnership also increases the basis of the land it holds with respect to David. Therefore, the basis of the land with respect to David gets a $25,000 step-up in basis. Thus, if the partnership sold the property immediately following the transfer of the interest to David, the partnership would recognize $25,000 of gain, all of which would be allocated to Mary, and David would recognize no gain on the transaction.

Unfortunately this same result would not occur if the entity were an S-corporation. In such case, upon the death of Ann, the shares of the corporation would pass to David and take a stepped-up basis under I.R.C. §1014. Thus, David would have a $50,000 basis in those shares and would recognize no gain if he immediately disposed of them for cash. On the other hand, if the corporation disposed of the land immediately following Ann's death, fifty percent of the gain

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recognized would be allocated to David. Thus, David would recognize $25,000 of gain on the disposition of the land by the corporation.

(ii) Distribution of Shares.

Section 743 also allows a partnership to increase the basis of its assets with respect to a partner who acquires an interest in a partnership.

Example. In the example above, if David had acquired Ann's interest for $50,000 in a sale, Ann would take a $50,000 basis in the partnership interest, and the partnership would step-up the basis of the property to $75,000. Thus, if the partnership disposed of the property immediately following Ann's acquisition, the partnership would recognize $25,000 of gain, all of which would be allocated to Mary, and David would recognize no gain on the transaction. If, instead, David were to acquire shares in an S-corporation from Ann, David would take a basis in the S-corporation stock of $50,000, but the basis of the assets held by the corporation would not be stepped-up. Thus, a subsequent disposition of the assets by the corporation would result in taxable gain being allocated to David.

(iii) Distributions.

Section 734 provides that if an I.R.C §754 election is in effect, the basis of partnership assets may be adjusted if a distribution results in gain to a partner. For example, assume that Arnold has a basis of $10,000 in his one-third interest in Hollywood Partnership. The partnership has no liabilities and has assets consisting of cash of $11,000 and property with a partnership basis of $19,000 and a value of $22,000. Arnold receives $11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of $1,000 under I.R.C. §731(a)(1). If the I.R.C. §754 election is in effect, Hollywood Partnership basis for the property becomes $20,000 ($19,000 plus $1,000). Subchapter S does not have a similar provision that would allow an S-corporation to increase the basis of corporate assets on the distribution of property to a shareholder.

9. S-corporations May Not Allocate Debt to Their Shareholders..

Section 752 provides that the partners of a partnership are deemed to make a cash contribution to a partnership when the partners' shares of partnership liabilities increases. Under I.R.C. §722, any such increase in partners' shares of partnership liabilities will result in an increase in the partners' bases in the partnership. This increase in a partner's basis in the partnership creates opportunities for partners that are not available to shareholders of S-corporations.

Example. Alan, Chris, and Tom are equal partners in Orange Partnership. Alan, Chris, and Tom each have a basis of $30,000 in their interests in Orange Partnership. Orange Partnership owns a single building worth $200,000 and having a basis of $90,000. The building is not subject to debt. Alan, Chris, and Tom decide to cause the partnership to borrow $150,000 and use the building as collateral for the loan. The liability of the partnership will be allocated equally among Alan, Chris, and Tom. After borrowing the funds, Alan, Chris, and Tom decide to distribute the $150,000 loan proceeds equally among the partners. Thus, Alan, Chris, and Tom each receive $50,000 of cash on the distribution. Because the $150,000 was allocated equally among Alan, Chris, and Tom, the outside basis of each partner is increased from $30,000 to $80,000. Thus the distribution of the $50,000 cash from the partnership to each partner does not result in gain to any of the partners. If, instead of being a partnership, Orange Partnership were a corporation taxed under Subchapter S, the corporation's borrowing of $150,000 would not increase any of the shareholders' basis in their Orange stock. Thus, a subsequent distribution of the loan proceeds would create taxable gain to each of the shareholders, as the $50,000 distribution would exceed the shareholders' basis in their stock by $20,000. Each shareholder would recognize $20,000 of income on the distribution.

B. Special Problems for S Corporations with C-Corporation History

The foregoing sections discussed challenges and drawbacks that could apply to any S-corporation. Additional challenges arise with respect to S-corporations with C-corporation history ("Converted C-corporations").[20]

As stated in the Introduction to this outline, S-corporations are one of the fastest growing business entity types. Conversions of C-corporations to S-corporations have contributed to the growth.[21] Each year between 78,000 and 97,000 C-corporations converted to S-corporations from tax years 2000 to 2006, representing 23 to 31 percent of new S corporations each year.[22] Taxpayers that seek to convert their incorporated business activities from C-corporations to S-corporations should be aware of specific issues that arise in Converted C-corporations.

Two such issues are particularly noteworthy: (i) the corporate level tax on built-in gains; the corporate level tax on excess passive investment income; and (iii) the corporate level tax on excess capital gains.[23]

1. Corporate Tax on Built-In Gains.

(i) In General

Section 1374 imposes a tax on a Converted C-corporation's built-in gains. In general terms, built-in-gain is the amount by which the fair market value of the assets of the Converted C-corporation exceed the aggregate adjusted bases of the assets.[24] The tax is imposed if (i) the S-election was made after 1986; (ii) the Converted C-corporation has a net recognized built-in gain within the recognition period; and (iii) the net recognized built-in gain for the tax year does not exceed the net unrealized built-in gain minus the net recognized built-in gain for prior years in the recognition period, to the extent that such gains were subject to tax.[25]

For an S-corporation's tax years other than 2009, 2010, and 2011, the recognition period is the ten-year period beginning on the first day on which the corporation is taxed as an S-corporation or acquires C-corporation assets in a carryover basis transaction.[26]. For tax years beginning in 2009 and 2010, no tax is imposed on the net-built in gain recognized in either of those years if the seventh tax year in the 10-year period preceding that tax year.[27] The Small Business Jobs Act of 2010 further temporarily shortens the recognition period to five years, for taxable years beginning in 2011.

The tax is computed by applying the highest corporate income tax rate to the Converted C-corporation's net recognized built-in gain for the tax year.[28]

(ii) Planning Considerations

Taxpayers can use a variety of techniques to minimize their exposure to the built-in gains tax.[29] If a C-corporation reasonably expects that appreciated assets will be sold soon after conversion (particularly if the sale proceeds will not be distributed to shareholders), it may be possible to generate tax savings by selling the assets prior to conversion. Assuming the C corporation is not a personal service corporation, the gain will be taxed under the graduated rates of I.R.C. §11. If the proceeds are not distributed to shareholders, no second level of tax is triggered. Taxpayers should understand that a sale without distribution will generate earnings and profits, which could create passive investment income issues under I.R.C. §1375 (discussed below).[30]

Rather than accelerating a sale of appreciated assets, a Converted C-corporation could delay the sale of the depreciable assets. A corporation is subject to built-in gains tax only if it has net unrealized built-in gain (i.e., the aggregate fair market value of its assets as of the effective date of its S-corporation election exceeds the aggregate adjusted bases of its assets on that date). By postponing the sale of depreciable assets until after the conversion, a Converted C-corporation may be able use the low value of those assets to decrease the aggregate fair market value of its assets.[31] The downside of this strategy is that the losses on sales of depreciated assets after the conversion do not reduce earnings and profits. These sales would do nothing to reduce a Converted C-corporation's exposure to tax and potential termination for excess passive investment income under I.R.C. §1375.[32] Similarly, where possible, a Converted C-corporation should attempt to delay sales of appreciated assets until after the close of its recognition period.

If delay of sale is not possible, a Converted C-corporation could use an I.R.C. §1031 like-kind exchange during its recognition period. No built-in gains tax arises unless the taxpayer receives taxable "boot" in the transaction. The replacement property received in the exchange bears the "taint" of built-in gains but does not extend the recognition period. Accordingly, so long as the replacement property is not disposed of in a taxable transaction during the recognition period, the Converted C-corporation should be able to avoid built-in gains tax on the sale of appreciated property.[33]

Finally, a Converted C-corporation can reduce or eliminate built-in gains tax by selling appreciated assets and depreciated assets in the same year; by selling appreciated assets in a year with no taxable income; or by selling assets before the expiration of applicable carryforwards.[34]

2. Corporate Tax on Excess Passive Investment Income.

(i) In General

Section 1375 provides that if, for a taxable year, an S corporation has (i) accumulated earnings and profits at the close of such taxable year, and (ii) gross receipts more than twenty five percent (25%) of which are passive investment income, then a tax is imposed on the income of such corporation for the taxable year. Such tax is computed by multiplying the corporation's excess net passive income by the highest rate of tax specified in I.R.C. §11(b). As a practical matter, only an S-corporation with a C-corporation history would have accumulated earnings and profits.

Section 1362(d)(3)(A)(i) provides that an S-election terminates whenever the corporation (i) has accumulated earnings and profits at the close of each of three consecutive taxable years, and (ii) has gross receipts for each of such taxable years more than twenty five percent (25%) of which are passive investment income. The election terminates even if the corporation is not liable for excise tax on excess passive investment income during such period. Thus, termination occurs even if the corporation does not have taxable income during the three-year period (and thus is not subject to excise tax because of the taxable income limitation) or if the deductions directly connected with its passive investment income result in the absence of net passive investment income.

Except as otherwise provided in I.R.C. §1362(d)(3)(C), I.R.C. §1362(d)(3)(C)(i) provides that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, and annuities.

Section 1.1362-2(c)(5)(ii)(B) of the Treasury Regulations provides that the term "rents" means amounts received for the use of, or right to use property of the corporation but does not include rents derived in the active trade or business of renting property.

Rents received by a corporation are derived in the active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business.[35] Whether significant services are performed or substantial costs are incurred is based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).[36]

In order to be subject to the tax on excess passive investment income, a corporation must have taxable income.[37] For this purpose, taxable income is determined generally as if the corporation were a C-corporation, except that no deduction is allowable under I.R.C. §172 for net operating loss carryovers or under I.R.C. §§241-250 except for organizational expenses authorized under I.R.C. §248.[38]

A corporation's "excess net passive income" (the amount on which tax is imposed) is the amount that bears the same ratio to the corporation's net passive investment income for the taxable year as the amount by which the passive investment income exceeds 25 percent of the corporation's gross receipts for the taxable year bears to the passive investment income for the taxable year:

<u>Excess Passive Income</u> = <u>Passive Investment Income – (.25 x Gross Receipts)</u>

Net Passive Income Passive Investment Income

A corporation's net passive income is the amount by which the corporation's gross receipts from passive investment income exceed its allowable deductions that are directly connected with the production of such income.[39] Deductions are considered to be directly connected with the production of passive income if they have a proximate and primary relationship to the income. Treas. Reg. §1.13751(b)(3)(i). Expenses, depreciation, and similar items *solely* attributable to the production of passive investment income are considered to have a proximate and primary relationship with such income. *Id.*

For purposes of the excess passive income rules, the term "gross receipts" refers to the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income.[40] Special rules apply for sales of capital assets, stock, and securities.[41]

(ii) Planning Considerations

The I.R.C. §1375 tax on excess net passive investment income and termination under I.R.C. §1362(d)(3) arise only if an S-corporation has earnings and profits (which would have arisen during a Converted C-corporation's C-corporation history). A Converted C-corporation can eliminate these consequences by eliminating its earnings and profits (for example, by making dividends prior to the conversion to S-corporation status, by electing to treat actual distributions as dividends bypassing the accumulated adjustments account ("AAA"), or by making a deemed distribution election).[42]

Where possible, a Converted C-corporation could eliminate its exposure to I.R.C. §1375 and termination under I.R.C. §1362(d)(3) by timely disposing of assets that generate passive income[43] or by acquiring assets that generate active gross receipts, thereby reducing the passive investment income under the 25 percent threshold.[44]

PART IV. THE STUDY: FINDINGS OF THE GOVERNMENT ACCOUNTABILITY OFFICE

A. STUDY FINDINGS

This Part summarizes the GAO Report and suggests actions taxpayers should consider in response to the GAO Report.

1. In General

To analyze S-corporation noncompliance, the GAO used data from S Corporation National Research Program ("NRP") samples drawn from tax years 2003 and 2004.[45] The NRP studied reporting compliance for a random sample of tax returns filed for tax years 2003 and 2004. According to the NRP, an estimated 68 percent of S corporation returns for tax years 2003 and 2004 misreported at least one item affecting net income.[46] For those years, the overall net misreported amount (accounting for both overreported and underreported amounts) that S-corporations passed through to individual shareholders was about $85 billion.[47]

The GAO found that the direction of misreporting provided tax advantages for the S-corporations and their shareholders.[48] Overall, of noncompliant S-corporations, about 80 percent underreported net income by understating income received and/or overstating expenses deducted.[49] For shareholder compensation, a tax advantage arises from understating (not overstating) the expense deduction, because lower wage compensation means a lower employment tax burden.[50] Of S-corporations that misreported shareholder compensation, 93 percent understated it.[51]

2. Basis Issues

The GAO acknowledged that in addition to S-corporation noncompliance, S-corporation shareholders make errors in how they incorporate the S-corporation into their individual returns.[52] For example, shareholder noncompliance occurs when a shareholder uses his share of S-corporation losses beyond his allowable stock and debt basis.[53] To better quantify the noncompliance arising from incorrect basis reporting, the GAO analyzed the Internal Revenue Service's annual examinations of individual tax returns that closed for fiscal years 2006 through 2008.[54] In those examinations, the amount of the misreported losses that exceeded basis limitations was over $10 million, or about $21,600 per taxpayer.[55] According to Internal Revenue Service examination officials, lack of basis is one of the largest issues for an S-corporation shareholder's tax return.[56]

3. Shareholder Compensation

S-corporation shareholders can receive both wages and distributions, but only wages are subject to employment taxes. As a result, S-corporations and their shareholders have an incentive to pay lower wages and increase the distributions to shareholders. S-corporations are required to pay reasonable compensation (wages) to shareholders who provide services to the S-corporation, and the Internal Revenue Service will recharacterize distributions provided in lieu of adequate compensation for services performed by shareholders as wages for employment tax purposes.[57]

According to NRP data for years 2003 and 2004, about 13 percent of S-corporations paid inadequate wage compensation.[58] The inadequate wages resulted in just over $23.6 billion in net underpaid wage compensation to shareholders and a corresponding $3 billion in lost employment tax revenue.[59] The median underpayment was $20,127.[60] The GAO found that S-corporations with the fewest shareholders made up the largest portion of shareholder compensation underpayments.[61]

B. RECOMMENDED RESPONSE TO STUDY FINDINGS

The GAO Report proposed various legislative and administrative methods to reduce noncompliance among S-corporations and their shareholders. It is not addressed to individual practitioners. The GAO Report does identify common areas of noncompliance, however.

Prudent practitioners should recognize that these areas—which the GAO Report indicates stymie large numbers of return preparers—warrant special attention and care.

1. Basis Issues

Shareholders (not S-corporations) are responsible for calculating and tracking basis.[62] The Schedule K-1 that is sent to shareholders includes some information that is relevant to calculating basis, but S-corporations are not required to report any basis calculations to shareholders.

The GAO makes various recommendations for how basis calculations could be streamlined or facilitated (including requiring S-corporations themselves to make the calculation and providing better taxpayer guidance and outreach). Until any such recommendations are implemented, practitioners should take special care to track their clients' bases in S-corporations.

2. Shareholder Compensation

Steven T. Miller the Internal Revenue Service's Deputy Commissioner for Services and Enforcement provided written comments on a draft of the GAO Report.[63] In his comments, Mr. Miller points out that tax examiners are required to document their consideration of the adequate shareholder issue in their audit workpapers and pledged to "reemphasize this requirement."[64]

Practitioners should recognize that their S-corporation clients' compensation arrangements will be scrutinized on audit and should proactively work with their clients to ensure that compensation is reasonable (to support a compensation deduction under I.R.C. §162) and adequate (to avoid recharacterization for employment tax purposes).

Whether compensation is reasonable is a question of fact, to be resolved on the basis of all facts and circumstances.[65] In addressing the reasonableness of compensation, courts have considered a number of factors, including (1) the employee's qualifications; (2) the nature, extent, and scope of the employee's work; (3) the size and complexities of the employer's business; (4) a comparison of salaries paid with the employer's gross and net income; (5) the prevailing general economic conditions; (6) a comparison of salaries paid with distributions and retained earnings; (7) the prevailing rates of compensation for comparable positions in comparable concerns; (8) the amount of compensation paid to the particular employee in previous years; and (9) the salary policy of the employer as to all employees.[66] No single factor is determinative, and a finder of fact must consider and weigh the totality of the facts and circumstances.[67]

Some courts have discarded the factor-by-factor analysis set forth above in favor of testing reasonability of compensation on the basis of return on investment from an investor's point of view.[68] The return-on-investment test posits that

> [a] corporation can be conceptualized as a contract in which the owner of assets hires a person to manage them. The owner pays the manager a salary and, in exchange, the manager works to increase the value of the assets that have been trusted to his

> management; that increase can be expressed as a rate of return on the owner's investment. The higher the rate of return (adjusted for risk), that a manager can generate, the greater the salary that he can command. If the rate of return is extremely high, it will be difficult to prove that the manager is being over paid, for it will be implausible that if he quit if his salary was cut, and he was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg.[69]

The return-on-investment test has been applied in the United States Tax Court.[70]

In *Exacto Spring*, the Seventh Circuit found that an investor would be "*overjoyed*" to receive a return of 20 percent (20%) (the return that the Tax Court found that the investors in the relevant corporation had obtained).[71] On those facts, the court found that an executive's salary that appeared "exorbitant" to the Internal Revenue Service and Tax Court was "presumptively reasonable."[72]

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[1] United States Government Accountability Office, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules*, Publication No. GAO-10-195 (December, 2009), at 1.
[2] *Id.*
[3] *See generally*, GAO Report at 6 et seq.
[4] I.R.C. §1363(a).
[5] I.R.C. §1366.
[6] I.R.C. §11.
[7] I.R.C. §61(a)(7).
[8] I.R.C. §1402(a).
[9] *See Bramblett v. Commissioner of Internal Revenue*, 960 F. 2d 526 (1990).
[10] *See generally* Rev. Proc. 2004-48, I.R.B. 2004-32 (August 9, 2004).
[11] GAO Report at 9.
[12] *Id.*
[13] *See* I.R.C. §1361(b)(1)(B) (There are exceptions for estates, certain types of trusts, certain types of tax-exempt organizations, and for S-Corporations with wholly-owned C-Corporation subsidiaries [QSUB's].).
[14] *See* I.R.C. §1361(b)(1)(C).
[15] *See* Treas. Reg. §1.1361-1(h)(1).
[16] *See* I.R.C. §1361(b)(1)(A).
[17] *See* I.R.C. §1361(b)(1)(D); Treas. Reg. §1.1361-(2)(iii).
[18] I.R.C. §1361(c)(4); Treas. Reg. §1.1361-1(l).
[19] I.R.C. §1366(a)(1).
[20] *See generally* Blau, Lemons, and Rohman, S Corp: Fed Tax §7:1 et seq (Thomson Reuters/West, 2008).
[21] GAO Report at 4.
[22] *Id.*
[23] The former-I.R.C. §1374 corporate-level tax on excess capital gains is effective for Converted C-corporations that filed their S-corporation elections before January 1, 1987 and has been largely replaced by the built-in gains tax under I.R.C. §1374 (discussed below). *See generally,* S Corp: Fed Tax, *supra* at §8.79. Accordingly, it is not discussed here.
[24] I.R.C. §1374(d)(1).
[25] I.R.C. §1374(c).
[26] I.R.C. §1374(d)(7), (8).
[27] I.R.C. §1374(d)(7)(B).
[28] I.R.C. §1374(b)(1).
[29] *See generally* S Corp: Fed Tax, *supra*, at §8:47.

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[30] *Id* at §8:47(a).
[31] *Id.* at §8:47(b).
[32] *Id.*
[33] *Id.* at §8:47(b)
[34] *Id.* at §8.47(c)-(e).
[35] Treas. Reg. §1.1362-2(c)(5)(ii)(B)(2).
[36] *Id.*
[37] I.R.C. §1375(b)(1)(B).
[38] *Id.*
[39] I.R.C. §1375(b)(2).
[40] Treas. Reg. §1.1362-2(c)(4)(i).
[41] *See* Treas. Reg. §1.1362-2(c)(4)(ii).
[42] *See generally* S Corp: Fed Tax, *supra* at §8.78(1).
[43] *Id.*, at §8:78(2).
[44] *Id.*, at §8:78(4).
[45] GAO Report at 2.
[46] GAO Report at 10.
[47] *Id.*
[48] GAO Report at 12.
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] GAO Report at 16.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *See* Rev. Rul. 74-44, 1974-1 C.B. 287; *see also*, *e.g.*, *Watson v. U.S.*, 714 F.Supp, 2d 954 (S.D. Iowa, 2010); *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141 (2001).
[58] GAO Report at 25.
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] GAO Report at 17.
[63] *See* Letter from Steven T. Miller, Deputy Commissioner to Michael Brostek, Director, Tax Issues, United States Government Accountability Office of December 4, 2009, Appendix 4 to GAO Report.
[64] *Id.*
[65] *See, e.g. Home Interiors & Gifts, Inc. v. Commissioner*, 73 T.C. 1142, 1155 (1980).
[66] *See Sunbelt Clothing Company, Inc. v. Commissioner*, T.C. Memo 1997-338, citing *Rutter v. Commissioner*, 853 F.2d 1267, 1274 (5th Cir. 1988), affg. T.C. Memo 1986-407; *Owensby &. Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1323 (5th Cir. 1987), affg. T.C. Memo 1985-267; *Home Interiors & Gifts, Inc., supra* at 1155-1156.
[67] Rutter, supra at 1271; Owensby & Kritikos, Inc., supra at 1323.
[68] *E.g.*, *Exacto Spring Corp., Inc. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).
[69] Exacto Spring, supra at 838.
[70] *See, e.g.*, *Menard, Inc.*, *supra*.
[71] *Exacto Spring*, *supra*, at 839 (emphasis in original).
[72] *Id.*

PARTNERSHIP TAX DISTRIBUTION CLAUSES EXPLAINED

By: *Jason L. McIntosh, Vinson & Elkins LLP*[1]

Tax distribution clauses often are contained in the organizational documents of entities classified as partnerships for U.S. federal income tax purposes, such as general partnerships, limited partnerships and limited liability companies.[2] Generally, a tax distribution clause obligates a partnership to make distributions to assist its partners in paying taxes with respect to their shares of income earned by the partnership.[3] For U.S. federal income tax purposes (and, in many cases, state and local tax purposes) income of an entity that is classified as a partnership is treated as earned by (and, thus, taxes are imposed on) the partners, regardless of whether or when the partners receive cash distributions from the partnership.

The following example will be used to illustrate the differences between the various provisions that might be included in tax distribution clauses. Investor and Manager form a limited partnership, Partnership X. Investor contributes $100.00 of cash, and Manager provides investment management services to Partnership X. Prior to making any regular distributions to Manager, Partnership X will distribute to Investor an amount equal to the $100.00 of capital it contributed. Next, Partnership X will distribute 100% of its cash until Investor has received a 10% annual rate of return (compounded annually) on its contributed capital. Thereafter, Partnership X will distribute amounts in the ratio of 80% to Investor and 20% to Manager. For the purposes of tax distributions, Partnership X assumes the tax rate of its partners is 40%.

A. Typical Negotiation Perspectives

In designing a tax distribution clause, the first and often most important step is to understand the perspectives of the various partners of the partnership. Consider the Partnership X example. If the Partnership X partnership agreement did not provide for tax distributions, Investor would receive 100% of all cash distributions until it had received return of and 10% return on its invested capital. However, if Partnership X were to earn taxable income, then Investor would not necessarily be allocated 100% of such income. Under the 80/20 split, Partnership X would allocate 20% of its income to Manager. A tax distribution clause would typically obligate Partnership X to distribute some cash to Manager prior to Investor receiving a full return of its investment. In other words, tax distributions divert cash flow from Investor to Manager.[4]

One might expect Investor to request that the partnership agreement not contain a tax distribution clause at all. However, this is not usually commercially feasible. In many cases, a service partner like Manager will not be able or willing to pay taxes arising from its ownership of an interest in the partnership without cash distributions. However, Investor generally would rather benefit from the single layer of tax in a partnership and subsidize tax distributions than invest in a corporation and be subject to two layers of tax.

Thus, it is far more common for someone like Investor to seek to minimize the negative impact of tax distributions than to seek to eliminate tax distributions altogether.

B. Taxable Base

Every tax distribution formula contains two basic variables, the amount of income with respect to which tax distributions will be made (the "taxable base") and the rate at which tax distributions will be computed (the "assumed tax rate"). The former is discussed in this Part B, and the latter is discussed in Part C below. The vast majority of tax distribution provisions use the amount of taxable income allocated to a partner by the partnership as the starting point for computing the taxable base. The amount and character of taxable income allocated to each partner can be easily determined, at least on an annual basis, because a partnership is required to provide a Schedule K-1 to each partner that contains such information. Usually, it is not appropriate to use the partnership's book profits and losses as a starting point for the taxable base because book profits and losses often include items that are not recognized for tax purposes.[5]

1. Period for Computation

The taxable base can be computed on a cumulative or annual basis. If the taxable base is computed on a cumulative basis, then tax distributions are made in the current year only to the extent that the tax liability arising from the cumulative taxable income allocated to the partner exceeds the cumulative amount of tax (and in many cases, non-tax) distributions received by that partner. If the taxable base is computed on an annual basis, then the tax distributions are made based on the tax liability arising from the taxable base only for the current year.

Computing the taxable base on a cumulative basis will have the effect of reducing current income (and, thus, tax distributions) by prior period losses. Some practitioners object to this approach because it necessarily makes assumptions about a partner's ability to utilize past losses, either by deducting them in prior years against income earned from unrelated sources or by carrying them forward and deducting them against income earned from the partnership in the current year. Alternatively, the cumulative concept can be burdensome to administer if it takes into account the various limitations on the use of loss carryforwards.[6] However, while computing the taxable base on an annual basis is simpler, a partner that has previously been allocated losses will receive current tax distributions even if it can use those prior losses to reduce or eliminate its actual current tax liability.

Example 1: Losses Followed by Income

Assume that in Year 1 Partnership X has net losses of $20.00. All of these losses would be allocated to Investor because Manager has not invested any capital and would not economically bear any share of a loss by Partnership X. In Year 2, Partnership X recoups the $20.00 of losses, and all of this income is allocated to Investor to replenish its capital account and reflect its right to receive the first $100.00 distributed from Partnership X. If Partnership X's agreement provided for an annual determination of the taxable base, then even though Investor's cumulative income and actual tax liability are zero, it would receive tax distributions with respect to the $20.00 of income it is allocated in Year 2. On the other hand, if Partnership X's agreement provided for a cumulative determination of the taxable base, then Investor would not receive any tax distributions. See Exhibit 1.

2. Allocations Relating to Built-in Gains or Losses

If a partner contributes property with a fair market value that differs from its tax basis (a built-in gain or loss) to a partnership, then the built-in gain or loss recognized upon a later sale of such property will be allocated to that contributing partner.[7] Some tax distribution clauses exclude such built-in gain or loss from the taxable base, based on the logic that the built-in gains or losses arose prior to the partnership's ownership of the property and thus do not relate to the operations of the partnership. As such, many practitioners posit that the non-contributing partners should not bear the financial burden of the related taxes. If tax distributions are provided with respect to built-in gains, then the non-contributing partners bear a cost[8] relating to the contributing partner's tax-deferred contribution to the partnership.[9]

Example 2: Built-in Gain Property

Assume that a third partner, Founder, had contributed Company to Partnership X at formation, which had a value of $100.00 and a tax basis of $60.00. Founder participates *pari passu* with Investor in distributions. Assume that Partnership X has not earned any income and that, because Company has not appreciated in value, Partnership X decides to sell it for $100.00 in Year 1. With the proceeds from the sale, Partnership X has decided to purchase a new asset with a value of $100.00. If the built-in gain with respect to Company were included in the taxable base for tax distributions, then the $40.00 of built-in gain recognized by Partnership X and allocated to Founder would result in a $16.00 tax distribution obligation. Thus, even though Company has not appreciated in value since its contribution, Partnership X would be required to distribute $16.00 of the $100.00 of proceeds from the Company sale to Founder. Partnership X would have only $84.00 remaining and could not acquire the new asset for $100.00 without funds from another source. See Exhibit 2.

Additionally, where built-in gain or loss property is depreciable, the built-in gain or loss with respect to a contributed property will be eliminated gradually by differences in book[10] and tax depreciation.[11] In order to provide the non-contributing partners with the amount of tax depreciation they would have received if the contributed property had a tax basis equal to its book value, the partnership might be required to divert tax depreciation deductions with respect to such property (or other tax deductions) away from or to the contributing partner.[12] Where there are not sufficient deductions to achieve this result, the partnership might elect to create "remedial" deductions and income items to resolve the disparity.[13]

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Any of the methods for allocating tax depreciation increases or decreases the contributing partner's share of the partnership's taxable income and, thus, reduces the built-in gain or loss, respectively, that would be allocated to the contributing partner upon a sale of the contributed property. Thus, any increase or decrease in the contributing partner's share of taxable income by reason of these rules is merely a consequence of this partner's tax-free contribution of property to the partnership. Again, by including these items in the taxable base for tax distributions the non-contributing partners bear a cost as a result of the tax-deferred contribution of property. Therefore, it may be argued that such increase or decrease in taxable income should be excluded from the taxable base upon which tax distributions are computed if the associated built-in gain or loss would be excluded. However, the counter-argument is that such increased income results in an actual tax liability and that the partners being allocated such income need liquidity to satisfy such liability.

3. Guaranteed Payments

Where a partner receives a payment for services or the use of capital that is determined without regard to the income of the partnership, such payment generally is treated as made to a non-partner.[14] As such, the payment typically will generate a deduction at the partnership level and the partner will recognize income upon accrual or receipt of the payment, as opposed to upon an allocation of income by the partnership. Most practitioners agree that such a payment should not give rise to a tax distribution. For example, a tax distribution clause should be drafted carefully so as not to include in the taxable base the compensation of partner-employees of the partnership, as taxes with respect to such compensation will be handled through employment and income tax withholding. However, although there is a risk that the preferred return paid to a preferred partner could be treated as a guaranteed payment, most practitioners agree that the income associated therewith generally should result in a tax distribution.

4. Partner-level Deductions

Some tax distribution clauses take into account certain partner-level deductions in computing the taxable base. For example, partners might be able to deduct state and local taxes from their U.S. federal taxable income,[15] thereby lowering their actual tax liability. Also, some deductions with respect to the partnership's assets or operations are determined by the partners for U.S. federal income tax purposes, such as depletion with respect to oil and gas wells.[16] Thus, given that the purpose of tax distributions is to provide partners with the liquidity to satisfy tax liabilities arising from their ownership of interests in the partnership, it generally is appropriate to reduce the taxable base by deductions that relate to the partnership but are not taken into account at the partnership level. On the other hand, such deductions often cannot be computed entirely by information within the possession of the partnership or vary depending upon the individual circumstances of each partner, so taking such deductions into account may be administratively burdensome in some cases.

C. Assumed Tax Rate

The other basic variable of a tax distribution formula is the assumed tax rate. The primary consideration in choosing the assumed tax rate is whether the partnership will treat each partner as having the same tax rate. The partners of a partnership are rarely similarly situated. Some partners may be individuals while others may be entities, such as corporations or partnerships. Some may be resident in states and localities with no income tax or in a foreign jurisdiction that does not treat the partnership as a pass-through entity, while other partners may be resident in New York City, where the state and local income tax burden exceeds 10%. These differences in circumstances can result in profound disparities between the effective tax rates of various partners of a partnership. As an extreme example, a partnership that earns all of its income from sources outside the United States may have foreign partners that have no current tax liability and U.S. individual partners living in a high-tax state with an effective tax rate near 50%.

1. Universal Tax Rate

One approach is to provide that all partners will receive tax distributions as if they were similarly situated. For example, a tax distribution clause might provide that each partner will receive a tax distribution based on the highest marginal federal, state and local rates applicable to an individual resident of New York City, New York. In many cases, such a hypothetical tax rate is intended to approximate the actual circumstance of the partner with the greatest relative tax burden, thereby ensuring that all partners are capable of satisfying their tax burdens. On the other hand, this also ensures that all partners other than those with the highest relative tax burden receive distributions in excess of their actual tax liabilities.

It is not uncommon for a partner that is preferred as to non-tax distributions ("regular distributions") to be subject to a higher rate of tax. In such a case, the preferred partner may think it benefits them to set the assumed tax rate at their higher tax rate so they will have the cash needed to pay their taxes. However, if tax distributions are credited against regular distributions (as discussed below), the preferred partner generally should prefer a lower assumed tax rate. Tax distributions are made to all partners, including those subordinated to the preferred partner'. Thus, all partners would receive tax distributions at the preferred partner's higher tax rate if that is the assumed tax rate. If a lower tax rate is used, then all partners would get tax distributions at the lower tax rate, and then the preferred partner can rely upon regular distributions, which are paid disproportionately to the preferred partner, to satisfy any remaining cash needs.[17] The result of this approach is that less cash is distributed to the subordinated partners, which get enough to pay their tax liabilities and little or none of the preferred regular distributions.

2. Individual Tax Rates

The alternative approach is to customize tax distributions to the circumstances of each partner. Although this approach may be more accurate and minimize tax distributions, it is often met with two objections. First, determining the tax situation of each partner can be administratively burdensome, especially where some of the partners also are classified as partnerships and have many different partners. Second, partners with lower tax burdens will point out that providing them with relatively low tax distributions causes them to subsidize those with higher tax burdens.[18]

D. Crediting of Tax Distributions

Many tax distribution clauses provide that the amount of any regular distributions to a partner will be reduced by the amount of any prior tax distributions made to such partner. This approach treats a tax distribution as simply an advance of the regular distributions to which a partner is otherwise entitled under the theory that tax distributions are intended to provide liquidity (to pay taxes) but not to alter the agreed economic arrangement of the partners. Contrary arguments have been made, however, that tax distributions merely satisfy a cost of doing business and represent a surrogate for tax paid at the corporate level for other businesses. If tax distributions are not credited against regular distributions, tax distributions have the effect of treating partner-level taxes as expenses of the partnership and causing each partner to bear a proportionate share of the aggregate tax burden of all of the partners.

1. Effects of Crediting

As discussed above, the result of a tax distribution clause is that the partners receive distributions from the partnership in a different manner than they otherwise would have if all distributions were regular distributions. For example, in a 50/50 partnership where tax distributions are computed based on the individual tax rates of each of the partners, the partner with the higher tax rate would receive more than 50% of tax distributions because he has a higher relative tax burden. Thus, a tax distribution has the effect of diverting all or a portion of the cash used for tax distributions away from the partner that would have received more in regular distributions (a "disadvantaged partner") to the partner that would have received less in regular distributions (an "advantaged partner").

Where tax distributions are not credited against regular distributions, a disadvantaged partner clearly subsidizes the advantaged partner. An advantaged partner would receive a greater total amount of cash from the partnership than a disadvantaged partner with the same economic interest in the partnership because such partner would receive the same amount of regular distributions as the disadvantaged partner but greater tax distributions. The additional cash flow received by the advantaged partner is funded by the disadvantaged partner because that cash otherwise would have been distributed as regular distributions and shared proportionately by all partners. As illustrated in Example 3, although it is often the partner that is preferred as to regular distributions that is disadvantaged, where tax distributions are not credited, the subordinated partner may be disadvantaged.

Example 3: Preferred Return

Again, Partnership X computes tax distributions based on an assumed tax rate of 40%. If tax distributions are credited against regular distributions, then after its first year of operations Partnership X must distribute $110.00 to Investor ($100.00 return of capital, plus a $4.00 tax distribution on 10% preferred return, plus $6.00

to distribute the remaining portion of the 10% preferred return) before Manager begins sharing in profits. If tax distributions are not credited, then Partnership X must distribute $114.00 to Investor ($100.00 return of capital, plus a $4.00 tax distribution on 10% preferred return, plus $10.00 to provide an unreduced 10% preferred return) before Manager begins sharing in profits. Thus, where tax distributions are not credited, Investor is entitled to an effective preferred rate of return of 14.0%, which provides it with an after-tax rate of return of 10%. Put another way, if tax distributions were credited and Partnership X had distributed $114.00, Manager would have received $0.80, i.e., 20% of the distributions in excess of $110.00. See Exhibits 3A and 3B.

Even where tax distributions are credited against regular distributions, a disadvantaged partner may subsidize an advantaged partner in two significant ways. First, a disadvantaged partner could still receive less total cash than it would otherwise receive without a tax distribution clause, if the partnership never makes the later regular distributions against which to credit tax distributions paid to the advantaged partner. This could occur, for example, if after making a tax distribution the partnership became insolvent and liquidated. In that case, the partnership would never have a chance to balance the "over-distribution" of cash to the advantaged partner by reducing regular distributions to such partner and diverting that cash back to the disadvantaged partner.

Second, even if a disadvantaged partner eventually receives the "right" amount of cash because later regular distributions to an advantaged partner are reduced, the disadvantaged partner would lose the time value of money with respect to the excess cash. If instead of distributing additional cash as tax distributions to the advantaged partner, the partnership had either reinvested the cash or distributed the cash to the disadvantaged partner as a regular distribution, the disadvantaged partner could have benefited from the reinvestment of that cash. Thus, regardless of whether tax distributions are credited against later regular distributions, a disadvantaged partner could be forced to subsidize an advantaged partner.

2. Method of Crediting

Where a tax distribution clause provides for crediting against regular distributions, there is also the question of how such crediting should operate. The two most common practices are (1) to treat all tax distributions made to a partner as offsets to any regular distributions that would otherwise be made to the partner, and (2) to offset tax distributions only against regular distributions that relate to the taxable income that gave rise to the tax distributions.

Example 4: Tracing of Tax Distributions

Assume that the distribution priority in the Partnership X example were slightly different. First, Partnership X will distribute 100% of its cash to Investor until Investor has received a return of the $100.00 of capital it contributed. Next, Partnership X will distribute 100% of its cash until Investor has received a 10% annual rate of return (compounded annually) on its contributed capital. Next, Partnership X will distribute its cash 90% to Investor and 10% to Manager until Investor has received a 19% annual rate of return (compounded annually). Thereafter, Partnership X will distribute amounts in the ratio of 80% to Investor and 20% to Manager. Also, assume that Partnership X has earned $25.00 of taxable income and has $20.00 of cash available to distribute.

Partnership X would allocate the first $10.00 of income entirely to Investor to provide it with a 10% rate of return (which would result in a $4.00 tax distribution). It would allocate the next $10.00 in the 90/10 split as follows: $9.00 to Investor (resulting in a $3.60 tax distribution) to provide it with a total 19% rate of return, and $1.00 to Manager (resulting in a $0.40 tax distribution). Finally, Partnership X would allocate the remaining $5.00 of income in the 80/20 split as follows: $4.00 to Investor (resulting in a $1.60 tax distribution), and $1.00 to Manager (resulting in a $0.40 tax distribution). Thus, Investor would be allocated $23.00 of the $25.00 of income and receive a $9.20 tax distribution, and Manager would be allocated $2.00 of the $25.00 of income and receive a $0.80 tax distribution. After the $10.00 of tax distributions, $10.00 of the original $20.00 of available cash remains available for regular distributions. (Note: If Partnership X distributed its $20.00 of available cash without regards to tax distributions, it would distribute the first $10.00 to Investor to provide it with a 10% rate of return and the next $10.00 under the 90/10 layer $9.00 to Investor and $1.00 to Manager.)

If Partnership X were to credit all tax distributions against any regular distributions, then Investor would receive an additional $9.80 of regular distributions (the $19.00 it would have received without regard to tax distributions, minus the full $9.20 it received as tax distributions), for a total of $19.00 of distributions to Investor. Manager would receive an additional $0.20 as regular distributions (the $1.00 it would have received without regard to tax distributions, minus the full $0.80 it received as tax distributions), for a total of $1.00 of distributions to Manager. See Exhibit 4A.

On the other hand, if Partnership X were to trace tax distributions to regular distributions of the related taxable income, then Investor would receive an additional $6.00 of regular distributions with respect to is 10% preferred return (the $10.00 it would have received without regard to tax distributions, minus the $4.00 it received as tax distributions with respect to the 10% preferred return). At this point, Partnership X has distributed a total of $16.00 of its original $20.00 available for distribution, of which $15.20 went to Investor ($9.20 as tax distributions and $6.00 as regular distributions) and $0.80 went to Manager (all as tax distributions). Thus, Partnership X would have an additional $4.00 to distribute in the 90/10 split. Partnership X is treated as already distributing another $4.00 in the 90/10 distribution split by way of tax distributions ($3.60 to Investor, and $0.40 to Manager). If Partnership had distributed the total $8.00 ($4.00 of tax distributions, plus $4.00 remaining after the preferred return distributions) in the 90/10 split, $7.20 would have been distributed to Investor, and $0.80 would have been distributed to Manager. After crediting the $4.00

distributed as tax distributions, the additional $4.00 will be distributed as regular distributions $3.60 to Investor ($7.20, minus $3.60 of tax distribution) and $0.40 to Manager ($0.80, minus $0.40 of tax distribution), for a total distributed under the 90/10 split of $7.20 to Investor and $0.80 to Manager. Thus, of the $20.00 available for distribution, $18.80 would be distributed to Investor ($10.00 pursuant to the preferred return, $7.20 pursuant to the 90/10 split and $1.60 as tax distributions with respect to the 80/20 split), and $1.20 would be distributed to Manager ($0.80 with respect to the 90/10 split and $0.40 as tax distributions with respect to the 80/20 split). By tracing tax distributions, $0.20 is diverted from Investor to Manager. See Exhibit 4B.

E. Crediting of Regular Distributions

Many tax distribution clauses also provide that regular distributions will offset future tax distributions. Such crediting would only arise where regular distributions are made prior to the recognition of the taxable income, i.e., not where the only regular distributions are made upon liquidation. Given that the regular distributions already provided the needed liquidity, there is no need for later tax distributions. Although such a provision would minimize tax distributions, a preferred partner could be disadvantaged by its inclusion because it has a greater share of earlier regular distributions.

Example 5: Crediting of Regular Distributions

Assume a simpler economic arrangement in the Partnership X example, where Investor is not entitled to preferred returns on its capital. Hence, Partnership X is first required to return to Investor its $100.00 of contributed capital and then profits are shared 80/20. Also, assume that in Year 1 Partnership X earns no income but distributes $10.00 as a return of capital to Investor. Then, in Year 2 Partnership X earns $50.00 of income, of which $40.00 is allocated to Investor and $10.00 is allocated to Manager under the 80/20 split. If regular distributions were not credited against later tax distributions, then in Year 2 Partnership X would make tax distributions of $16.00 to Investor and $4.00 to Manager. However, if the $10.00 regular distribution to Investor is credited against its later tax distribution, Investor would receive a tax distribution of only $6.00, and Manager would still receive a tax distribution of $4.00. Thus, Investor receives $10.00 less if regular distributions are credited against later tax distributions. See Exhibit 5.

F. Clawback for Excess Tax Distributions

As noted previously, if a partnership starts out profitable but then runs into trouble a partner may receive tax distributions in an early year that ultimately exceeds its actual tax liability determined on a cumulative basis. Moreover, as a result, other partners may ultimately receive less cash from the partnership than they were entitled to under the agreed economic arrangement (i.e., regular distributions). This situation can be rectified by requiring the partner that receives such excess tax distributions to return the excess to the partnership (a "clawback") for distribution to the other partners.

Proponents of a clawback might point out that the partner receiving excess distributions will also recognize a loss (or reduced gain) upon the liquidation of the partnership in the amount of the income that resulted in the excess tax distribution, which will exactly offset the taxable income that prompted the excess tax distribution. However, opponents of a clawback might argue that the partner receiving the excess tax distribution had an actual tax liability arising in relation to the returned tax distribution and that the tax benefit derived from the loss (or reduced gain) upon liquidation of the partnership might not fully offset such actual tax liability. For example, this could be the case if the partner does not have other income against which to use the loss. Similarly, the loss (or reduced gain) could be capital in nature, which would create a tax benefit at lower preferential rates, while the income resulting in the excess tax distribution was ordinary income taxed at higher rates. In these scenarios, the amount of the actual tax liability of the partner is higher than the tax savings from the loss (or reduced gain) upon liquidation, so returning the tax distribution and taking the loss (or reduced gain) would be a net negative for the clawback partner. Some clawback provisions account for this inequity by providing that a partner need only return tax distributions to the extent they exceed the cumulative tax liability of the partner arising from its ownership of interests in the partnership.

G. Conclusion

There are many considerations to be taken into account in drafting a tax distribution clause. Further, it is not always intuitive which partners will be advantaged or disadvantaged by a particular provision. However, by understanding the options available, the perspectives of the various partners and the potential traps for the unwary, the drafter of a tax distribution clause will be able to design a clause that satisfies the requirements of the various partners and minimizes unintended consequences.

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[2] Tax distribution clauses also may be found in the organizational documents of entities that are treated as S corporations for U.S. federal income tax purposes. However, this article does not address any issues that are specific to S corporations.

[3] Note that many tax distribution clauses are subject to the partnership having available cash. If a tax distribution provision is not subject to the partnership having available cash, the partnership would be required to borrow money or sell assets to make tax distributions where it does not have cash on hand. Also, tax distributions often are limited to the extent they would run afoul of any credit agreements to which the partnership is a party. The drafter of a tax distribution provision should familiarize himself or herself with distribution limitations in the credit agreements of the partnership, if any, so that the tax distribution provision will not conflict with such requirements.

[4] As discussed further below in Part D, this diversion of cash flow can be temporary or permanent.

[5] For example, upon the admission of a new partner, the assets of a partnership often are revalued at fair market value, which may result in book profit or loss. However, such a revaluation is not a taxable event that should give rise to tax distributions.

[6] For example, capital losses generally cannot offset ordinary income to any significant extent.

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[7] Section 704(c) provides that "income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." Thus, for example, where the partnership sells property that had a built-in gain when it was contributed to the partnership, the contributing partner would be allocated all of that built-in gain for tax purposes.

[8] The assets of the partnership are reduced to provide the contributing partner a tax distribution with respect to the built-in gain, thereby decreasing the assets available for investment or distribution by the partnership.

[9] See the discussion in Part D.

[10] The book value of a property contributed to the partnership will initially be its fair market value. Book depreciation is based on this book value. *See generally* Treas. Reg. § 1.704-1(b).

[11] For example, assume that the assets of Company are depreciable on a straight-line basis over 10 years. Each year, there will be $10.00 ($100.00 book value, divided by 10 years) of book depreciation and $6.00 ($60.00 tax basis, divided by 10 years) of tax depreciation with respect to the assets of Company. Thus, in each year the difference between the book value and tax basis of the assets of Company will be reduced by the $4.00 of book depreciation that is not matched by tax depreciation.

[12] Without the rules of Section 704(c), each partner would be allocated the same proportion of tax depreciation as such partner's share of book depreciation. However, Section 704(c) requires that a partnership allocate depreciation deductions with respect to built-in gain or loss property using a reasonable method to reflect such book-tax differences, which includes any of the following methods: (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial allocation method. *See* Treas. Reg. § 1.704-3(a)(1). The traditional method allows a partnership to allocate a disproportionate amount of the tax depreciation with respect to a built-in gain or loss property to the partners. *See* Treas. Reg. § 1.704-3(b). If the tax depreciation with respect to a built-in gain or loss property is not sufficient to provide deductions to the non-contributing partners equal to their shares of the book depreciation with respect to such property, then the traditional method with curative allocations would allow the partnership to allocate unrelated income, gain, loss and deduction items of the partnership to resolve the difference. *See* Treas. Reg. § 1.704-3(c).

[13] If the partnership does not have sufficient income, gain, loss and deduction items to provide the non-contributing partners with deductions equal to their shares of book depreciation, the remedial allocation method would allow the partnership to create "remedial" deductions and income items to resolve the difference. *See* Treas. Reg. § 1.704-3(d).

[14] *See* I.R.C. § 707(c).

[15] *See* I.R.C. §164(a).

[16] *See* I.R.C. § 613A(c)(7)(D).

[17] Of course, tax distributions are mandatory, and regular distributions are generally discretionary. Therefore, this general rule might not apply where the preferred partner (along with similarly-situated partners) does not control the partnership such that it could get the needed cash through regular distributions.

[18] See the discussion in Part D.

NONPROFIT EXECUTIVE COMPENSATION

By: *Terri Lynn Helge and David M. Rosenberg*[1]

I. **Introduction.** Excessive compensation paid to nonprofit executives and board members is one of the key issues concerning charitable organizations that garner the attention of the general public and Congress. Charitable organizations may pay reasonable compensation to their directors, executive officers and employees for their services without violating applicable federal tax law or state law. The determination of reasonable compensation depends on several factors – the budget of the organization being the most significant factor. Other factors include the number of employees of the organization, the particular sector of the charitable community served by the organization, the geographic location of the organization, the focus of the organization as being national or local, the length of the employee's service and external market forces.

Even if executive compensation is considered reasonable in light of the foregoing factors, the perception that a charitable organization is paying excessive compensation can be damaging to the organization's reputation. Some nonprofit executive salaries have reached seven figures, particularly in the larger health care systems and higher education.[2] In some cases, the highest paid employee of a charitable organization is not its chief executive officer, but instead may be a senior administrator or key physician of a large urban medical center, a key athletic coach at a Division I university, or a chief investment officer of a university or foundation with a large endowment. Reports of high nonprofit executive compensation have lead the Internal Revenue Service to conduct an Executive Compensation Compliance Initiative in 2004 (with its findings published in March 2007, discussed below), and the Internal Revenue Service continues to scrutinize nonprofit executive compensation. In addition, because nonprofit executive compensation must be reported annually on the organization's Form 990, the general public, the media, and charity watchdog organizations also scrutinize nonprofit executive compensation. Therefore, it is important for charitable organizations not only to understand the federal tax law governing the payment of reasonable compensation to their directors, officers and key employees, but also to understand their reporting obligations and best practices with respect to executive compensation to avoid undue scrutiny.

II. **Prohibition on Private Inurement.** Section 501(c)(3) of the Code[3] provides that no part of the net earnings of an organization described therein may inure to the benefit of any private shareholder or individual. The Internal Revenue Service takes the position that any element of private inurement can cause an organization to lose or be deprived of tax exemption, and that there is no de minimus exception.[4] The private inurement prohibition contemplates a transaction between a charitable organization and an individual in the nature of an "insider," who is able to cause application of the organization's assets for private purposes because of his or her position.[5] In general, an organization's directors, officers, members, founders and substantial contributors are insiders. The meaning of the term "net earnings" in the private inurement context has been largely framed by the courts. Most decisions reflect a pragmatic approach, rather than a literal construction of the phrase "net earnings."[6] Common transactions that may involve private inurement include (i) excessive compensation for services; (ii) inflated or unreasonable rental prices; (iii) certain loan arrangements involving the assets of a charitable organization; (iv) purchases of assets for more than fair market value; and (v) certain joint ventures with commercial entities.

A. Public Charities. In general, a charitable organization is presumed to be a private foundation unless it can establish that it qualifies as a public charity under Sections 509(a)(1)–(3) of the Code. Types of public charities described under Section 509(a)(1) of the Code include churches, schools, hospitals, government entities and university endowment funds.[7] In addition, an organization which normally receives more than one-third of its total support from contributions from the general public is considered a public charity under Section 509(a)(1) of the Code.[8] An organization which receives more than one-third of its total support from exempt function revenues, such as admission fees to a museum or patient revenues for a hospital, is considered a public charity under Section 509(a)(2) of the Code, provided the organization does not normally receive more than one-third of its support from gross investment income. An organization which does not meet either of these tests may still qualify as a public charity under Section 509(a)(3) of the Code as a "supporting organization" of another public charity by virtue of the relationship between the first organization and the second public charity.

B. Excess Benefit Transactions. Section 4958 of the Code imposes an excise tax on disqualified persons who engage in excess benefit transactions with public charities.[9] An "excess benefit transaction" is any transaction in which an economic benefit is provided by the public charity directly or indirectly to or for the use of any disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received in exchange for such benefit.[10] The term "transaction" is used very generally and includes a disqualified person's use of a charitable organization's property and services provided to a disqualified person without adequate payment. Prototypical examples of excess benefit transactions include paying excessive compensation to a director or officer or overpaying a director or officer for property the director or officer sells to the charitable organization. However, any direct or indirect benefit to a disqualified person may result in a violation of Section 4958 if the disqualified person does not provide adequate consideration for the benefit.

When it applies, Section 4958 imposes an initial tax equal to 25% of the excess benefit on any disqualified person.[11] A tax of 10% of the excess benefit is imposed on any organization manager, i.e., any officer, director, or trustee of the organization, who knowingly participates in the transaction.[12] The initial excise tax on organization managers is capped at $20,000.[13] If a disqualified person engages in an excess benefit transaction with a public charity, corrective action must be taken to essentially undo the excess benefit to the extent possible and to take any additional measures to put the public charity in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[14]

C. Disqualified Persons. The term "disqualified person" includes any person who was, at any time during the 5-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization.[15] Some persons, including (but not limited to) board members, the president or chief executive officer, the treasurer or chief financial officer, family members of such individuals, and entities in which such individuals own 35% of the interests, are automatically considered "disqualified."[16]

Where a person is not automatically disqualified, all of the facts and circumstances will generally be considered to determine if the person has substantial influence over the affairs of the organization.[17] Factors tending to show that an individual exercises substantial influence include:

i. the individual is a founder of the organization;

ii. the individual is a substantial contributor to the organization;

iii. the individual's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the individual controls;

iv. the individual has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees;

v. the individual manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or

vi. the individual owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person.[18]

Factors tending to show that an individual does not exercise substantial influence include:

i. the individual has taken a bona fide vow of poverty as an employee, agent, or on behalf, of a religious organization;

ii. the individual is a contractor (such as an attorney, accountant, or investment manager or advisor) whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the individual will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered);

iii. the direct supervisor of the individual is not a disqualified person;

iv. the individual does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or

v. any preferential treatment the individual receives based on the size of that individual's contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.[19]

1. Exception for Non-Highly Compensated Employees. Nonetheless, an employee who does not receive economic benefits from the organization in excess of the indexed amount for being considered a highly compensated employee ($110,000 in 2011),[20] is not a disqualified person even if the above factors indicate that the individual may have substantial influence over the affairs of the organization.[21] This exception does not apply to employees who are automatically considered disqualified or who are substantial contributors to the organization.[22]

2. Initial Contract Exception. The theory behind the initial contract exception is that an individual who negotiates an employment agreement in good faith before the individual is in a position to exercise substantial influence over the organization should not be subject to sanctions even if the compensation under the employment agreement turns out to be excessive. Accordingly, Section 4958 does not apply to any fixed payment made to an individual with respect to an initial contract, regardless of whether the payment would otherwise constitute an excess benefit.[23] An "initial contract" is a binding written agreement between the charitable organization and an individual who was not a disqualified person immediately before entering into the agreement.[24] A "fixed payment" an amount of cash or other property specified in the agreement, or determined by a specified objective fixed formula, which is to be paid or transferred in exchange for the provision of specified services or property.[25] A fixed formula may incorporate an amount that depends on future specified events or contingencies (such as the amount of revenues generated by one or more activities of the organization), provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment.[26] If an initial contract provides for both fixed and non-fixed payments, the fixed payments will not be subject to Section 4958 while the non-fixed payments will be evaluated under an excess benefit transaction analysis, taking into account the individual's entire compensation package.[27]

D. What Constitutes Compensation? A disqualified person's entire compensation package must be evaluated to determine whether on the whole, the compensation received by the individual is reasonable for the services provided. Accordingly, if the organization is relying on the rebuttable presumption of reasonableness (discussed below), the organization's board of directors must consider and approve the disqualified person's entire compensation package, not merely salary and bonuses. The compensation package includes all forms of cash and noncash compensation, all forms of deferred compensation if earned and vested, most fringe benefits whether or not taxable, employer-paid premiums for liability insurance coverage,[28] expense allowances and reimbursements, and other economic benefits received by the disqualified person from the organization in exchange for the performance of services.[29] However, the following benefits may be disregarded in evaluating the compensation package under Section 4958: (i) employee fringe benefits that are excluded from gross income under Section 132; (ii) expense reimbursements paid pursuant to an accountable plan; (iii) economic benefits provided to a disqualified person solely as a member of or volunteer for the organization if the same benefit is available to the general public in exchange for a membership fee of no more than $75 per year;

and (iv) economic benefits provided to a disqualified person solely as a member of a charitable class that the organization is organized to serve.[30]

1. Determination of Reasonable Compensation. In general, the value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation). Section 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than any benefits specifically disregarded under Treasury Regulation Section 53.4958-4(a)(4)) provided to a person and the rate at which any deferred compensation accrues.[31] The factors generally considered for purposes of Section 162 include (i) the employee's qualifications, (ii) the nature, extent and scope of the employee's work, (iii) the size and complexities of the employer's business, (iv) the prevailing economic conditions, (v) the prevailing rates of compensation for comparable positions in comparable employers, and (vi) the employer's salary policy that applies to all employees.[32] The fact that bonus or revenue-sharing arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation. The fact that a state or local legislative or agency body or court has authorized or approved a particular compensation package paid to a disqualified person is not determinative of the reasonableness of compensation for purposes of Section 4958.[33]

Normally, the facts and circumstances to be taken into consideration in determining reasonableness of a fixed payment are those existing on the date the parties enter into the agreement pursuant to which the payment is made.[34] However, in the event of substantial non-performance, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment. In the case of any payment that is not a fixed payment under an agreement, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment.[35]

2. Substantiation of Economic Benefit Treated as Compensation. To monitor disguised compensation, the Treasury Regulations require a charitable organization to clearly indicate its intent to treat an economic benefit as compensation when it is paid. This rule is intended to prevent a charitable organization from later claiming that an excess benefit transaction, such as a below-market loan or personal expense allowance, was actually compensation and that the overall compensation package of the disqualified person was reasonable.[36] To establish its intent, the organization must provide contemporaneous written substantiation of the economic benefit intended to be compensation for services.[37] Contemporaneous written substantiation can be accomplished through the inclusion of the economic benefit on the individual's Form W-2 or Form 1099, through a written employment agreement, or through the written contemporaneous documentation of the approved compensation package under the rebuttable presumption of reasonableness.[38] However, the organization is not required to provide written substantiation of its intent to include nontaxable economic benefits, such as employer-provided medical insurance or employer contributions to a qualified retirement plan, as part of the individual's compensation.[39] As a result, even though contributions to qualified retirement plans and other nontaxable benefits are required to be taken into account in evaluating whether the overall compensation package is reasonable, they are not subject to the contemporaneous written substantiation requirement.

3. Revenue-sharing Compensation Arrangements. Revenue-sharing arrangements between a charitable organization and a disqualified person may be treated as an excess benefit transaction if the transaction results in prohibited private inurement.[40] The scope of this rule is uncertain and is not addressed in the final regulations. However, the implications of this rule may be significant for performance-based compensation arrangements and more complex arrangements to share revenue from intellectual property or other income-producing activities.

After the enactment of Section 4958, proposed regulations were issued that addressed the application of the excess benefit transaction rules to revenue-sharing compensation arrangements. These rules were not incorporated into the final regulations, and the Internal Revenue Service may later issue guidance in this area. In the meantime, revenue-sharing compensation arrangements are evaluated under the general rules governing reasonableness of compensation paid to a disqualified person, leaving a fog of uncertainty about whether these arrangements are in fact reasonable.

Since the old proposed regulations provide the only guidance on this issue, they are discussed herein for informational purposes, although they have no precedential value. In general, whether a revenue-sharing arrangement constitutes an excess benefit transaction depends on all relevant facts and circumstances. The arrangement may result in excess benefit if it permits a disqualified person to receive additional compensation without providing proportional benefits for the charitable organization. Relevant factors include the relationship between the size of the benefit provided and the quality and quantity of the services provided, and the ability of the disqualified person to control the activities generating the revenues.[41] The proposed regulations provided three examples illustrating the principles for determining whether a revenue-sharing transaction resulted in an excess benefit:[42]

i. In the first example, the disqualified person was an in-house investment manager for the charitable organization. In addition to the individual's regular salary and benefits, the individual was entitled to a bonus equal to a percentage of any increase in the net value of the portfolio. The bonus was considered an incentive to maximize benefits and minimize expenses to the organization. Thus, even though the individual had a measure of control over the portfolio performance, the bonus produced a proportional benefit for the organization. Therefore, the revenue-sharing arrangement was not considered an excess benefit transaction.

ii. In the second example, the disqualified person was a third-party management company managing the charitable organization's charitable gaming activities. The management company controlled all of the activities generating revenues and paid the charitable organization a percentage of the net profits from these activities. Since the management company provided all the personnel and equipment for the activities, the management company controlled all the costs charged to revenues and net revenues. This structure did not provide the management company with an appropriate incentive to maximize benefits and minimize costs to the charitable organizations because the management company benefitted whether the net revenues were low because expenses were high or net revenues were high because expenses were low. In contrast, the charitable organization only benefitted if the net revenues were high. As a result, the entire transaction was considered an excess benefit transaction.

iii. In the third example, the disqualified person was a university professor who was the principal investigator in charge of certain scientific research. In addition to the professor's regular salary and benefits, the professor was entitled to a specified percentage of any patent royalties on inventions produced by the professor's research. This arrangement provided an incentive for the professor to produce especially high quality work and no incentive to act contrary to the university's interest. Moreover, the university shared proportionately with the professor. Lastly, the university owned and controlled the patent and the professor had no control over the revenues generated from the patent. This arrangement was not considered an excess benefit transaction. Many research institutions have invention and research policies similar to this example.

E. <u>Rebuttable Presumption of Reasonableness</u>. The Treasury Regulations provide for a procedure, which if followed, creates a rebuttable presumption that a transaction between a public charity and a disqualified person will not constitute an excess benefit transaction within the meaning of Section 4958 of the Code. These procedures apply to fixed payments and, with minor additional requirements, to non-fixed payments subject to a cap.[43] Legislative history indicates that compensation arrangement or other financial transactions will be presumed to be reasonable if the transaction arrangement was approved in advance by an independent board (or an independent committee of the board) that was composed entirely of individuals unrelated to and not subject to the control of the disqualified person, obtained and relied upon appropriate data as to comparability, and adequately documented the basis for its determination.[44] The Treasury Regulations read into the legislative history three distinct requirements: (1) approval by an authorized body, (2) the appropriate data as to comparability, and (3) the documentation.[45]

1. <u>Approval by an Authorized Body</u>. The authorized body may be the Board of Directors or a committee duly authorized under state law to act on behalf of the Board of Directors.[46] A person is not considered part of the authorized body if he merely meets to provide information to the board and then recuses himself.[47] No person voting on the matter may have a conflict of interest with respect to the transaction.[48] A member of the authorized body does not have a conflict of interest if the member:

i. is not the disqualified person or related to any disqualified person who benefits from the transaction;

ii. is not employed by or controlled by any disqualified person benefiting from the transaction;

iii. is not receiving compensation or other payments from a disqualified person benefiting from the transaction;

iv. has no material financial interest affected by the compensation arrangement or transaction; and

v. does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or transaction, who in turn has approved or will approve a transaction providing economic benefits to the member.[49]

2. Appropriate Data as to Comparability. The authorized body must have sufficient information to determine whether a compensation arrangement or other transaction will result in the payment of reasonable compensation or a transaction for fair value. Relevant information includes, but is not limited to:

i. compensation levels paid by other similarly-situated organizations (taxable or tax-exempt);

ii. availability of similar services in the applicable geographic area;

iii. independent compensation surveys;

iv. written offers from similar institutions competing for the services of the person;

v. independent appraisals of all property to be transferred; or

vi. offers for property received as part of an open and competitive bidding process.[50]

3. Documentation. For the decision to be adequately documented, the records of the authorized body must note:

i. the terms of the transaction and the date it was approved;

ii. the members of the authorized body who were present during the debate on the transaction or arrangement and those who voted on it;

iii. the comparability data obtained and relied upon and how the data was obtained;

iv. the actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction; and

v. the basis for any deviation from the range of comparable data obtained.[51]

Moreover, such records must be prepared by the next meeting of the authorized body (or within 60 days after the final action of the authorized body, if later than the next meeting) and must be reviewed and approved as reasonable, accurate and complete within a reasonable time period thereafter.[52]

III. **Best Practices for Executive Compensation.**

A. Internal Revenue Service Executive Compensation Compliance Initiative. The Internal Revenue Service has devoted substantial time and attention to executive compensation paid by nonprofit organizations. In August 2004, the Internal Revenue Service announced that it would conduct a Compensation Compliance Initiative aimed at identifying and stopping abuses by nonprofit organizations that pay excessive compensation to their directors, officers and key employees. The Compensation Compliance Initiative involved Internal Revenue Service contact of over 1,800 public charities and private foundations, seeking information about their compensation practices and procedures. In March 2007, the Internal Revenue Service issued a report summarizing the results of its Compensation Compliance Initiative.[53] In its report, the Internal Revenue Service made the following points:

1. There were significant reporting issues with respect to executive compensation. Over thirty percent of the organizations had to amend their Form 990 and approximately fifteen percent of the organizations were selected for examination.

2. Examinations primarily showed problems with reporting, rather than other concerns. However, the Internal Revenue Service cautioned that this was not a statistical sample, so no definitive statement could be made about the level of compliance in the area of executive compensation. The Internal Revenue Service will conduct continued work with respect to executive compensation.

3. Where problems were discovered, the Internal Revenue Service made large assessments of excise taxes with respect to excess compensation – 25 examinations of 40 disqualified persons or organizations managers have resulted in proposed excise tax assessments in excess of $21 million.

4. While high compensation amounts were found in many cases, they generally were substantiated with appropriate comparability data.

Prior to the release of the final report on the Compensation Compliance Initiative, the Internal Revenue Service conducted an Executive Compensation Phone Forum in May 2006 to discuss the issues which emerged from the Compensation Compliance Initiative.[54] The Phone Forum provided an interesting view of the Internal Revenue Service's thoughts on nonprofit executive compensation. In particular, Internal Revenue Service representatives suggested that nonprofit organizations should focus their attention on the following best practices:

1. Legal Protection. According to the Internal Revenue Service representatives "every board should consider meeting the requirements of the rebuttable presumption of reasonableness."

2. Timely Reporting and Disclosure. All economic benefits to directors, officers and key employees should be reported timely on the organization's Form 990. If an organization does not clearly indicate its intent to treat an economic benefit provided to an officer, director or key employee as compensation for services, it will automatically be treated as an excess benefit transaction. Accordingly, organizations that fail to report "fringe benefit perks" like personal use of an automobile of reimbursement of personal expenses will subject the disqualified person to an automatic 25% excise tax on the amount of the fringe benefit as an automatic excess benefit transaction.

3. Transparency. While many charitable organizations have compensation committees that are given the authority to evaluate and approve executive compensation, the full board still has the ultimate responsibility over executive compensation matters. Therefore, to the extent appropriate, executive compensation matters decided by a committee of the board should be reported to the full board. The level of oversight by the full board may vary depending on the type and size of the organization, but there should be a system in place to ensure that the full board is aware of the most important compensation matters within the organization. The Internal Revenue Service representatives on the Phone Forum indicated there are specific problem areas that "frequently fall through the cracks." In particular, personal components of business travel, personal use of employer-owned property, gifts and gift certificates, tax gross-ups, expense reimbursements outside corporate travel policies, spouse travel expenses, non-accountable expense allowances, and club memberships, are additional perks that some nonprofit executive receive and should be considered as part of the overall compensation package. However, these items may not be disclosed to the board or the committee of the board making compensation determinations.

B. Panel on the Nonprofit Sector Recommendations. Over the past several years, the Senate Finance Committee has scrutinized the compensation practices of charitable organizations. While no legislation affecting compensation of nonprofit executives has been proposed, the staff of the Senate Finance Committee released a discussion draft on proposed reforms and best practices in the charitable community in June 2004 that may still be considered for future proposed legislation.[55] At the prompting of the Senate Finance Committee, an independent nonprofit organization, the Independent Sector, convened the Panel on the Nonprofit Sector (the "Panel") to study the proposals in the discussion draft and make recommendations with respect to the reforms needed in the charitable community. The result was the issuance of the Panel's final report "Strengthening Transparency Governance Accountability of Charitable Organizations" in June 2005.[56] Most recently, the Panel issued a draft "Principles for Effective Practice," which are a series of voluntary best practices standards for effective governance of charitable organizations.[57]

1. Compensation of Individuals Serving the Organization in a Dual Capacity. Under current law, there is no prohibition on directors of a charitable organization receiving compensation from the organization for their services to the organization in some other capacity. However, the Senate Finance Committee staff discussion draft contained proposals that would limit the ability of a director of a charitable organization to receive compensation from the organization in some other capacity. In particular, the proposals would allow only one member of the board to receive compensation from the organization, and such individual could not serve

as chair or treasurer of the organization. Similarly, in its recommended "Principles for Effective Practice," the Panel advocates separation of the paid chief executive officer and the treasurer and the chair of the charitable organization as an essential good governance practice. The Panel's rationale for this principle is as follows:

> Concentrating authority for the organization's governance and management practices in one or two individuals removes valuable checks and balances that help ensure that conflicts of interest and other personal concerns do not take precedence over the best interests of the organization. Both the board chair and the treasurer should be independent of the chief staff executive to provide appropriate oversight of the executive's performance and to make fair and impartial judgments about the appropriate compensation of the executive. When the board deems it is in the best interests of the charitable organization to have the chief executive officer/executive director serve as the board chair, the board should appoint another board member (sometimes referred to as the "lead director") to handle issues that require a separation of duties. For example, the lead director would serve as chair for deliberations involving the responsibilities, performance or compensation of the chief executive officer/executive director.

In addition, the Panel advocates that a "substantial majority" of the directors of a charitable organization not be compensated for their services to the organization in any capacity other than as directors of the organization. The Panel reasons "[w]hen a majority of the board members are free of the conflicts of interest that can arise from having a personal interest in the financial transactions of the charity, the board as a whole may be more likely to exercise its responsibility to review and take action on materials and information independent of the staff management." Accordingly, if a director of the charitable organization receives compensation for services to the organization in some other capacity, it is essential that the composition of the board be large enough so that the compensated individual does not unduly influence the board's decisions.

2. <u>Compensation of the Chief Executive Officer</u>. The Panel advocates that the board annually evaluate the performance of the chief executive officer prior to any change in that officer's compensation, unless there is a multi-year contract in force or the change consists solely of routine cost of living adjustments. The Panel considers the selection, evaluation and determination of compensation of the chief executive officer of the organization as one of the most important responsibilities of the board. Accordingly, the Panel recommends that the full board approve the compensation of the chief executive officer annually. Although delegation of chief executive officer compensation decisions to a compensation committee of the board is not recommended, the Panel provides that "[i]f the board designates a separate committee to review the compensation and performance of the CEO, that committee should be required to report its findings and recommendations to the full board for approval and should provide any board member with details, upon request. The board should then document the basis for its decision and be prepared to answer questions about it." Therefore, even though the rebuttable presumption of reasonableness would allow approval of the chief executive officer's compensation by a duly authorized committee of the board, the Panel does not recommend that the final approval rest with a committee. Even if a charitable organization does leave the approval of the chief executive officer's compensation to a duly authorized compensation

committee, the committee should report the basis for its approval to the full board in a timely manner.

3. Compensation of Other Officers and Key Employees. As for the compensation of other officers and key employees, the determination of the amount of compensation is normally delegated to the chief executive officer. However, the Panel recommends that the board approve "the compensation range of other persons in a position to exercise substantial control of the organization's resources. It is the responsibility of the CEO to hire and set the compensation of other staff, consistent with reasonable compensation guidelines set by the board. If the CEO finds it necessary to offer compensation that equals or surpasses his or her own, in order to attract and retain certain highly qualified and experienced staff, the board should review the compensation package to ascertain that it does not provide an excess benefit."

IV. Special Rules Applicable to Supporting Organizations and Donor Advised Funds.

A. Supporting Organizations. Organizations that support a public charity are allowed public charity status if they meet certain requirements. These "supporting organizations" are grouped into three types: (i) those that are "operated, supervised, or controlled by" the public charity they support (Type I); (ii) those that are "supervised or controlled in connection with" the public charity they support (Type II); and (iii) those that are "operated in connection with" the public charity they support (Type III).[58] Type III supporting organizations are further divided into functionally integrated Type III supporting organizations and other Type III supporting organizations. A functionally integrated Type III supporting organization[59] is defined as a Type III supporting organization that is not required to make payments to the supported organizations due to the supporting organization's activities being related to performing the functions of, or carrying out the purposes of, such supported organizations.[60]

Enacted on August 17, 2006, the Pension Protection Act of 2006[61] (the "PPA") contains many reforms for supporting organizations and donor advised funds (discussed below). In particular, if an individual or entity is a disqualified person with respect to a supporting organization, such individual or entity is automatically a disqualified person with respect to the supported organization(s) as well.[62] Accordingly, transactions between such individual or entity and the supported organization must be analyzed under the excess benefit transaction rules of Section 4958 of the Code. In addition, all types of supporting organizations are prohibited from making grants, loans, compensation or similar payments[63] to a substantial contributor of the supporting organization or a person related to a substantial contributor.[64] Similarly, all loans to disqualified persons of the supporting organization are prohibited.[65] The prohibitions do not apply if the substantial contributor or disqualified person is a public charity (other than another supporting organization). If a prohibited payment is made, the substantial contributor is treated as a disqualified person and the entire amount of the payment is treated as an excess benefit transaction under Section 4958(c) of the Code.

B. Donor Advised Funds. Donor advised funds are generally funds owned by a public charity in which a donor is able to make non-binding recommendations as to their management and investment. The charity remains in control over the use of the funds and is free to disregard the advice of the donor. Because the donor is able to influence how the funds are used, there is concern that donor advised funds are being abused in various ways. The PPA adds Sections 4966 and 4967 to the Code which is designed to improve the accountability of donor advised funds.

1. Definitions. Section 4966(d) of the Code contains four important definitions, including a statutory definition of donor advised funds:

a. Sponsoring Organization: A Sponsoring Organization is any charitable organization that is not a private foundation and that maintains one or more Donor Advised Funds.[66]

b. Donor Advised Fund: The term "donor advised fund" means a fund or account: (1) that is separately identified by reference to contributions of a donor or donors;[67] (2) that is owned and controlled by a Sponsoring Organization; and (3) with respect to which a donor, or the donor's designee has, or reasonably expects to have, advisory privileges[68] regarding the distribution or investment of any amounts held in the fund.[69] However, the term "donor advised fund" does not include a fund or account from which grants to individuals for travel, study or similar purposes are made as long as (a) the donor's advisory privileges are performed exclusively by such donor in his capacity as a member of a committee appointed by the Sponsoring Organization, (b) no combination of a donor and persons related to or appointed by such donor control such committee, and (c) all grants from such funds satisfy the requirements applicable to private foundations under Section 4945(g) with respect to grants made for travel, study or similar purposes.[70] In addition, a fund which benefits a single identified organization or governmental entity is exempted from treatment as a Donor Advised Fund.[71] Furthermore, the Secretary of the Treasury (the "Secretary") may exempt from treatment as a Donor Advised Fund a fund which is advised by a committee not controlled by a donor, donor advisor or related persons or which is designed to benefit a single identified charitable purpose. In Notice 2006-109, the Internal Revenue Service determined that employer-sponsored disaster relief funds are excluded from treatment as Donor Advised Funds, provided certain requirements are met.[72]

c. Fund Manager: A Fund Manager is any officer, trustee, or director of a Sponsoring Organization and, with respect to a specific act or failure to act, the employees of the Sponsoring Organization having authority or responsibility with respect to such act or failure to act.[73]

d. Disqualified Supporting Organization: A Disqualified Supporting Organization is (1) any Type III supporting organization that is not a functionally integrated Type III supporting organization, (2) any Type I, Type II or functionally integrated Type III supporting organization over which a donor or donor appointee who advises regarding distributions from a Donor Advised Fund to such organization has direct or indirect control, or (3) any other supporting organization that the Secretary determines by regulation to be a Disqualified Supporting Organization.[74]

2. Inappropriate Donor Benefits. In order to combat abuses where donors are inappropriately benefiting from Donor Advised Fund assets, the PPA imposes several reforms. First, Section 4966 of the Code prohibits distributions from a Donor Advised Fund to individuals. Second, donors, donor advisors, and investment advisors to Donor Advised Funds are automatically treated as disqualified persons with respect to the Sponsoring Organization for purposes of Section 4958(f) of the Code.[75] Accordingly, transactions between these persons and the Sponsoring Organization are subject to the excess benefit transaction rules contained in Section 4958 of the Code. In addition, the definition of "excess benefit transaction" is amended to include any grant, loan, compensation or similar payment[76] from a Donor Advised Fund to a person who is a donor, donor advisor, or related person.[77] The entire amount of any such grant, loan, compensation or similar payment is treated as an "excess benefit" subject to the tax, regardless of whether the terms of the payment are reasonable. Finally, if a donor, donor advisor, or related person receives, directly or indirectly, a benefit as a result of a distribution from a Donor Advised Fund, and such benefit is more than incidental, Section 4967 of the Code would impose excise taxes of 125% of the more than incidental benefit[78] on the donor or donor advisor who recommended the distribution and on the recipient of the benefit.[79] An excise tax of 10% of the more than incidental benefit is also imposed on Fund Managers who approved the distribution.[80] There is no exception for Fund Managers acting not willfully and due to reasonable cause. No tax will be imposed under Code Section 4967 if a tax has been imposed under Code Section 4958 with respect to the distribution.[81]

V. Reporting Compensation on Form 990

A. Key Thresholds and Definitions. Thresholds vary for purposes of reporting names and compensation on Form 990 as follows:

1. Director or Trustee. All voting directors and trustees of a charitable organization are reported on Form 990 without regard to compensation.

2. Officer. All officers of a charitable organization are reported without regard to compensation.

3. Key Employee. A key employee is reported on Form 990 only if the employee's compensation exceeds $150,000 and the employee (a) has responsibilities, powers or influence over the organization similar to those of officers, directors or trustees, (b) manages a discrete segment or activity of the organization that represents at least 10% of the assets, income or expenses of the organization, or (c) has or shares authority to control or determine at least 10% of the organization's capital expenditures, operating budget or employee compensation.

4. Highest Compensated Employees. An organization's highest compensated employees include its other employees whose compensation exceeds $100,000. Only the top five highest compensated employees are reported on Form 990.

5. ODTKEs. ODTKEs include officers, directors, trustees and key employees.

6. Family Member / Family Relationship. For purposes of Form 990 reporting, a family member includes an individual's spouse, ancestors, siblings (whole or half), children (natural or adopted), grandchildren, great-grandchildren, and spouses of siblings, children, grandchildren, and great-grandchildren.

B. Part VI – Line 15; Rebuttable Presumption of Reasonableness. Line 15 of Part VI asks "[d]id the process for determining compensation of the CEO/Executive Director/top management official and other officers or key employees of the organization include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision?" Essentially, the organization is asked to describe if and how it establishes a rebuttable presumption of reasonableness for compensation paid to the listed individuals. Schedule O must include a description sufficient to evidence that the organization takes appropriate steps to avoid the payment of "excess benefits" that could be taxable to the recipient and managers under Section 4958 of the Code. A clue to the desired elements of the compensation determination process is found in Schedule J, Part 1, Line 3, which lists the following components: compensation committee, independent compensation consultant, Form 990s of other organizations, written employment contracts, compensation surveys, and approval by the governing board or compensation committee.

C. Part VII – ODTKEs and Highest Compensated Employees. All compensation paid to ODTKEs and highly compensated employees must be reported in Part VII. For purposes of Part VII, a person with any voting power at any time during the year, whether compensated or not, is considered a director or trustee and must be listed. If the membership of the board changes during the year, there will be more directors listed than the number that served at any one time, and all of them will be listed as "current" members of the board per the Form 990 instructions. Officers include anyone with top administrative and financial duties without regard to designation or title.

One objective of the Form 990 redesign with respect to compensation reporting was to gain the ability to compare similar organizations with different tax years. Thus, compensation for all organizations is reported on a calendar year basis as reflected on Forms W-2 or 1099. The following compensation must be reported for the individuals required to be listed in Part VII regardless of amount: (i) salaries and bonuses; (ii) employer contributions to defined benefit retirement plans; (iii) tax deferred employer and employee contributions to qualified defined contribution retirement plans; (iv) increase in the actuarial value of a qualified or nonqualified defined benefit plan, whether or not the plan is funded, vested or subject to a substantial risk of forfeiture; (v) increase in the value of a deferred compensation plan, whether or not vested or paid to the employee; and (vi) the value of health benefits provided by the employer that are not reported as part of reportable compensation, such as health insurance premiums, medical reimbursement, flexible spending plan contributions, and the value of health coverage provided by an employer's self-insured or self-funded health plan. Other compensation, such as compensation from a related organization and other reportable employee benefits (e.g., automobile allowances, life insurance, tuition assistance, dependent care assistance, disability insurance and club dues), must be reported if it exceeds $10,000 per item.[82]

Reporting difficulties with Part VII stem primarily from payments made by affiliated organizations, outside management companies, and common paymasters, including how to obtain the proper information and what to report. For example, Organization A serves as common paymaster for itself and Organization B, a related entity. Officer M works 75% of her time for A and 25% for B. One hundred percent of M's compensation is reported on the returns for both organizations. Thus, a person reading both organizations' Forms 990 may conclude that Officer M received more compensation than was actually paid due to the requirement to report the same compensation on both returns. The organizations can alleviate this misperception of excessive compensation by including a statement on Schedule O of both returns that describes the allocation of Officer M's compensation between the two organizations and that explains the same compensation is required to be reported on both returns.

D. Schedule J – Compensation Information for Certain ODTKEs and Highest Compensated Employees. Schedule J requires an organization to report additional detailed information regarding the compensation paid to certain ODTKEs and highest compensated employees. An organization is required to complete Schedule J if it meets any of the following requirements: (i) the organization is required to list any former ODTKE or highest compensated employees in Part VII; (ii) the sum of reportable compensation and other compensation paid to any individual listed in Part VII exceeds $150,000; or (iii) the organization participated in an arrangement in which an unrelated organization paid compensation to one of its ODTKEs or highest compensated employees for services performed for the filing organization. If an organization is required to file Schedule J, the organization only needs to report on Schedule J the individuals that satisfy one of the three threshold requirements; other ODTKEs and highest compensated employees are not required to be reported on Schedule J.

Part I contains questions regarding the organization's executive compensation practices and policies. Line 3 asks about the method for determining compensation for the organization's chief executive officer. Like line 15 in Part VI of the core form, the question seeks to determine if the organization is following the rebuttable presumption of reasonableness procedures in determining the CEO's compensation. All other questions in Part I relate to the organization's compensation practices and policies with respect to all of its ODTKEs and highest compensated employees reported in Part VII, even if the details of the compensation paid to some of those individuals are not required to be reported on Schedule J. Line 4 asks whether any of the reported individuals received a severance or change of control payment, participated in a supplemental nonqualified retirement plan, or participated in an equity-based compensation arrangement. If so, the details of the arrangement must be described in Part III of Schedule J. In particular, the Internal Revenue Service is likely to scrutinize severance payments and equity-based compensation arrangements for potential excess benefit. The Internal Revenue Service is suspicious of any compensation that does not have a fixed amount or value. Therefore, lines 5, 6, and 7 ask whether the organization has paid any non-fixed payments to or participates in revenue-sharing arrangements with its ODTKEs and highest compensated employees. If so, the details of the arrangement must be reported in Part III of Schedule J.

E. Schedule L – Relationships. This schedule should be considered hand-in hand with responses provided in the governance portion of Part VI of Form 990. The completion of

Schedule L is made more complicated by the fact that the four separate parts each have a different definition of the term "interested person."

Part I requires disclosure of impermissible excess benefits with disqualified persons, which are subject to the intermediate sanctions penalties under Section 4958 of the Code and required to be reported on Form 4720. Coordination of the information provided in Line 15 of Part VI and Lines 1-8 of Schedule J, Part I (relating to compensation), is prudent.

Part II reports loans to or from interested persons that are outstanding at the end of the year, regardless of whether the loans constitute excess benefit transactions under Section 4958. Loans for this purpose include salary and other advances and receivables. Interested persons include current and former ODTKEs listed in Part VII, Section A, highest compensated employees, and disqualified persons as defined in Section 4958 of the Code. Even though loans to or from interested persons may be permissible, the Internal Revenue Service, the Panel on the Nonprofit Sector and charity watchdog groups all view interested person loans with great skepticism.

Part III reports grants or assistance benefiting interested persons. Interested persons for this purpose include current and former ODTKEs listed in Part VII, Section A, substantial contributors, and family members and 35% controlled entities of any of the foregoing. The INTERNAL REVENUE SERVICE has stipulated that grants paid to an interested person who is a member of the charitable class which the grant is intended to benefit in furtherance of the organization's exempt purpose, such as disaster relief or trauma counseling, need not be reported. Grants to enhance one's literary, artistic or other skills are reportable. The names of interested person grantees receiving funding for study or travel or for achievement awards must be included. Schools that award scholarships are not required to identify interested persons who receive grants.

Part IV identifies reportable business transactions for which payments were made between the organization and an interested person during the tax year. The definition of interested person is broad and includes current and former ODTKEs listed on Part VII, Section A, family members or 35% controlled entities of any ODTKEs, or an entity (other than an exempt organization described in Section 501(c) of the Code or a governmental unit or instrumentality) of which a current or former ODTKE listed in Form 990, Part VII, Section A was serving at the time of the transaction as (1) an officer, (2) a director, (3) a trustee, (4) a key employee, (5) a partner or member with a direct or indirect ownership interest in excess of 5% (including ownership by a family member) if the entity is treated as a partnership, or (6) a shareholder with a direct or indirect ownership interest in excess of 5% (including ownership by a family member) if the entity is a professional corporation. Business transactions include contracts of sale, lease, license, and performance of services and also joint ventures in which the interest of the organization and of the interested person each exceeds 10%. Business transactions with interested persons are reportable if: (1) all payments during the tax year between the organization and interested person exceeded $100,000, (2) all payments from a single transaction between the organization and interested person exceeded the greater of $10,000 or 1% of the organization's total revenues, (3) compensation payments by the organization to a family member of certain persons exceeded $10,000, or (4) in the case of a joint venture with an interested person, the organization has invested $10,000 or more.

VI. **Texas Law Related to Nonprofit Executive Compensation.** Texas law is similar to federal tax law regarding compensation of officers and directors of a nonprofit organization. The Texas Nonprofit Corporation Law (TNCL) allows nonprofit corporations to "pay compensation in a reasonable amount to its . . . directors and officers for services rendered."[83]

A. Role of the Board of Directors. Typically, Texas nonprofit corporations are managed by a board of directors (sometimes called the board of trustees). Texas law requires a minimum of three directors of a nonprofit corporation.[84] The board of directors is ultimately responsible for the oversight of the nonprofit corporation. The board of directors elects the officers of the nonprofit corporation who are responsible for the day to day management of the corporation.[85]

B. Fiduciary Duties of Nonprofit Directors. The fiduciary standards applicable to charitable directors include the duty of care, the duty of loyalty, and the duty of obedience.

1. Duty of Care. All nonprofit directors are subject to a duty of care. The duty of care requires a nonprofit director to discharge his responsibilities in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the director reasonably believes is in the best interests of the organization.[86] The degree of skill required is that of the ordinary prudent person, that is, the basic directorial attributes of common sense, practical wisdom, and informed judgment. If a director has special expertise, such as accounting, legal or investment expertise, then that director must exercise the degree of skill that a prudent person with similar expertise would exercise in the same or similar circumstances. The duty of care also requires that directors make decisions they reasonably believe to be in the best interests of the corporation.[87]

A director can fail to discharge the duty of care in two ways: by failing to supervise or by failing to make an informed decision. Adequate supervision means that the director actively participates in the charity's governance, such as by regularly attending board meetings, reviewing minutes and other materials disseminated to board members, meeting periodically with senior management, periodically reviewing the charity's financial statements and annual information returns (IRS Form 990), and asking questions of outside experts such as consultants, accountants and attorneys when appropriate. To make an informed decision, a director must be adequately informed about the material aspects of a proposed transaction before approving it. In discharging the duty of care, a director may rely in good faith on information, opinions, reports or statements concerning the corporation that was prepared or presented by officers, employees, a committee of the board of which the director is not a member, or outside professional advisors to the corporation (e.g., auditors, legal advisors, and investment advisors).[88] Thus, directors should be aware of the compensation paid to the organization's officers and the method used to determine the officers' compensation. If the director is serving on a compensation committee (or if approval of officer compensation is done by the entire board), then the director should review all relevant materials related to the compensation decision prior to the meeting and ask relevant questions of any compensation consultant retained by the organization.

The business judgment rule protects nonprofit directors by providing that directors will not be liable for harm to the corporation for the exercise of their judgment so long as they exercised care in the decision making process. Thus more than simple negligence on the part of the director is required to hold the director liable for a breach of the duty of care. The business judgment rule applies only in the absence of fraud, illegality or a disabling conflict of interest. In summary, the duty of care relates to the decision-making process. If a nonprofit director acts in good faith and satisfies the requisite standard of care, a court generally will not review the action, even if it proves disastrous to the charity. Accordingly, compliance with the duty of care protects a nonprofit director from liability for decisions that, with the benefit of hindsight, turn out to be wrong.

2. Duty of Loyalty. To satisfy the duty of loyalty, a nonprofit director must act in the best interests of the corporation, but does not need to avoid personal gain at all costs. In the nonprofit corporate setting, a conflict-of-interest or self-dealing transaction is not flatly prohibited, but should be carefully scrutinized. The only exception is a blanket prohibition on loans to directors of a nonprofit corporation; any director who votes for or assents to the making of the loan is jointly liable for the amount of the loan until it is repaid.[89] Before engaging in a self-dealing or conflict-of-interest transaction with a charitable organization (including payment of compensation to the director in the director's capacity as an officer of the organization), the director should disclose all material facts relating to his personal interest in the transaction to the board of directors or a committee of the board comprised of disinterested directors, and a majority of disinterested directors or committee members should approve the transaction only after concluding that it is fair and reasonable to the charity.[90] If this procedure is followed, then the transaction is not void or voidable solely because of the director's interest in the transaction. If the transaction occurred prior to obtaining approval from a majority of disinterested directors, then the transaction may be ratified by a majority of disinterested directors or a committee of the board comprised of disinterested directors provided the transaction is fair to the nonprofit corporation. A breach of the duty of loyalty not only gives rise to a tort claim under state law, but may also implicate penalties under federal tax law as an excess benefit transaction.

3. Duty of Obedience. The duty of obedience requires a director to adhere to the governing documents of the organization and to faithfully adhere to its mission, and to follow restrictions imposed by donors on contributions of charitable funds. Essentially, the duty of obedience requires directors and trustees to refrain from transactions and activities that are ultra vires. Thus, a director must carefully review the governing documents of the organization and adhere to any provisions in the governing documents addressing the compensation of the organization's directors and officers.

4. Limitation of Liability. Texas law allows for a nonprofit corporation to limit the liability of its directors to the organization or its members for monetary damages for an act or omission by the director in the person's capacity as a director by including appropriate provisions in its certificate of formation.[91] However, the elimination or limitation of the liability of a director is not allowed to the extent the person is found liable under applicable law for: (1) a breach of the director's duty of loyalty; (2) an act or omission not in good faith that: (A) constitutes a breach of duty of the director to the organization; or (B) involves intentional misconduct or a knowing violation of law; (3) a transaction from which the director received an

improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the director's duties; or (4) an act or omission for which the liability of a director is expressly provided by an applicable statute.[92]

C. Enforcement by the Texas Attorney General. Officers and directors who breach their fiduciary duties to the nonprofit corporation may be held liable to the nonprofit corporation for the resulting damages to the corporation. Generally, the Texas Attorney General is vested with the authority to investigate and enforce potential breaches of fiduciary duties by nonprofit officers and directors. While the enforcement of excessive compensation paid to nonprofit directors and officers in Texas by the Texas Attorney General is not common, it has been successfully done.

Most recently, the Texas Attorney General brought suit against several directors of the Carl B. and Florence E. King Foundation seeking to recover excessive compensation paid to the officers.[93] The King Foundation was established in 1966 by oilman Carl B. King and his wife, Florence E. King. The primary defendant in the case, Carl L. Yeckel, is the Kings' grandson. Yeckel was elected to the King Foundation's board of directors in 1971. At the time, Florence King was the board's president. Thereafter, in 1975, Yeckel accepted full-time employment with the King Foundation for an annual salary of $24,000. Yeckel was elected president of the King Foundation in 1993, after the death of both his grandparents. On October 6, 1994, during his first year as Foundation president, Yeckel sent a memorandum to the board proposing raises for himself and the King Foundation's two other employees, Thomas Vett, the corporate secretary and accountant, and office staffer Carolyn Mott. In the memo, Yeckel advised the board that his annual salary as of that date was $220,800, that Vett's salary was $120,700, and that Mott's salary was $75,500. Yeckel proposed a four percent fixed salary increase for each employee plus "a possible merit scale of 0 - 4%," effective as of June 1, 1994. Yeckel further stated that the King Foundation's practice had been to increase or adjust salaries each April 1, and justified the raises he proposed as necessary to correct a "twenty month oversight" in making those annual adjustments. Yeckel's memo prompted at least one of the King Foundation's board members to raise concerns that the salary levels were high compared to comparable foundations--between seventeen and sixty-five percent higher, the board member claimed--and could create problems with the Internal Revenue Service. Similar concerns were raised by the accountant who prepared the King Foundation's tax returns.

In the years that followed, Yeckel did not again disclose employee salaries to the King Foundation's board, although this information was included in the Foundation's annual tax returns. Yeckel was able to set his own compensation and that of Vett and Mott, without board approval. He steadily increased his compensation during each year of his presidency between twenty and twenty-six percent each year from 1996 through 2000, while awarding Vett annual increases of between nineteen and twenty-two percent. By 2002, Yeckel's annual salary was $974,978, Vett's was $451,937, and Mott's was $141,622, not counting benefits. In addition, a separate bank account was established from which the salaries of Yeckel and Vett were paid, and no one other than Yeckel and Vett saw the checks written on that account. Board members were unaware of the continued increases in Yeckel's compensation after 1994 and of various benefits that Yeckel provided to himself using Foundation funds, including use of vehicles, private club memberships, payment of all unreimbursed health expenses for himself and his family, and use of Foundation credit cards for personal charges that were not required to be reimbursed.

In August 2002, after receiving a complaint from Yeckel's sister, the Texas Attorney General sued the King Foundation, Yeckel, Vett, and other directors to protect the public interest in the administration of charitable assets held by the King Foundation. The suit asserted claims against Yeckel, Vett and other officers and directors of the King Foundation for breach of fiduciary duty, conversion, conspiracy to commit fraud, and violation of the Texas Non-Profit Corporation Act. Subsequently, Yeckel resigned from the King Foundation, each of the other members of the five-member board either resigned or was removed, and Vett was terminated. With a new board of directors in control, the Texas Attorney General dropped its suit against the King Foundation, and the King Foundation asserted its own claims against Yeckel, the other former directors, and Vett, and was realigned as a co-plaintiff with the Texas Attorney General. Ultimately, settlements were reached with most of the other directors and a trial on the claims against Yeckel and Vett ensued. The jury found Yeckel and Vett breached their fiduciary duties to the King Foundation and received excessive compensation for their services. Yeckel was ordered to reimburse the King Foundation $5,286,946.76 and Vett was ordered to reimburse the King Foundation $2,304,629.49. Additional punitive damages of $14 million awarded by the jury were not upheld on appeal.[94] The King Foundation case is representative of situations in which the failure of board members to properly exercise their duty of care by staying informed and properly supervising creates an environment ripe for abuse by self-interested officers and directors.

D. <u>Proposed Legislation</u>. The Texas Legislature is currently considering legislation that would increase the enforcement power of the Texas Attorney General with respect to charitable organizations. House Bill 2921[95] would amend the Texas Business Organizations Code to provide:

> If the attorney general has reason to believe that a nonprofit entity with a charitable purpose is engaging in, has engaged in, or is about to engage in an unlawful act or practice or that it would be in the public interest to conduct an investigation to ascertain whether the entity is engaging in, has engaged in, or is about to engage in an unlawful act or practice, the attorney general may:
>
> (1) require an employee or agent of the entity to file on forms prescribed by the attorney general a statement or report in writing, under oath or otherwise, as to all the facts and circumstances concerning the alleged unlawful act or practice and other data and information the attorney general considers necessary; and
>
> (2) examine under oath any person in connection with the alleged unlawful act or practice.[96]

A similar amendment is proposed for the Texas Trust Code relating to charitable trusts.[97] House Bill 2921 was recently reported favorably out of the State Affairs Committee on April 19, 2011 and may now be considered by the Texas House of Representatives. A similar Senate Bill 342[98] is currently pending for Senate committee action.

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[2] *See, e.g.*, Chronicle of Philanthropy 2010 Executive Compensation Survey, available at http://philanthropy.com (the Chronicle of Philanthropy's annual survey lists the compensation and benefits paid to top executives of some the nation's largest charitable organizations and is not a representative sample of nonprofit executive compensation generally); The Chronicle of Higher Education 2010 Executive Compensation Survey, available at http://chronicle.com (The Chronicle of Higher Education's annual survey lists the compensation and benefits of the chief executive officers at hundreds of public and private institutions).

[3] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

[4] Gen. Couns. Mem. 35855 (June 17, 1974). The U.S. Tax Court has also adopted this approach. McGahen v. Comm'r, 76 T.C. 468, 482 (1981), *aff'd*, 720 F.2d 664 (3d Cir. 1983); Unitary Mission Church of Long Island v. Comm'r, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981).

[5] *See* Treas. Reg. § 1.501(a)-1(c); *see, e.g*, South Health Ass'n v. Comm'r, 71 T.C. 158, 188 (1978) (stating that the private inurement prohibition has generally been applied to an organization's founders or those in control of the organization).

[6] *See, e.g.*, Texas Trade Sch. v. Comm'r, 30 T.C. 642 (1958) (holding that net earnings inured to insiders' benefit when the insiders leased property to an organization and caused it to make expensive improvements that would remain after the lease expired); Rev. Rul. 67-4, 1967-1 C.B. 123 (holding that an organization did not qualify for tax exemption because private inurement occurred when (i) the organization's principal asset was stock in the insiders' family-owned corporation, and (ii) the organization's trustees failed to vote against the corporation's issuance of a new class of preferred stock, diluting the organization's holdings); Tech. Adv. Mem. 9130002 (Mar. 19, 1991) (concluding that private inurement occurred when a hospital sold a facility to a private entity controlled by insiders for less than the fair market value).

[7] I.R.C. §§ 509(a)(1), 170(b)(1)(A)(i)-(v).

[8] I.R.C. §§ 509(a)(1), 170(b)(1)(A)(vi); Treas. Reg. § 1.170A-9(e)(2).

[9] Private foundations are subject to a different excise tax regime on transactions with disqualified persons. *See* I.R.C. § 4941. Section 4941 of the Code prohibits direct or indirect acts of "self dealing" between a private foundation and those individuals or entities who are "disqualified persons" with respect to the foundation. Typically, in considering whether a transaction between a private foundation and a disqualified person is an act of self-dealing, it is immaterial whether the transaction results in a benefit or detriment to the foundation. Treas. Reg. § 53.4941(d)-1(a). However, a private foundation generally may pay reasonable compensation to a disqualified person, including its officers and directors, without creating a prohibited act of self-dealing. The payment of compensation to a disqualified person for services unrelated to carrying out the foundation' s exempt purposes and the payment of excessive compensation (or payment or reimbursement of excessive expenses) by a private foundation to a disqualified person are prohibited acts of self-dealing. I.R.C.§ 4941(d)(2)(E).

[10] I.R.C. § 4958(c)(1).

[11] I.R.C. § 4958(f)(1).

[12] I.R.C. § 4958(a)(2).

[13] I.R.C. § 4958 (d)(2).

[14] I.R.C. § 4958(f)(6). The Treasury Regulations contain specific procedures to correct certain excess benefit transactions between a public charity and a disqualified person. *See* Treas. Reg. § 53.4958-7.

[15] I.R.C. § 4958(f)(1).

[16] Treas. Reg. § 53.4958-3(c).

[17] Treas. Reg. § 53.4958-3(e).

[18] Treas. Reg. § 53.4958-3(e)(2).

[19] Treas. Reg. § 53.4958-3(e)(3).

[20] Notice 2010-78, 2010-49 I.R.B. 808 (Oct. 28, 2010). Note that this is a different standard than the one used to determine which individuals are "highly-compensated employees" for Form 990 reporting purposes.

[21] Treas. Reg. § 53.4958-3(d)(3).

[22] *Id*.

[23] Treas. Reg. § 53.4958-4(a)(3)(i).

[24] Treas. Reg. § 53.4958-4(a)(3)(iii).

[25] Treas. Reg. § 53.4958-4(a)(3)(ii).

[26] *Id*.

[27] Treas. Reg. § 53.4958-4(a)(3)(vi).
[28] A charitable organization's payment of premiums for liability insurance covering Section 4958 excise taxes or indemnification of such taxes will not be an excess benefit if the premium or indemnification is included in the disqualified person's compensation when paid and the disqualified person's total compensation is reasonable. Treas. Reg. § 53.4958-4(b)(1)(B)(2).
[29] Treas. Reg. § 53.4958-4(b)(1)(B).
[30] Treas. Reg. § 53.4958-4(a)(4).
[31] Treas. Reg. § 53.4958-4(b)(1)(ii).
[32] Mayson Mfg. Co. v. Comm'r, 178 F.2d 115 (6th Cir. 1949).
[33] Treas. Reg. § 53.4958-4(b)(1)(ii).
[34] These general timing rules also apply to property subject to a substantial risk of forfeiture. Therefore, if the property subject to a substantial risk of forfeiture satisfies the definition of fixed payment, reasonableness is determined at the time the parties enter into the agreement providing for the transfer of the property. Treas. Reg. § 53.4958-4(b)(2)(i).
[35] Treas. Reg. § 53.4958-4(b)(2)(i).
[36] *See, e.g.*, Treas. Reg. § 53.4958-4(c)(4) Example 2.
[37] Treas. Reg. § 53.4958-4(c)(1).
[38] Treas. Reg. § 53.4958-4(c)(3).
[39] Treas. Reg. § 53.4958-4(c)(2).
[40] I.R.C. § 4958(c)(4).
[41] Prop. Treas. Reg. § 53.4958-5(a) (withdrawn).
[42] Prop. Treas. Reg. § 53.4958-5(d) (withdrawn).
[43] Non-fixed payments to a disqualified person not subject to a cap are generally not advisable. The Internal Revenue Service will not presume any non-fixed payments to be reasonable until the amounts are determined. Treas. Reg. § 53.4958-6(d). Therefore uncapped non-fixed payments are highly vulnerable to challenges as excess benefit transactions or private inurement.
[44] H.R. Rep. No. 104-506, at 56-57.
[45] Treas. Reg. § 53.4958-6(a)(1)-(3).
[46] Treas. Reg. § 53.4958-6(c)(1)(i)(A)-(C).
[47] Treas. Reg. § 53.4958-6(c)(1)(ii).
[48] Treas. Reg. § 53.4958-6(a)(1).
[49] Treas. Reg. § 53.4958-6(c)(1)(iii)(A)-(E).
[50] Treas. Reg. § 53.4958-6(c)(2)(i). For organizations with annual gross receipts of less than $1 million, the authorized body will be considered to have appropriate data as to comparability if it has compensation data of three comparable organizations in the same or similar communities for similar services. Treas. Reg. § 53.4958-6(c)(2)(ii).
[51] Treas. Reg. § 53.4958-6(c)(3)(i)(A)-(D), (ii).
[52] Treas. Reg. § 53.4958-6(c)(3)(ii).
[53] Report on Exempt Organizations Executive Compensation Compliance Project – Parts I and II (March 2007), available at http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf.
[54] The 18-page script from the Phone Forum is available at http://www.irs.gov/pub/irs-tege/may_17_final_script_exec_comp_phone_forum.pdf.
[55] In fact, many of the proposed reforms contained in the discussion draft found their way into the Pension Protection Act of 2006 (the "PPA"), which was enacted in August 2006. While compensation reforms were not contained in the PPA, then-serving Senate Finance Committee Chairman Grassley indicated that the PPA was only the first of proposed legislative reforms for the charitable community and that more should be expected.
[56] Available at http://www.nonprofitpanel.org/Report/final/Index.html.
[57] Available at http://www.nonprofitpanel.org/Report/principles/Principles_Guide.pdf.
[58] I.R.C. § 509(a)(3).
[59] Proposed regulations issued on September 24, 2009 provide an integral part test to determine whether a Type III supporting organization qualifies as a functionally integrated Type III supporting organization. *See* Prop. Treas. Reg. § 1.509(a)-4(i)(4). A Type III supporting organization satisfies this integral part test if it either (1) serves as the parent of each of its supported organizations or (2) engages in activities (i) substantially all of which directly further the exempt purposes of its supported organizations, by performing the functions of, or carrying out the purposes of,

such supported organizations, and (ii) that, but for the involvement of the supporting organization, would normally be engaged in by its supported organizations. *Id*.

[60] I.R.C. § 4943(f)(5)(B). As the Joint Committee on Taxation explains:

> The current such regulation is Treasury regulation section 1.509(a)-4(i)(3)(ii). Under Treasury regulation section 1.509(a)-4(i)(3), the integral part test of current law may be satisfied in one of two ways, one of which requires a payout of substantially all of an organization's income to or for the use of one or more publicly supported organizations, and one of which does not require such a payout. There is concern that the current income-based payout does not result in a significant amount being paid to charity if assets held by a supporting organization produce little to no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundations. There also is concern that the current regulatory standards for satisfying the integral part test not by reason of a payout are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations. In revising the regulations, the Secretary has the discretion to determine whether it is appropriate to impose a payout requirement on any or all organizations not currently required to pay out. It is intended that, in revisiting the current regulations, if the distinction between Type III supporting organizations that are required to pay out and those that are not required to pay out is retained, which may be appropriate, the Secretary nonetheless shall strengthen the standard for qualification as an organization that is not required to pay out. For example, as one requirement, the Secretary may consider whether substantially all of the activities of such an organization should be activities in direct furtherance of the functions or purposes of supported organizations.

Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 360, n. 571.

[61] Pub. L. No. 109-280 (2006).

[62] I.R.C. § 4958(f)(1)(D).

[63] The term "other similar payment" is not intended to include a payment pursuant to a bona fide sale or lease of property. Such payments are instead subject to the general rules of Section 4958 if the substantial contributor meets the definition of a "disqualified person." Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 358.

[64] I.R.C. § 4958(c)(3).

[65] *Id.*

[66] I.R.C. § 4966(d)(1).

[67] A fund or account of a Sponsoring Organization which pools contributions of multiple donors generally will not meet the first prong of the definition of "donor advised fund" unless the contributions of specific donors are in some way tracked and accounted for within the fund. Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 342-43.

[68] This requirement is satisfied only if the expectation of advisory privileges is by reason of the donor's status as donor, and not solely by reason of the donor's service to the Sponsoring Organization, such as by reason of the donor's position as an officer, employee or director of the Sponsoring Organization. Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 344.

[69] I.R.C. § 4966(d)(2).

[70] I.R.C. § 4966(d)(2)(B)(ii).

[71] I.R.C. § 4966(d)(2)(B)(i).

[72] Notice 2006-109, 2006-51 I.R.B. 1121.

[73] I.R.C. § 4966(d)(3).

[74] I.R.C. § 4966(d)(4).

[75] I.R.C. § 4958(f)(1)(D) and (E).

[76] The term "other similar payment" is not intended to include a payment pursuant to a bona fide sale or lease of property. Such payments are instead subject to the general rules of Section 4958. Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 347.

[77] I.R.C. § 4958(c)(2).

[78] Although there is no statutory definition of "incidental benefit," the Joint Committee on Taxation's interpretation of this provision states that there is only an incidental benefit if, as a result of a distribution from a Donor Advised Fund, a donor, donor advisor or related person, receives a benefit that would have reduced a charitable contribution deduction if the benefit was received as part of the contribution to the Sponsoring Organization. Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 350.
[79] I.R.C. § 4967(a)(1).
[80] I.R.C. § 4967(a)(2).
[81] I.R.C. § 4967(b).
[82] The $10,000 reporting threshold for other employee benefits and compensation paid by related organizations applies only to compensation reported in Part VII. These items are also required to be reported on Schedule J, regardless of amount. Accordingly, the amounts reported on Schedule J may exceed the amount of compensation reported in Part VII for the same person.
[83] Tex. Bus. Org. Code § 22.054.
[84] Tex. Bus. Org. Code § 22.204(a).
[85] *See* Tex. Bus. Org. Code § 22.232(b).
[86] *See* Tex. Bus. Org. Code § 22.221(a).
[87] *See* Tex. Bus. Org. Code § 22.221.
[88] *See* Tex. Bus. Org. Code § 3.102.
[89] *See* Tex. Bus. Org. Code § 22.225. In addition, loans to officers of a nonprofit corporation are prohibited unless the loan is "(1) made for the purposes of financing the officer's principal residence; or (2) set in an original principal amount that does not exceed: (A) 100 percent of the officer's annual salary, if the loan is made before the first anniversary of the officer's employment; or (B) 50 percent of the officer's annual salary, if the loan is made in any subsequent year." Tex. Bus. Org. Code § 22.055(b).
[90] *See* Tex. Bus. Org. Code § 22.230. Note that the procedure under Texas law for interested director transactions is not as stringent at the rebuttable presumption of reasonableness procedure for transactions with disqualified persons under Section 4958 of the Code.
[91] *See* Tex. Bus. Org. Code § 7.001(b).
[92] *See* Tex. Bus. Org. Code §7.001(c).
[93] *See* Yeckel v. Abbott, No. 03-04-00713-CV, 2009 Tex. App. LEXIS 3881 (Tex. App. – Austin June 4, 2009, pet. denied) (mem. op.).
[94] *Id.*
[95] Tex. H.B. 2921, 82nd Leg., R.S. (2011).
[96] *Id.*
[97] *Id.*
[98] Tex. S.B. 342, 82nd Leg., R.S. (2011).

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DON'T TAX US, WE'RE EXEMPT

By: *Glen A. Yale*[1]

I. Introduction.

Real and tangible personal property that the State of Texas has jurisdiction to tax is taxable unless exempt by law. Texas Tax Code Sec. 11.01.

Recognition of exemption under IRC Sec. 501(c)(3) does not automatically translate into property tax exemption under the Texas Tax Code. To obtain a property tax exemption, the exempt organization must:

- Be a qualified organization as set forth in a section of the Texas Tax Code;
- Own the type of property that is specified as exempt;[2] and
- Make proper application for the property to be exempt.

A failure to meet any of these requirements may result in loss of exemption and taxation.

There is not a single definition of exempt organizations that tries to cover all organizations that are intended to be exempt, much like IRC Section 501(c)(3) does. Rather the Texas Tax Code has an exemption for Charitable Organizations that is mostly a list of types of charitable organizations by function, and for religious organizations and for schools. These will be discussed in that order.

II. Charitable Organizations.

To obtain an exemption from property taxes most tax exempt organizations, other than churches and schools, must meet the specific requirements that are set forth in Sec. 11.18,[3] entitled "Charitable Organizations." To obtain an exemption the organization must be a qualified charitable organization, as provided under that section of the code.

A. Qualified charitable organizations. A qualified charitable organization can be operated by as individual or as a corporation, foundation, trust, or association. Sec. 11.18 (c). Nothing is said about a limited liability company in the statute, so that would seem to place that structure in doubt. Yet, Subsection 11.18(e) provides that with certain specific exceptions, that the organization be a nonprofit corporation as defined by the Texas Non-Profit Corporation Act, now the Business Organizations Code.

To be a qualified charitable organization, it must also meet the applicable requirements of Subsections (d), (e), (f) and (g). *Id*. Actually only the first three subsections apply to all charitable organizations, as they are general in nature. Subsection (g) applies to organizations that collect funds from the general public for other charitable organizations, such as the United Way.

B. Organize and perform charitable functions. Not all charitable organizations qualify for exemption. Subsection (d) requires,

> "A charitable organization must be organized exclusively to perform religious, charitable, scientific, literary, or educational purposes and except as permitted by Subsections (h) and (l), engage exclusively in performing one or more of the following charitable functions." The bold subheadings are the author's.

1. **Indigent medical care.** Providing medical care without regard to the beneficiaries' ability to pay, which in the case of a nonprofit hospital or hospital system means providing charity care and community benefits in accordance with Texas Tax Code Sec 11.1801, entitled "Charity Care and Community Benefits Requirements for Charitable Hospital."

2. **Indigent and disaster care.** Providing support or relief to orphans, delinquent, dependent, or handicapped children in need of residential care, abused or battered spouses or children in need of temporary shelter, the impoverished, or victims of natural disaster without regard to the beneficiaries' ability to pay.

3. **Support to elderly and handicapped.** Providing support to elderly persons, including the provision of recreational or social activities and facilities designed to address the special needs of elderly person, or to the handicapped, without regard to the beneficiaries' ability to pay.[4]

4. **Historical landmarks.** Preserving a historical landmark or site.

a. Section 11.24, entitled "Historic Sites," states that the governing body of a taxing unit by official action of the body adopted in the manner required by law for official actions *may* exempt from taxation part or all of the assessed value of a structure or archeological site and the land necessary for access to and use of the structure or archeological site, if the structure or archeological site is:

(i) designated as a Recorded Texas Historic Landmark under Chapter 442, Government Code, or a state archeological landmark under Chapter 191, Natural Resources Code, by the Texas Historical Commission; or

(ii) designated as a historically or archeologically significant site in need of tax relief to encourage its preservation pursuant to an ordinance or other law adopted by the governing body of the unit.

b. Section 11.24 is the only exemption that is granted not by the appraisal district but by each taxing unit and application must be made to each taxing unit. That may make application under Sec. 11.18(d)(4) preferable.

5. **Cultural sites.** Promoting or operating a museum, zoo, library, theater of the dramatic or performing arts,[5] or symphony orchestra or choir.

6. **Humane society.** Promoting or providing humane treatment of animals.

7. **Water companies.** Acquiring, storing, transporting, selling, distributing water for public use.

8. **Volunteer fire companies.** Answering fire alarms and extinguishing fires with no compensation or only nominal compensation to the members of the organization.

9. **Youth athletics.** Promoting the athletic development of boys or girls under the age of 18 years.

10. **Wildlife conservation.** Preserving or conserving wildlife.

11. **Student scholarships.** Promoting educational development through loans or scholarships to students.

12. **Halfway houses.** Provide halfway house services pursuant to a certification as a halfway house by the parole division of the Texas Department of Criminal Justice.

13. **Housing for the elderly.** Providing permanent housing and related social, health care, and educational facilities for persons who are 62 years of age or older without regard to the residents' ability to pay.

14. **Art collection.** Promoting or operating an art gallery, museum or collection in a permanent location or on tour, that is open to the public.

15. **United Way type organizations.** Providing for the organized solicitation and collection for distributions through gifts, grants, and agreements to nonprofit charitable, educations, religious, and youth organizations that provide direct human, health, and welfare services.

a. Section 11.18(g) provides that a charitable organization that performs a charitable function specified by Subsection (d)(15) must:

(i) be affiliated with a state or national organization that authorizes, approves, or sanctions volunteer charitable fundraising organizations;

(ii) qualify for exemption under IRC 501(c)(3);

(iii) be governed by a volunteer board of directors;

(iv) distribute contributions to at least five other associations to be used for general charitable purposes, with all recipients meeting the following criteria: (A) be governed by a volunteer board of directors; (B) qualify for exemption under IRC 501(c)(3); (C) receive a majority of annual revenue from private or corporate charitable gifts and government agencies; and (D) provide services without regard to the ability of persons receiving the services to pay for the services.

16. **Biomedical and scientific research.** Performing biomedical or scientific research or biomedical or scientific education for the benefit of the public.

17. **Public television station.** Operating a television station that produces or broadcasts educational, cultural, or other public interest programming and that receives grants from the Corporation for Public Broadcasting under 47 U.S.C. Section 396, as amended.

18. **Low income housing.** Providing housing for low-income and moderate-income families, for unmarried individuals 62 years of age or older, for handicapped individuals, and for families displaced by urban renewal, through the use of trust assets that are irrevocably and, pursuant to a contract entered into before December 31, 1972, contractually dedicated on the sale or disposition of the housing to a charitable organization that performs charitable functions described by Subdivision (9).

19. **Retirement communities.** Providing housing and related services to persons who are 62 years of age or older in a retirement community, if the retirement community provides independent living services, assisted living services, and nursing services to its residents on a single campus: (A) without regard to the residents' ability to pay, or (B) in which at least four percent of the retirement community's combined net resident revenue is provided in charitable care to its residents. See special definitions in Section 11.18(k) that apply to retirement communities.

a. Special definitions for retirement communities. Subsection 11.18(k) gives special definitions that apply to nursing homes or retirement communities under Subsection 11.18(d).

(i) "Assisted living services" means responsible adult supervision of or assistance with routine living functions of an individual in instances where the individual's condition necessitates that supervision or assistance.

(ii) "Charity care," "government-sponsored indigent health care," and "net resident revenue" are determined in the same manner for a retirement community or nursing home as for a hospital under Section 11.1801(a)(2).

(iii) "Nursing care services" includes services provided by nursing personnel, including patient observation, the promotion and maintenance of health, prevention of illness or disability, guidance and counseling to individuals and families, and referral of patients to physicians, other health care providers, or community resources if appropriate.

(iv) "Retirement community" means a collection of various types of housing that are under common ownership and designed for habitation by individuals over the age of 62.

(v) "Single campus" means a facility designed to provide multiple levels of retirement housing that is geographically situated on a site at which all levels of housing are contiguous to each other on a single property.

20. **Cooperative university housing.** Providing housing on a cooperative basis to students of an institution of higher education if: (A) the organization is exempt under IRC Sec. 501(c)(3); (B) membership in the organization is open to all students enrolled in the institution and is not limited to those chosen by current members of the organization; (C) the organization is governed by its members; and (D) the members of the organization share the responsibility for managing the housing.

21. **Urban land bank demonstration program.** Acquiring, holding and transferring unimproved real property under an urban land bank demonstration program established under Chapter 379C, Local Government Code, as or on behalf of a land bank.

22. **Urban land bank program.** Acquiring, holding, and transferring unimproved real property under an urban land bank program established under Chapter 379E, Local Government Code, as or on behalf of a land bank.

23. **Public radio station.** Operating a radio station that broadcasts educational, cultural, or other public interest programming, including classical music, and that in the preceding five years has received or been selected to receive one or more grants from the Corporation for Public Broadcasting under 47 U.S.C. Section 396, as amended.[6]

24. **Housing for homeless.** Providing housing and related services to individuals who: (A) are unaccompanied and homeless and have a disabling condition; and (B) have been continuously homeless for a year or more or have had at least four episodes of homelessness in the preceding three years.[7]

C. <u>Not Operated for Private Gain</u>. Subsection (e) requires,

> "A charitable organization must be operated in a way that does not result in accrual of distributable profits, realization of private gain resulting from payment of compensation in excess of a reasonable allowance for salary or other compensation for services rendered, or realization of any other form of private gain and, if the organization performs one or more of the charitable functions specified by Subsection (d) other than a function specified by

Subdivision (1), (2), (8), (9), (12), (16), or (18), be organized as a nonprofit corporation as defined by the Texas Non-Profit Corporation Act."

D. Dissolution. Subsection (f) requires, "A charitable organization must:

1. use its assets in performing the organization's charitable functions or the charitable functions of another charitable organization; and

2. by charter, bylaw, or other regulation adopted by the organization to govern its affairs direct that on discontinuance of the organization by dissolution or otherwise:"

a. the assets are to be transferred to this state, the United States, or an educational, religious, charitable, or other similar organization that is qualified as a charitable organization under IRC Sec. 501(c)(3);

b. if required for the organization to qualify as a tax-exempt organization under IRC Sec 501(c)(12), [benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations], the assets are to be transferred directly to the organization's members, each of whom, by application for an acceptance of membership in the organization, has agreed to immediately transfer those assets to this state or to an educational, religious, charitable, or other similar organization that is qualified as a charitable organization under IRC Sec. 501(c)(3), as designated in the bylaws, charter, of regulation adopted by the organization.

E. Exclusively, not so much. There are two exceptions to the "exclusively function" requirement that apply generally and one that applies to organizations that provides services to the elderly.

1. Generally. Subsection 11.18(h) states that performance of noncharitable functions by a charitable organization that owns or uses exempt property does not result in loss of an exemption authorized by Section 11.18 if those other functions are incidental to the organization's charitable functions.

Subsection (h) also provides that the division of responsibilities between an organization that qualifies as a charitable organization under Subsection (c) and another organization will not disqualify the organizations or any property owned or used by either organization from receiving an exemption under section 11.18 if the collaboration furthers the provision of one or more of the charitable functions described in Subsection 11.18(d) and if the other organization:

a. is exempt from federal income taxation under IRC Sec 501(c)(3);

b. meets the criteria for a charitable organization under Subsections (e) and (f); and

c. is under common control with the charitable organization described in this subsection.

2. Services to elderly. Subsection 11.18(l) provides that a charitable organization described in Subsection 11.18(d)(3) that provides support to elderly persons must engage primarily in performing charitable functions described by Subsection (d)(3), but may engage in other activities that support or are related to its charitable functions.

III. Religious Organizations.

Religious organizations are covered under a separate section, Sec. 11.20.

A. Qualified religious organizations.

To qualify for an exemption as a religious organization, an organization (whether operated by an individual, as a corporation, or as an association) must; Sec. 11.20(c):

1. be organized and operated primarily for the purpose of engaging in religious worship or promoting the spiritual development or well-being of individuals.

"Religious worship" means individual or group ceremony or meditation, education, and fellowship, the purpose of which is to manifest or develop reverence, homage, and commitment in behalf of a religious faith; Sec. 11.20(e);

Evidence was legally sufficient to support jury finding that entire 64-acre tract owned by the church and used as a church camp site was an actual place of worship, thereby qualifying for property tax exemption. *Kerrville Independent School Dist. v. Southwest Texas Encampment Ass'n*, 673 S.W. 2d 256 (Texas App. 4th 1984 writ ref'd n.r.e). A building used by a minister to prepare religious radio programs was exempted in *Highland Church of Christ v. Powell*, 644 S.W.2d 177 (Tex. App. – Eastland 1983, writ ref'd n.r.e.). Church owned parking lots also may be exempted from taxation even if they are leased out during the week[8]. *First Baptist Church of San Antonio v. Bexar County Appraisal District*, 833 S.W.2d 108 (Tex. 1992).

2. be operated in a way that does not result in accrual of distributable profits, realization of private gain resulting from payment of compensation in excess of a reasonable allowance for salary or other compensation for services rendered, or realization of any other form of private gain;

3. use its assets in performing the organization's religious functions or the religious functions of another religious organization;

4. by charter, bylaw, or other regulation adopted by the organization to govern its affairs direct that on discontinuance of the organization by dissolution or otherwise the assets are to be transferred to this state, the United States, or a charitable, educational, religious, or other similar organization that is a qualified IRC Sec. 501(c)(3) organization.

B. Exempt property. There are eight types of exempt property for a qualified religious organization; Sec. 11.20(a) and (b). The bold subheadings are the author's.

1. **Place of regular religious worship.** The real property that is owned by the religious organization, is used primarily as a place of regular religious worship, and is reasonably necessary for engaging in religious worship; Sec. 11.20(a)(1).

2. **Tangible personal property.** The tangible personal property that is owned by the religious organization and is reasonably necessary for engaging in worship at the place of regular religious worship; Sec. 11.20(a)(2).

3. **Residence for clergy.** The real property that is owned by the religious organization and is reasonably necessary for use as a residence (but not more than one acre of land for each residence) if the property: (A) is used exclusively as a residence for those individuals whose principal occupation is to serve in the clergy of the religious organization; and (B) produces no revenue for the religious organization; Sec. 11.20(a)(3).

4. **Tangible personal property in residence.** The tangible personal property that is owned by the religious organization and reasonably necessary for use of the residence specified in (3); Sec. 11.20(a)(4).

5. **Incomplete improvement.** The property owned by the religious organization consisting of: (A) an incomplete improvement that is under active construction or other physical preparation and that is designed and intended to be used by the religious organization as a place of regular religious worship when complete; and (B) the land on which the incomplete improvement is located that will be reasonably necessary for the religious organization's use of the improvement as a place of regular religious worship. A property may not be exempt under this provision for more than three years; Sec. 11.20(a)(5).

6. **Expansion land.** The land that the religious organization owns for the purpose of expansion of the religious organization's place of regular religious worship or construction of a new place of regular religious worship if: (A) the religious organization qualifies other property, including a portion of the same tract or parcel of land, owned by the organization for an exemption under (1) or (5); and (B) the land produces no revenue for the religious organization. A tract of land that is contiguous to the tract of land on which the religious organization's place of regular religious worships is located may not be exempted under the provisions for more than six years and a tract of land that is not contiguous to the tract of land on which the religious organization's place of regular religious worship is located may not be exempted under this provisions for more than three years; a tract of land is considered to be contiguous with another tract of land if the land if the tracts are divided only by a road, railroad track, river, or stream; Sec. 11.20(a)(6).

7. **School property.** The real property owned by the religious organization that is leased to another person and used by the person for the operation of a school that qualifies as a school under Section 11.21(d); Sec. 11.20(a)(7).

8. **Endowment funds.** Endowments funds the organization owns that are used exclusively for the support of the religious organization and are invested exclusively in bonds, mortgages, or property purchased at a foreclosure sale for the purpose of satisfying or protecting the bonds or mortgages; foreclosure sale property that is held by an endowment fund for longer than the two year period immediately following purchase a the foreclosure sale is not exempt from taxation. Sec. 11.20(b).

C. Occasional secular use. Use of property that qualifies for exemption as a religious organization for occasional secular purposes other than religious worship does not result in loss of the exemption if the primary use of the property is for religious worship and all income from the other use is devoted exclusively to the maintenance and development of the property as a place of religious worship.

D. Increased tax on sale of expansion land. For a sale of land that is exempt under Section 11.20(a)(6) to another person, an additional tax is imposed on the land equal to the tax that would have been imposed on the land had the land been taxed for each of the five years preceding the year in which the sale or transfer occurs in which the land received an exemption under that subsection, plus interest at an annual rate of seven percent calculated from the dates on which the taxes would have become due.

These sanctions do not apply if the sale or transfer occurs as a result of :

1. a sale for right-of-way:

2. a condemnation;

3. a transfer of property to the state or a political subdivision of the state to be used for a public purpose;

4. a transfer of property to a religious organization that qualifies the property for an exemption under Section 11.20 for the tax year in which the transfer occurs. Sec. 11.201(e).

This caution is addressed to purchasers of land from churches:

> [W]hen buying land from a church, it is important to determine whether or not the land is expansion land. If it is, it will be necessary to estimate the taxes that would have been imposed on the land for the prior 5 years and escrow the same until the roll back is assessed. This may impose a challenge, because in contrast to ag use exempt land, for which the appraisal district makes an annual valuation determination, land held by a church is listed as exempt on the tax rolls, so there is no annual determination of value

> by the appraisal district. As such, it may be safest for the buyer to insist that the parties utilize the current sale price of the land for tax estimation purposes, as it is unlikely that the appraisal district could prevail in an argument that the land was worth more during any of the 5 previous years than the buyer is currently paying for the land. D. Becker, “Avoiding Malpractice – Property Tax Pitfalls, 2008 State Bar College “Summer School”, p. 7.

A caution could also be addressed to a church selling expansion land to make sure that the sales contract does not place the increased taxes upon the church.

IV. Schools.

Schools and exemption from taxation are covered in Sec. 11.21, entitled “Schools.”

A. Qualified schools. To be a school qualified for an exemption, an organization (whether operated by an individual, as a corporation, or as an association) must:

1. be organized and operated primarily for the purpose of engaging in educational functions;

2. normally maintain a regular faculty and curriculum and normally have a regularly organized body of students in attendance at the place where its educational functions are carried on;

3. be operated in a way that does not result in accrual of distributable profits, realization of private gain resulting from payment of compensation in excess of a reasonable allowance for salary or other compensation for services rendered, or realization of any other form of private gain and, if the organization is a corporation, be organized as a nonprofit corporation as defined by the Texas Non-Profit Corporation Act;

4. use its assets in performing the organization’s educational functions or the educational functions of another educational organization; and

5. by charter, bylaw, or other regulation adopted by the organization to govern its affairs direct that on discontinuance of the organization by dissolution or otherwise the assets are to be transferred to this state, the United States, or an educational, charitable, religious, or other similar organization that is qualified as a charitable organization under IRC Sec. 501(c)(3).

B. School exemptions. A person is entitled to an exemption from taxation of:

1. the buildings and tangible personal property that the person owns and that are used for a qualified school in Section (d) if: (A) the school is operated exclusively by the person owning the property; (B) the buildings and tangible personal property are used exclusively for educational functions; use of exempt tangible property for functions other than

educational functions does not result in loss of an exemption authorized by this section if those other functions are incidental to use of the property for educational functions and benefit the students or faculty of the school; (C) the buildings and tangible personal property are reasonably necessary for the operation of the school;

2. the real property owned by the person consisting of: (A) an incomplete improvement that: (i) under active construction or other physical preparation; and (ii) is designed and intended to be used for a school that is a qualified school in Section 11.21(d); but not for more than three years, Sec. 11.21(g).

C. Endowment funds. Endowments funds that are used exclusively for the support of the school and are invested exclusively in bonds, mortgages, or property purchased at a foreclosure sale for the purpose of satisfying or protecting the bonds or mortgages; foreclosure-sale property that is held by an endowment fund for longer than the two-year period immediately following purchase at the foreclosure sale is not exempt from taxation.

V. Miscellaneous Organization Exemptions.

Other sections of the Tax Code, Section 11.23 in particular, contain miscellaneous provisions, applicable to specific types of organizations and to specific named organizations. Some provisions of general application are:

A. Veteran's Organizations. A nonprofit organization that is composed primarily of members or former members of the armed forces of the United States or its allies and that is chartered or incorporated by the United State Congress is entitled to an exemption from taxation of each of the buildings (including the land that is reasonable necessary for use of, access to, and ornamentation of the buildings) and other property owned and primarily used by the organization if the property is not used to produce revenue or held for gain. Occasional renting of the post or chapter property for other nonprofit activities does not result in loss of the exemption provided by this subsection if the rental proceeds are used solely for the maintenance and improvement of the property. An organization is a nonprofit organization if it is organized and operated in a way that does not result in the accrual of distributable profits, realization of private gain from payment of compensation in excess of a reasonable allowance for salary or other compensation for services rendered, or realization of any other form of private gain. Section 11.23 (a).

B. Private Enterprise Demonstration Associations. An association that engages exclusively in conducting nonprofit educational programs designed to demonstrate the American private enterprise system to children and young people and that operates under a state or national organization that is organized and operated for the same purpose is entitled to an exemption from taxation of the tangible property that it owns and uses exclusively if it is reasonably necessary for the association's operation. Section 11.23(e).

C. Theater Schools. The provisions of Section 11.23(g) are so detailed they appear to have been to qualify one specific taxpayer.

A corporation that is organized to promote the teaching and study of the dramatic arts is entitled to an exemption from taxation of the property it owns and uses in the operation of a school for the dramatic arts if:

1. the corporation is organized as a nonprofit corporation as defined by the Texas Non-Profit Corporation Act;

2. the corporation is not self-sustaining in any fiscal year from income other than gifts, grants, or donations;

3. the corporation is exempt from federal income taxes;

4. the school maintains a theater-school program with regular classes for at least four grades, formal textbooks and curriculum, an enrollment of 150 or more students during each of at least two semesters every calendar year, and a faculty substantially all of whom hold degrees in theater arts from an accredited school of higher education;

5. the school offers apprenticeship or other practical training in theater management and operation for college students or offers similar training for playwrights, actors, and production personnel; and

6. more than one-half of each season's theatrical productions for which admission is charged have significant literary merit of the character that contributes to the educational programs of secondary schools and schools of higher education.

D. <u>County Fair Associations</u>. A county fair association organized to hold agricultural fairs and encourage agricultural pursuits is entitled to an exemption from taxation of the land and building that it owns and uses to hold agricultural fairs. Section 11.23(h).

E. <u>Community Service Clubs</u>. Section 11.23(i) provides that an association that qualifies as a community service club is entitled to an exemption from taxation of the tangible property the club owns that qualifies under Article VIII, Section 2, of the constitution and that is not used for profit or held for gain. To qualify as a community service club for the purposes of this subsection, an association must:

1. be organized to promote and must engage primarily in promoting: (A) the religious, educational, and physical development of boys, girls, young men, or young women; (B) the development of the concepts of patriotism and love of country; and (C) the development of interest in community, national, and international affairs;

2. be affiliated with a state or national organization of similar purpose;

3. be open to membership without regard to race, religion, or national origin; and

4. be operated in a way that does not result in accrual of distributable profits, realization of private gain resulting from payment of compensation in excess of a reasonable allowance for salary or other compensation for services rendered, or realization of any other form of private gain.

F. Youth Spiritual, Mental and Physical Development Associations. Property that is owned by an organization that is organized and operated primarily for the purpose of promoting the threefold spiritual, mental, and physical development of boys, girls, young men, or young women, and operates in conjunction with a state or national organization may be exempt. Sec. 11.19.

G. Limited Organizations

There are exemptions granted for organizations that are granted for organizations of very limited application.

1. Exemptions for Specific Organizations.

a. Federation of Women's Clubs. 11.23(b).

b. Nature Conservancy of Texas. 11.23(c)

c. Congress of Parents and Teachers. 11.23(d)

2. Specific Types of Organizations;

a. Medical Center Development. 11.23(j)

b. Medical Center Development in Populous Counties. 11.23(j-1)

c. Scientific Research Corporations. 11.23(k)

3. There are several Sections that are limited in their application to specific types of organizations:

a. Section. 11.30 Nonprofit Water Supply or Wastewater Service Corporation.

b. Section 11.32 Certain Water Conservation Initiatives.

VI. Date of ownership.

To qualify for an exemption, one must normally own the property on January 1 to qualify for the exemption for that year. 11.42(a).

But a charitable organization that acquires property after January 1 of a tax year may receive an exemption authorized by Section 11.17, 11.18, 11.19, 11.20, 11.21, 11.23, 11.231, or 11.30 for the applicable portion of that tax year immediately on qualification for the exemption. Sec. 11.42(d).

VII. Application for Exemption.

No exemptions are automatic, but result after application for the exemption by filing an exemption application for with the chief appraiser for each appraisal district in which the property subject to the claimed exemption has situs. Sec. 11.43(a).

Most individual exemptions must be claimed annually, but charitable exemptions once allowed need not be claimed in subsequent years, until the property changes ownership or the organization's qualification for the exemption changes. Sec. 11.43 (c). The chief appraiser may require an organization allowed one of the exemptions in a prior year to file a new application to confirm the organization's current qualification for the exemption by delivering a written notice that a new application is required, accompanied by an appropriate application form. *Id.*

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[1] Glen Yale is with Yale Law Firm PC in San Antonio, Texas.

[2] Op. Atty. Gen. 1999 No. JC-0134 held that Cameron County may not waive taxes, penalties, and interest on real property owned by an individual that houses a nonprofit organization. To be exempt, the property must be owned by the charitable organization; leasing is not sufficient.

[3] Unless otherwise specified all Sections are from the Texas Tax Code.

[4] There is a slight wording difference in the text of this subsection as reenacted by Acts 2009, 81st Leg., R.S., Ch. 1246, Sec. 1 and Acts 2009, 81st Leg., R.S., Ch. 1314, Sec. 1.

[5] See the discussion below on Sec. 11.23(g) on Theater Schools.

[6] Text of Subsection 11.18(d)(23) as reenacted by Acts 2009, 81st Leg., R.S., Ch. 1246, Sec. 1.

[7] Text of Subsection 11.18(d)(23) as reenacted by Acts 2009, 81st Leg., R.S., Ch. 1314, Sec. 1.

[8] Under Sec. 11.20(d), all income from such leasing must be devoted exclusively to the maintenance and development of the property as a place of religious worship.

EMPLOYMENT TAX AND EMPLOYEES ON THE OUTER CONTINENTAL SHELF

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

On March 30, 2011, the Internal Revenue Service (the "IRS") released Industry Director's Directive #2 – Employment Tax and the Employees on the U.S. Outer Continental Shelf ("Directive #2"). Directive #2 provides notice and field direction on the application of section 3402 of the Internal Revenue Code,[2] the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA") to remuneration for work performed by nonresident alien employees on the Outer Continental Shelf in the Gulf of Mexico (the "OCS"). Directive #2 draws from the legal conclusions reached in Chief Counsel Advice 201027046 released on July 9, 2010. CCA 201027046 concluded that services performed by a nonresident alien employee on structures permanently or temporarily attached to the OCS, or on vessels or other devices engaged in activities related to the exploration for, or exploitation of, natural resources on the OCS are performed within the U.S. and that any remuneration paid for such services is subject to withholding of income tax, FICA and FUTA.

The IRS has determined that many employers fail to comply with their withholding obligations for nonresident alien employees working on the OCS. An OCS compliance steering committee has been established to help identify, develop, resolve and improve IRS coordination of issues related to OCS activities.

Income Tax Withholding

Employers that employ nonresident alien individuals on the OCS have withholding obligations with respect to compensation paid to those employees if the employees provide services in the United States. The definition of the "United States" for federal income tax purposes is very broad when analyzing whether personal services provided on the OCS are provided in the U.S.[3] Nonresident alien employees who perform services on structures permanently or temporarily attached to the OCS, or on vessels or other devices engaged in activities related to the exploration for, or exploitation of, natural resources on the OCS, are generally engaged in a U.S. trade or business.[4] Accordingly, the compensation paid to such nonresident alien employees is effectively connected with the conduct of a U.S. trade or business[5] and subject to withholding of income tax by the employer.

Section 1441 requires a 30% withholding tax on the gross amount of salaries, wages, compensation, remuneration, or other fixed or determinable annual or periodic income derived by a nonresident alien employee from U.S. sources. The withholding under section 1441 is not required, however, to the extent that withholding is required under section 3402.[6] Section 3402 simply requires that every employer making a payment of wages must withhold income tax. Although wages generally include all remuneration for services performed by an employee for an employer,[7] wages subject to withholding do not include remuneration for services performed in the U.S. by a nonresident alien employee if the remuneration is (or will be) exempt from income tax under a provision of the Code or an income tax treaty to which the U.S. is a party.[8]

A nonresident alien employee claiming an exemption from withholding under an income tax treaty must provide the employer with a Form 8233, Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.

If no income tax treaty exemption from U.S. federal income tax withholding applies, a nonresident alien employee may claim withholding allowances on Form W-4, Employee's Withholding Allowance Certificate. Notice 2005-76, 2005-2 CB 947, provides special rules for nonresident alien employees to use in completing Form W-4 and for employers to determine how much income tax to withhold from wages. Modified rules applied for wages paid to nonresident alien employees during calendar year 2010,[9] but Notice 2005-76 continues to be fully in effect for wages paid on or after January 1, 2011.[10] If the nonresident alien employee does not furnish a fully completed Form W-4 to the employer, the employer is required to withhold as if the employee were a single person with no withholding allowances.

FICA and FUTA Withholding

For purposes of FICA and FUTA, wages include all remuneration for employment. Employment generally includes any service performed by an employee for an employer within the U.S. regardless of the citizenship or residence of either. For example, the employee and employer may be citizens and residents of a foreign country and the contract of service may be entered into in a foreign country, but if the services under the contract are performed within the U.S., such services may be deemed "employment" for FICA and FUTA purposes.[11] Section 3121(b)(4) provides an exception for FICA from the definition of "employment" if: (A) the services provided by an individual are on or in connection with a vessel that is not an American vessel, (B) the individual is employed on and in connection with such vessel when outside the U.S., and (C) either: (i) such individual is not a U.S. citizen, or (ii) the employer is not an American employer. Section 3121(h) defines an "American employer" for FICA purposes to include an individual who is a resident of the U.S., a partnership, if two-thirds or more of the partners are residents of the U.S., and a corporation organized under the laws of the U.S. or of any State. Section 3306(c)(4) provides a similar exception for FUTA from the definition of "employment," but the FUTA exception requires only that the services be performed on or in connection with a vessel that is not an American vessel as long as the individual is employed on and in connection with such vessel when outside the U.S.

FICA is calculated as a percentage of wages and imposed in addition to other taxes on those wages;[12] whereas, an employer is liable for FUTA in an amount equal to a certain percentage of total wages paid by the employer during the calendar year.[13] Wages that are covered by a totalization agreement, as evidenced by a certificate of coverage issued by a foreign country, are exempt from FICA.[14] An employer is never exempt from FUTA, however, under a treaty or totalization agreement. Additionally, an employer is subject to FUTA without regard to whether it is required to make contributions to, or its employees are eligible to receive benefits under, a state unemployment compensation law.[15]

IRS Enforcement of Noncompliance

The IRS' newly created OCS compliance steering committee is designed to help identify, develop, resolve and improve IRS coordination of issues related to OCS activities. In addition, the IRS advises employers subject to these withholding rules to provide all information related to OCS employment tax obligations directly to the examiner instead of filing delinquent returns with the Campus Centers, which will facilitate the proper calculation of employment tax. Some specific requirements under Directive #2 for OCS employers include: (A) accounting for quarterly employment tax periods during which an OCS employer had no employees working on the OCS by placing zeroes on the appropriate report; and (B) for employers with a continuing presence on the OCS, filing future quarterly employment tax return Forms 941 by using zeroes for any quarterly period during which they had no employees actually working in the OCS.

Examiners have been directed to notify the OCS compliance steering committee if the examiners are contacted by employers with questions about employment tax obligations for individuals employed on the OCS. With respect to planning and examination risk analysis, Directive #2 instructs examiners to address all relevant issues, including an employer's solicitation of Forms W-4, withholding, reporting, and payment of employment tax, and claims for tax exemption under an income tax treaty or totalization agreement and to challenge arguments by taxpayers who have not complied with the provisions of the Code relating to employment tax.

In conclusion, employers that employ nonresident alien individuals on the OCS should focus on their withholding obligations and should be prepared for potential IRS inquiries. OCS employers may also need to consider making adjustments to their tax compliance protocol going forward to ensure that the proper forms are filed with the IRS.

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[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code").
[3] *See* Andrius R. Kontrimas & Robert C. Morris, *Where is the "United States" for Federal Tax Purposes?*, 36 TEX. TAX LAW. 9 (2009).
[4] IRC sections 864(b) and 638(1); Treas. Reg. sections 1.638-1(a) and (c).
[5] IRC section 871(b).
[6] IRC section 1441(c)(4); Treas. Reg. section 1.1441-4(b)(1).
[7] IRC section 3401(a).
[8] Treas. Reg. section 31.3401(a)(6)-1(f).
[9] Notice 2009-91, 2009-48 IRB 717.
[10] Notice 2011-12, 2011-8 IRB 514.
[11] Treas. Reg. sections 31.3121(b)-3(b) and 31.3306(c)-2(b).
[12] IRC sections 3101, 3111 and 3121(a).
[13] IRC section 3301 and 3306.

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[14] The Social Security Administration's website provides a list of countries with which the U.S. has entered into a totalization agreement: http://www.ssa.gov/international/agreements_overview.html.
[15] Rev. Rul. 75-87, 1975-1 CB 325.

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REPORTING UNCERTAIN TAX POSITIONS HEIGHTENS PRESSURE ON PRIVILEGE CONCERNS

By: *Marcus Brooks*[i]

The Internal Revenue Service (IRS) in 2010 set forth a draft "Schedule UTP" requiring certain taxpayers to disclose with their tax return "uncertain tax positions." The determination of what exactly constitutes an uncertain tax position is driven largely by Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," (FIN 48) which imposes various assurance requirements on companies who issue financial statements in compliance with GAAP**.**

The disclosure of "uncertain tax positions" created by FIN 48, the opinion of the First Circuit Court of Appeals in *Textron*, discussed below, and now Schedule UTP have created much hand-wringing and analysis among large public companies and those who represent them. Up to this point, these issues may not have received as much attention from more moderately-sized private companies. However, for midsized private companies that will fall under the purview of Schedule UTP, Schedule UTP puts more pressure on these issues.

Early considerations of attorney-client privilege, attorney work product doctrine, and related issues will help mitigate the increased exposure resulting from these new developments.

<u>FIN 48</u>

FIN 48 provides the GAAP-required process for estimating potential tax liabilities that may arise from uncertainty associated with tax positions. This process requires the exercise of careful judgment, can be highly subjective, and often involves the consideration of sensitive taxpayer information. FIN 48 is full of complexity and nuance but a simple overview will suffice for present purposes.

The application of FIN 48 involves two major steps. First, a tax position is measured against a more likely than not standard. If it does not meet this threshold, the taxpayer must reserve on its financial statements all benefits associated with the position. Second, even where the more likely than not threshold is met, where a position is not "highly certain" the financial statement issuer must determine the likely settlement value of the tax position claimed and establish a partial reserve based on that number. Note: no reserve is required for immaterial positions.

This process often involves the creation of very sensitive tax analyses that consider the most significant weaknesses in a taxpayer's reported tax positions and may include a review of the analyses by an outside auditor, which may waive any attorney-client privilege that might otherwise have been associated with such documents and, more broadly, the subject matter they cover. Further, the discovery of these tax analyses would often provide the IRS with its best possible audit ammunition, as it is the type of information that is very difficult and time-consuming for an IRS auditor to develop.

United States v. Textron, 577 F.3d 21 (1st Cir. 2009) (en banc)

The First Circuit's opinion in *Textron*, combined with FIN 48, has caused a great deal of consternation, especially within the world of large public companies and their tax professionals. The First Circuit's *en banc* decision in *Textron* generally holds that there is no attorney-client privilege associated with tax accrual workpapers containing risk assessments of tax positions when those assessments are disclosed to the CPA firm auditing the issuer's financial statements; such disclosure waives any attorney-client privilege that may have existed. *Textron* also holds that these tax accrual workpapers are not entitled to attorney work product protection (which is stronger than attorney client privilege in the respect that it is not waived by mere disclosure to any third party) because the Court reasoned that these documents did not meet the Court's work product test of having been prepared in anticipation of litigation. Rather, the Court reasoned, these assessments were prepared for financial accounting purposes.

Textron thus effectively makes all of the tax position analyses developed in furtherance of the FIN 48 process subject to discovery by the IRS. *Textron* is technically binding only within the First Circuit (Maine, Massachusetts, New Hampshire, Rhode Island, and Puerto Rico). The United States Supreme Court has declined the opportunity to review the First Circuit's decision in *Textron*. *See Textron, Inc. v. United States*, 2010 U.S. LEXIS 4373 (U.S. May 24, 2010) (denying Textron's petition for writ of certiorari). There is significant debate regarding whether it was correctly decided and whether other circuits will follow suit, but it has received a great deal of discussion and attention as the seminal case regarding the discovery of tax accrual workpapers and will no doubt continue to be influential.

United States v. Deloitte, LLP, 610 F.3d 129 (D.C. Cir. 2010)

The U.S. Court of Appeals for the District of Columbia Circuit subsequently issued an opinion that gives taxpayers further reason to hope that *Textron* is not the categorical victory that the IRS hopes it to be. In *United States v. Deloitte, LLP*, 610 F.3d 129 (D.C. Cir. 2010), the D.C. Circuit ruled that a memorandum prepared by an outside auditor *could* constitute protected attorney work product to the extent that the memorandum contained thoughts and analysis by the client's attorney with respect to potential litigation. The D.C. Circuit remanded to the district court for a determination of whether, and to what extent, the memorandum did constitute work product. The D.C. Circuit also held that work product protection was not waived by disclosure to a financial auditor with respect to the memorandum in question as well as two other documents, which were conceded by the government to constitute work product – one a memorandum and flow chart prepared by an in-house attorney and an accountant and the other a tax opinion prepared by outside counsel. The *Deloitte* opinion, as it currently stands, supports (i) a broader interpretation of work product protection and (ii) the position that such protection is not waived by FIN 48-related disclosures to financial auditors.

Schedule UTP

Adding insult to the injuries from FIN 48 and *Textron*, the IRS announced in IRS Announcement 2010-9, 2010-7 IRB 408, that it will require from certain taxpayers the disclosure of "uncertain tax positions" on a schedule to be filed with a taxpayer's tax return. IRS Announcement 2010-30, 2010-19 IRB, included a draft "Schedule UTP" and draft instructions.

Under Announcement 2010-9, for 2010, Schedule UTP was to be filed with Form 1120, U.S. Corporation Income Tax Return, by taxpayers with total assets in excess of $10 million and who issue financial statements audited in accordance with GAAP or a foreign equivalent (for example, International Financial Reporting Standards). The initial instructions for Schedule UTP required, *inter alia,* a concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statements, including the rationale for the position and a general statement of the reasons for determining that the position is an uncertain tax position. Those instructions also required disclosure of the maximum amount of potential federal tax liability attributable to each uncertain tax position in the event that the IRS completely prevails on the issue (i.e. with no credit for a taxpayer's view of the merits of its position).

Uncertain tax positions that must be reported were also to include positions related to the determination of any United States federal income tax liability for which a taxpayer or a related entity has not recorded a tax reserve because (i) the taxpayer expects to litigate the position, or (ii) the taxpayer has determined that the IRS has a general administrative practice not to examine the position ("administrative practice tax positions"). Tax positions that are reasonably conservative and well-founded can fall into this category.

It first appeared unlikely that any significant IRS pull-back would result from the comments received with respect to draft Schedule UTP and its draft instructions. In announcing the upcoming Schedule UTP proposal at the January 26 meeting of the New York State Bar Association Tax Section, IRS Commissioner Douglas Shulman stated: "We could've asked for more. A lot more. But we chose not to." The IRS has not yet asked for all of the discoverable information in the workpapers, Shulman granted, but he reminded his audience that the IRS has court decisions allowing it to subpoena workpapers whenever it wants.

Despite a deluge of negative comments regarding Schedule UTP – including by the American Bar Association's (ABA) Standing Committee on Governmental Affairs, the ABA Tax Section, and the Tax Executives Institute, among others – the IRS initially stood its ground. IRS Chief Counsel William J. Wilkins on June 18 stated that, while the IRS was reviewing a large volume of public comments on the draft UTP schedule, it did not anticipate releasing a second draft of the proposal for additional comment and was actually close to becoming publicly silent on Schedule UTP while shifting focus to determining its final form.

Nevertheless, in Announcement 2010-75, 2010-41 IRB, issued on September 24, the IRS made some changes to its draft Schedule UTP requirements in response to a number comments. The principle changes are

(i) instituting a five-year phase-in of the reporting requirement based on a corporation's asset size ($100 million asset threshold for 2010; $50 million for 2012, $10 million for 2014);

(ii) replacing the requirement to report maximum tax adjustments for positions with rankings of those positions based on the sizes of their respective tax reserves (taxpayers are required to "designate" positions exceeding 10% of the aggregate reserve);

(iii) eliminating the requirement to report the rationale and nature of uncertainty as part of the "concise description" of the position; and

(iv) eliminating the requirement to report administrative practice tax positions.

The final (or at least current) version of Schedule UTP and its instructions are currently available on the IRS website. The IRS is also evaluating additional options for penalties or sanctions to be imposed when a taxpayer fails to make adequate disclosure of the required information regarding its uncertain tax positions. The IRS has mentioned opening exams based on apparent failures to appropriately complete Schedule UTP. Another option being considered is to seek legislation imposing a penalty for failure to file Schedule UTP or to make adequate disclosure. The IRS is still considering when to require the filing of Schedule UTP by pass-through entities and tax-exempt organizations.

Schedule UTP may significantly raise the stakes regarding the ramifications of FIN 48 for private companies that in the recent past have generally not expected to be subject to an IRS audit. Having potentially discoverable materials where there is little expectation of an IRS audit is one thing; affirmatively reporting all related "uncertain tax positions" with your tax return is quite another.

In short, the combination of FIN 48, *Textron*, and Schedule UTP means that the IRS will now require covered taxpayers to disclose uncertain tax positions on a going-forward basis (*i.e.*, tax positions taken in years before 2010 need not be reported) taken, the relative value to the government of the issue, and an explanation of the issue. The IRS can then, based on this disclosure with the tax return, request all of the taxpayer's detailed analyses of the issue, all of which under *Textron* is ostensibly freely discoverable by the IRS. While the decision in *Deloitte* and the IRS's own policy of restraint will hopefully mitigate these issues to some extent, this level of self reporting combined with fully discoverable taxpayer materials is a sea change from the level of self reporting in which most taxpayers expect to be required to engage.

<u>Public Company Dynamic Contrasted with Midsized Private Companies</u>

Public companies and the largest private companies that issue financial statements under GAAP or similar international reporting standards frequently receive pre-return advice from law firms or their tax departments. Further, many of these entities live under perpetual IRS audit or are at least frequently audited and view an IRS audit as a likely occurrence requiring planning and preparation.

However, smaller and midsized private companies that issue audited financial statements face a very different scenario. Many do not have in-house tax departments and only receive tax advice from the CPA firm that prepares their tax returns. Further, many of these companies rely solely on a single CPA firm for both tax and attestation functions. In those situations, the firm will be performing an attest function on its own tax decisions regarding FIN 48 and will be detailing, for filing with the client's tax return, its own tax advice. These professionals are put in a more difficult position than those firms that are performing financial statement audits for large public companies who have generated most of their tax planning either in-house or through third party law firms or tax advisors.

In addition, many of these moderately-sized private companies view the likelihood of an IRS audit as low. For companies under perpetual audit or under pre-filing scrutiny by the IRS through the Compliance Assurance Program, Schedule UTP is not a minimal consideration, but it is somewhat mitigated by the fact that it will often be reporting information which has already to some extent been brought to the attention of the IRS. For private companies that have not had any significant contact with an IRS auditor in a long time, if ever, the information contained on Schedule UTP will be the initial exposure to the IRS of these companies' most sensitive tax positions.

At an April 22 tax lecture co-sponsored by New York University and KPMG LLP, J. Richard "Dick" Harvey Jr., senior adviser to the IRS commissioner, spoke in response to the question of whether IRS auditors will examine every uncertain tax position identified on Schedule UTP. Harvey repeated the answer that Heather Maloy, commissioner of the IRS Large and Midsize Business Division, gave at a recent Tax Executives Institute meeting, saying that all issues identified on Schedule UTP will be evaluated, but that does not mean they will be challenged.

Taxpayers likely took no comfort from this statement. The fact that the IRS may decide that a taxpayer's treatment of an uncertain item is correct underscores that private companies who have heretofore been largely flying under the radar will, through Schedule UTP, be inviting a level of scrutiny that they have not to this point experienced.

<u>The combined effect of FIN 48 and Schedule UTP presents new potential challenges to the Attorney-Client Privilege and Attorney Work Product Protections.</u>.

A number of attorney-client privilege and attorney work product doctrine issues may be relevant in mitigating the increased tax risk exposure to companies stemming from the preparation of financial statements in accordance with FIN 48 and the preparation of Schedule UTP.

The IRS has stated in Announcement 2010-76, 2010-41 IRB that, under its "policy of restraint," if documents that are otherwise privileged or attorney work product were disclosed to an auditor as part of an audit of the taxpayer's financial statements, the IRS will not argue that such disclosure waived the privilege, unless unusual circumstances exist or the taxpayer has claimed the benefits of a listed transaction. While it is not clear what constitutes "unusual circumstances," and while this policy is an internal IRS policy that is not enforceable against the IRS, this position is some nod to the result reached in *Deloitte*. Under *Deloitte* and this policy of restraint, there will be a premium on making certain that any sensitive materials are originally entitled to claims of privilege or work product protection.

Most recently, on March 4, 2011, the IRS issued additional information in the form of seven Frequently Asked Questions on Schedule UTP. Interestingly, Question #6 asks whether the changes to the IRS's policy of restraint from Announcement 2010-76 apply to document requests by IRS counsel in Tax Court. The IRS answers that "In general, Counsel attorneys will not issue discovery requests for documents or information that the IRS would not seek under its policy of restraint," and states that the application of the policy of restraint in Tax Court litigation will be addressed in a revision to the Chief Counsel Directives Manual.

Depending on the circumstances, there are a number of ways in which early attention from a contested tax / privilege perspective might mitigate a company's increased exposure from the application of FIN 48, *Textron*, and Schedule UTP.

For example, the retention of separate tax controversy counsel to evaluate uncertain tax issues in anticipation of litigation, separate and apart from tax planning and from the FIN 48 framework, may bolster attorney work product protection arguments. Schedule UTP may actually bolster attorney work product claims in this regard, as it makes it more reasonable for a taxpayer to expect a controversy with respect to certain matters disclosed on Schedule UTP. In light of *Textron*, however, it will be important to make clear that such engagement was undertaken primarily because of the expectation of a controversy – not for the purposes of FIN 48 compliance. The D.C. Circuit's opinion in *Deloitte* may provide some support and guidance along this line.

Additionally, it is important to remember that anything reported on a tax return is effectively an admission by the taxpayer that is difficult to overcome in any resulting controversy. Thus, careful attention must be paid to the disclosures required by Schedule UTP to ensure that items are made sufficiently clear that the IRS's interest will not be piqued where it is not justified but also that disclosures use an economy of words so as not to result in a controversy where none need exist or to create unnecessary difficulties in any resulting controversy.

Also, in the preparation of materials to be used in supporting FIN 48 figures or Schedule UTP, it is intuitive that the less shown to third parties the better, with respect to preserving privilege over documents containing any detailed tax analysis. However, tax sensitivity must be balanced with the requirements of FIN 48 and Schedule UTP, and in some circumstances added disclosures may actually be more protective of client interests.

For example, Schedule UTP and its draft instructions include in the definition of "uncertain tax positions" not only positions that have given rise to a tax reserve under FIN 48 but also positions for which a taxpayer or a related entity has not recorded a tax reserve because the taxpayer expects to litigate the position. As previously mentioned, the application of the attorney work product doctrine hinges on a determination of whether the material in question was prepared "in anticipation of litigation." Thus, in the absence of a disclosure on Schedule UTP, the IRS may argue that no attorney work product doctrine protection applies to the materials in question. Taxpayers could respond either by stating that the position was highly certain or immaterial, thus providing an alternate explanation for the absence of a tax reserve, but depending on the facts these arguments might not be supportable.

The initial proposed instructions to Schedule UTP included one example of the expectation to litigate:

> A corporation takes a position that it can exclude certain income from its 2010 tax return. On September 30, 2010, the corporation determines that, if the IRS had full knowledge of the tax position, there is less than a 50% probability of settling the issue with the IRS. The corporation also determines that, if the tax position were litigated, it has a 60% probability of prevailing in the litigation. Based upon these determinations, the corporation did not record a reserve for the tax position. Because the corporation made a decision not to record a reserve with respect to its 2010 tax position based on a determination, consistent with applicable accounting standards, that it will litigate, rather than settle, the issue with the IRS and that the corporation will prevail in the litigation, and because that decision was made

> more than 60 days before filing its 2010 tax return, the corporation must report this tax position on the Schedule UTP filed with its 2010 tax return.

Without opining on the propriety of the IRS's interpretation of FIN 48 here, the rule appears to be that a taxpayer who does not record a reserve for a position under FIN 48 because it expects to litigate the position and to prevail in such litigation must still report such position on Schedule UTP where such position is not highly certain. Announcement 2010-75 confirms this view.

While there will be a natural inclination for private companies unfamiliar with IRS audits to report as little as possible to the IRS (and while this may well be a correct instinct), in this situation a failure to report the position in question on Schedule UTP might very well result in no work product doctrine protection for any underlying materials. "If litigation were anticipated, this issue would have been disclosed on Schedule UTP. Since it was not, you must not have anticipated litigation, and thus the attorney work product doctrine is inapplicable," so the argument would go.

This could be a particularly difficult question to analyze in a situation where the taxpayer is confident that its tax position is correct (such that it is arguably highly certain), but there is still some colorable chance that the IRS will challenge it. One example of such a situation would be where the IRS has lost this issue in another jurisdiction but not yet challenged it in the taxpayer's jurisdiction, and it is not clear whether the IRS has given up on the issue.

Decisions related to the execution of FIN 48 or the preparation of Schedule UTP will be very fact specific and require careful thought. Early consideration of contested tax issues and the attendant privilege and work product questions could prove to be quite beneficial. Consideration of these issues after-the-fact may be too late to be of significant value.

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A Field Guide to Cancellation of Debt Income

MARTIN J. MCMAHON, JR. AND DANIEL L. SIMMONS*

I. Introduction

The United States is awash in a sea of debt. In June 2009, there was more than $14 trillion of mortgage debt outstanding—approximately $11 trillion on one to four family residences, approximately $900 billion on multifamily residences, slightly more than $2.5 trillion on nonfarm nonresidential real estate, and $111 billion on farms.[1] Over $2.5 trillion dollars of consumer debt was outstanding as of May of 2009.[2] At the end of June of 2009, over $ 1.2 trillion of commercial paper was outstanding.[3] At the end of the first quarter of 2009, over $11 trillion of nonfinancial business debt, approximately $7.2 trillion of which was owed by corporations, was outstanding.[4]

Many individuals and businesses are drowning in that debt. In the midst of the most severe recession since the Great Depression, major corporations, such as the American icon General Motors, have been unable to pay their debts and have gone into bankruptcy. Millions of individuals and small businesses have defaulted on their debts. Loan delinquencies and charge-offs are at levels heretofore unknown in the modern financial era. According to the Federal

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[1] FED. RESERVE STATISTICS AND HISTORICAL DATA, MORTGAGE DEBT OUTSTANDING (2009), *available at* http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

[2] FED. RESERVE STATISTICAL RELEASE, CONSUMER CREDIT (2009), *available at* http://www.federalreserve.gov/releases/g19/current/g19.htm. This category "covers most short- and intermediate-term credit extended to individuals," including revolving credit, "automobile loans, and all other loans not included in revolving credit, such as loans for mobile homes, education, boats, trailers, or vacations, but excluding loans secured by real estate. These loans may be secured or unsecured." *Id.*

[3] FED. RESERVE STATISTICAL RELEASE, CONSUMER PAPER (2009), *available at* http://www.federalreserve.gov/releases/cp/outstandings.htm. "Commercial paper consists of short-term, promissory notes issued primarily by corporations. Maturities range up to 270 days but average about 30 days." FED. RESERVE RELEASE, ABOUT COMMERCIAL PAPER (2006), *available at* http://www.federalreserve.gov/releases/cp/about.htm.

[4] BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES 3 (2009), *available at* http://www.federalreserve.gov/releases/Z1/current/Coded/coded.pdf.

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Reserve Board, bank loan charge-off rates more than quadrupled from the first quarter of 2006 to the first quarter of 2009; the charge off rate in the first quarter of 2009 exceeded 2%.[5] In that same period, loan delinquency rates more than tripled and stood at 5.6% in the first quarter of 2009.[6] Almost 8% of residential real estate loans and 6.4% or commercial real estate loans were in default.[7] In the spring of 2009, the Mortgage Bankers Association reported that the share of loans entering foreclosure rose to 1.37%, the highest on record going back to 1972.[8] The number of bankruptcies filed in 2008 totaled 1,117,771, up from 850,912 bankruptcies filed in 2007.[9]

Every loan charge-off and mortgage foreclosure has tax consequences. While the creditor most often claims a bad-debt deduction or business-related loss,[10] the debtor generally must recognize gross income and pay income taxes on an amount roughly equal to the creditor's loss, unless a special exception applies to exclude the debt relief from income.

Almost every form of gross income required to be included under section 61 entails the receipt of money, property, or services of value (or the accrual of the right to receive money, property, or services in the year of receipt). The requirement that a debtor pay taxes when a loan goes unpaid is one of only a few situations in which a tax obligation arises without the contemporaneous receipt of valuable consideration. That the debtor must pay taxes in the

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[5] Fed. Reserve Statistical Release, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks: Charge-Off Rates (2009), *available at* http://www.federalreserve.gov/releases/chargeoff/chgallsa.htm.

[6] Fed. Reserve Statistical Release, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks: Delinquency Rates (2009), *available at* http://www.federalreserve.gov/releases/chargeoff/delallsa.htm. "Delinquent loans . . . are those past due thirty days or more and still accruing interest as well as those in nonaccrual status." Fed. Reserve Statistical Release, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks (2009), *available at* http://www.federalreserve.gov/releases/chargeoff/.

[77] Fed. Reserve Statistical Release, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks: Delinquency Rates (2009), *available at* http://www.federalreserve.gov/releases/chargeoff/delallsa.htm.

> Residential real estate loans include loans secured by one- to four-family properties, including home equity lines of credit, booked in domestic offices only. Commercial real estate loans include construction and land development loans, loans secured by multifamily residences, and loans secured by nonfarm, nonresidential real estate, booked in domestic offices only.

Id.

[8] Kathleen M. Howley, *Mortgage Delinquencies, Foreclosures, Rates Increase*, Bloomberg.com, May 28, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aE_j_CA8fCao.

[9] Press Release, U.S. Courts, Bankruptcy Filings Up In Calendar Year 2008 (March 5, 2009), *available at* http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsDec2008.cfm.

[10] Losses incurred in a business or investment (other than bad-debt deductions) are deductible under section 165. Bad debts arising from a trade or business are deductible under section 166. *See* Boris I. Bittker, Martin J. McMahon, Jr. & Lawrence A. Zelenak, Federal Income Taxation of Individuals ¶¶ 16.1–16.7, 17.1–17.8 (3d ed. 2002).

year in which it is determined that a loan will not be repaid follows from the proposition that a borrower is not required to include loan proceeds in gross income upon receipt and thus not required to pay taxes at that time.[11]

This Article deals with the tax consequences to the debtor of the discharge of a debt for less than full payment.[12] Part II explain the origins and rationale for the rule, now codified in section 61(a)(12), that requires the inclusion of "[i]ncome from discharge of indebtedness." Part III examines the various events that trigger recognition of income under section 61(a)(12). Part IV deals with the manner in which the amount of income from discharge of indebtedness is computed. This part also discusses the tax consequences to a business entity that issues an equity interest to a creditor to satisfy a debt. Part V explores the myriad of statutory rules in section 108 that permit nonrecognition of income from discharge of indebtedness under particular circumstances, and the various ancillary consequences that follow from non-recognition. Throughout, the Article will explore the relationship of income from discharge of indebtedness to realization of gain from the transfer of property to satisfy a debt by contrasting the tax consequences of transfers of property to discharge a debt with the consequences of discharge of a debt for less than full payment.

II. The Origins of the Income from Cancellation of Debt Principle

If the loan transaction is viewed as a whole, when a borrower receives money in a loan transaction and is later discharged from the liability without repaying the debt, the borrower has realized an accession to wealth. Recognizing the existence of income in this situation generally is not a problem for the income tax system. The receipt of the proceeds of a loan is not income because the receipt is offset by an obligation to repay the borrowed amount. If the obligation to repay the borrowed amount is eliminated or reduced without the concomitant repayment, the borrower realizes an accession to wealth that, as a matter of tax theory, should be included in gross income.[13]

A. *Tax Consequences of Incurring Debt*

Gross income is based on the presence of an accession to wealth (*i.e.*, an economic benefit). As a fundamental principle of tax, borrowed funds are excluded from gross income because the obligation to repay borrowed funds offsets the economic increment even though borrowed funds increase a taxpayer's assets and can be used as the taxpayer sees fit.[14] As stated by the Supreme Court in *Commissioner v. Tufts*,

[11] *See infra* Part II.A.

[12] *See* Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. TAX REV. 1 (1990) (giving an early comprehensive survey of the issues and rules).

[13] *Id.* at 6–7.

[14] Commissioner v. Tufts, 461 U.S. 300, 307 (1983).

> When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.[15]

If borrowed money is used to acquire property, the taxpayer's basis in the property under section 1012 is the full purchase price, including the borrowed funds applied to the purchase price.[16] The repayment of the borrowed funds is a prerequisite to full enjoyment of ownership and therefore represents a cost of the property. Upon the sale of the property, the borrower's gain is the sales proceeds minus the cost of the property, including the borrowed funds.[17]

The same principles apply whether the loan is a recourse loan or a nonrecourse loan (*i.e.*, one with respect to which the creditor's rights upon default are limited to foreclosing on property secured by the loan). No gross income is realized upon the receipt of the proceeds of a nonrecourse loan, even if the amount of the loan exceeds the basis of the property.[18] Furthermore, if the acquisition of property is financed through nonrecourse borrowing, the taxpayer generally acquires a normal section 1012 cost basis in the debt-financed property.[19] Even if the borrower has no personal liability to repay the debt, just as is the case with recourse debt, before the borrower can dispose of the property and enjoy the fruits of an economic gain, the full amount of the borrowed capital must be returned to the lender. Thus, the borrower's gain is determined by subtracting from the full proceeds of borrowing the full amount of a purchase-money nonrecourse loan (and any other cost of the property).

Because the borrowing of money is not a realization event, and property acquired with borrowed funds or in exchange for the purchaser's promissory note to the seller takes a section 1012 cost basis equal the full value of the consideration provided by the buyer, tax consequences must attach to the

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[15] *Id.*

[16] *See* Brons Hotels, Inc. v. Commissioner, 34 B.T.A. 376, 379–80 (1936) ("Petitioner, as the owner of the Walton Hotel, was entitled to take—and required to take—as a 'basis' for determining gain or loss upon the sale or other disposition of such property the cost thereof [I.R.C. § 1012]. When it acquired the property, it received, as part of its cost, the benefit of the mortgage which it assumed, although it actually acquired only an equity in the property."); *see also Tufts*, 461 U.S. at 307–08 ("Another consequence to the taxpayer from this obligation occurs when the taxpayer applies the loan proceeds to the purchase price of property used to secure the loan. Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property; the loan, under section 1012, is part of the taxpayer's cost of the property.").

[17] *See Brons Hotels, Inc.*, 34 B.T.A. at 381; Crane v. Commissioner, 331 U.S. 1, 11 (1947); *Tufts*, 461 U.S. at 308–09.

[18] Milenbach v. Commissioner, 318 F.3d 924, 930 (9th Cir. 2003); Woodsam Assocs. v. Commissioner, 198 F.2d 357, 359 (2d Cir. 1952).

[19] Mayerson v. Commissioner, 47 T.C. 340, 352 (1966); *see also Tufts*, 461 U.S. at 309 ("no difference between recourse and nonrecourse obligations is recognized in calculating basis").

debtor subsequently being discharged from the debt obligation for less than full payment.

B. *Tax Consequences of Cancellation of Debt*

1. *General Background*

If a taxpayer renegotiates the amount of the debt owed or is otherwise able to discharge the debt for less than its original amount, the taxpayer generally must recognize gross income under section 61(a)(12), subject to the various exclusions and special rules in section 108. Although section 61(a)(12) refers to income from the "discharge of indebtedness," the term "cancellation of indebtedness income" is a more accurate description of the transaction, and, in fact, the income includable under section 61(a)(12) is commonly termed "COD" income, the acronym referring to "cancellation of debt." Cancellation of debt is the terminology that we will use. This change in terminology reflects the fact that section 61(a)(12) applies when a debt is "discharged" for less than full payment to the creditor or is "cancelled" in whole or in part, but section 61(a)(12) has no relevance when a debt is "discharged" either by full payment or by a novation agreement under which a third party assumes the taxpayer's liability for the debt.

Section 61 (a)(12) represents a codification of the Supreme Court's seminal 1931 decision in *United States v. Kirby Lumber Co.*,[20] a landmark case involving a corporation that had issued about $12 million of bonds and later repurchased some of them for about $138,000 less than their face amount. In holding that the transaction generated gain, the Supreme Court said:

> [T]he taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 [of] assets previously offset by the obligation of bonds now extinct. . . . The [taxpayer] has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here.[21]

Although the result in *Kirby Lumber Co.* is clear, the rationale is not necessarily so transparent.[22]

2. *Ambiguities in the* Kirby Lumber Co. *Rationale*

The language of *Kirby Lumber Co.* suggests two separate theories for the result. On the one hand, if a debt is cancelled and the borrower is relieved of the duty to repay the loan, the cancellation of the debt has tax consequences because the benefit of receipt of cash at the time of the borrowing with-

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[20] 284 U.S. 1 (1931).

[21] *Id.* at 3; *see also* Helvering v. Am. Chicle Co., 291 U.S. 426, 430 (1934) (taxpayer recognized cancellation of debt income on its purchase for less than face value of a predecessor corporation's bonds, which had been assumed by the taxpayer when purchasing the predecessor's assets several years earlier).

[22] *See* Theodore P. Seto, *The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System*, 51 Tax L. Rev. 199, 202–03 (1996).

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out realization of income is offset by elimination of repayment, producing an overall economic benefit to the borrower.[23] Alternatively, as suggested by the second sentence of the quotation above, the borrower has gross income because the borrower's net worth has been increased with an elimination of the obligation to return borrowed funds.[24]

Depending on which of these theories is applied, the consequences that flow from the debt cancellation might differ. *Kirby Lumber Co.* often has been interpreted to be grounded on the rationale that when a debt is discharged for less than full repayment, the portion of the debt cancelled without payment is income because the borrower's net worth has been increased. Some of the provisions in section 108 reflect the "increase in net worth" origins of the rule. The focus in *Kirby Lumber Co.* on the freeing of the taxpayer's assets from the obligation of its cancelled indebtedness raises a question whether it is simply the reflected balance sheet improvement resulting from eliminating the offsetting obligation that creates gross income on the cancellation of indebtedness, or whether the existence of cancellation of debt income depends on the presence of some other factor.

In *Commissioner v. Jacobson*, the Supreme Court repeated both formulations.[25] In *Jacobson*, the Supreme Court held that an individual recognized cancellation of indebtedness income on the repurchase of his personal bonds for an amount less than their issue price.[26] The Court pointed out that the taxpayer's acquisition of his bonds improved his "net worth" by the difference between the face amount of the bonds and the acquisition price. The Court noted that, "[i]n the first instance [Jacobson] had received the full face amount in cash for these bonds so that his repurchase of them for 50 percent, or less, of that amount reflected a substantial benefit which he had derived from the use of that borrowed money."[27]

Some cases have analyzed *Kirby Lumber Co.* by comparing the consideration received in exchange for the taxpayer's note with the payment made to discharge the obligation. In *Commissioner v. Rail Joint Co.*, the taxpayer issued bonds as a dividend to shareholders and accounted for the bonds on the corporate books at their face value.[28] When the corporation repurchased the bonds for less than their face amount, the Commissioner asserted that the corporation realized cancellation of debt income because its balance sheet was improved by removing the bonds as a corporate liability while the corporate assets were reduced only by the lesser amount used to repurchase the bonds. The court disagreed and held that in applying *Kirby Lumber Co.*, "the consideration received for the obligation evidenced by the bond as well as the consideration paid to satisfy that obligation must be looked to in order to

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[23] *See Kirby*, 284 U.S. at 3.
[24] *Id.*
[25] 336 U.S. 28 (1949).
[26] *Id.* at 38.
[27] *Id.* at 38–39.
[28] 61 F.2d 751 (2d Cir. 1932).

determine whether gain or loss is realized when the transaction is closed; i.e., when the bond is retired."[29] The Rail Joint Company did not have cancellation of debt income on retirement of its bonds because the corporation had not increased its assets at the time the bonds were issued. In fact, since the bonds were issued by the corporation as a dividend, the corporation had not received any assets in consideration of its issuance of the bonds. Viewing the transaction as a whole, the corporation received nothing that it did not possess prior to the opening and closing of the bond transaction, and thus there was no gain to be treated as income.[30]

The Tax Court reached the same conclusion in *Fashion Park, Inc. v. Commissioner*.[31] The taxpayer corporation had issued debenture bonds, each with a stated face value of $50, in a tax-free reorganization in exchange for shares of its preferred stock that also had a par and stated value of $50 per share. The preferred stock had been issued for $5 per share, and the $45 difference between the cash consideration received and the $50 face value of the stock had been transferred from earned surplus to paid-in capital on the corporation's books. The Tax Court held that no cancellation of debt income was realized when the taxpayer subsequently purchased some of the bonds for an amount in excess of $5 each, but less than $50 each, citing *Rail Joint* as authority.[32]

A number of early cases followed the freeing of assets branch of the *Kirby Lumber Co.* reasoning to hold that no gross income was realized from the cancellation of debt when the debtor taxpayer was insolvent at the time of the debt cancellation. For example, in *Dallas Transfer & Terminal Warehouse*

[29] *Id.* at 751–52.

[30] It is not entirely clear whether the taxpayer in *Kirby Lumber Co.* actually received full value for the issue of its bonds. The bonds were issued in exchange for the taxpayer's preferred stock with dividends in arrears, but the case has often been thought to have involved bonds issued for cash, perhaps because the Supreme Court said that the taxpayer, on issuing the bonds, "received their par value." *See* Boris I. Bittker, *Income from the Cancellation of Indebtedness: A Historical Footnote to the* Kirby Lumber Co. *Case,* 4 J. Corp. Tax'n 124 (1977). The case was tried before the Court of Claims on a stipulation that the bonds had been issued for their par value. "Both the Court of Claims and the Supreme Court stated that the company had received par value when the bonds were issued." Daniel L. Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37*, 59 Or. L. Rev. 3, 36 n. 172 (1980) (citations omitted). These express statements, plus "the tenor of the Supreme Court's opinion, lead to the conclusion that" the Court's analysis is based upon the assumption that the Kirby Lumber Company received full value on issue of the bonds. *Id.*

[31] 21 T.C. 600 (1954); *accord* U.S. Steel Corp. v. United States, 848 F.2d 1232 (Fed. Cir. 1988) (repurchase of bonds at less than face value did not give rise to cancellation of debt income because the bonds had been issued to redeem preferred stock with par value of less than repurchase price; thus the corporation had not increased its assets); *see also* Bradford v. Commissioner, 233 F.2d 935 (6th Cir. 1956) (note issued to bank to obtain reduction of debt owed by taxpayer's husband; taxpayer is described as issuing her note "without receiving any consideration in return," although it might have been treated as indirect way of getting cash to reduce husband's debt); Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990) (taxpayer did not realize income on cancellation of debt that "arose out of his acquisition of gambling chips").

[32] *Fashion Park,* 21 T.C. at 605.

Co. v. Commissioner, an insolvent debtor compromised a debt for less than its principal amount, and the Court of Appeals for the Fifth Circuit held that *Kirby Lumber Co.* did not require any of the cancelled debt to be included in gross income.[33] The court explained the reason as follows:

> In effect the transaction was to what occurs in an insolvency or bankruptcy proceeding when, upon a debtor surrendering, for the benefit of his creditors, property insufficient in value to pay his debts, he is discharged from liability for his debts. This does not result in the debtor acquiring something of exchangeable value in addition to what he had before. There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income.[34]

Dallas Transfer & Terminal Warehouse Co. was followed by the Board of Tax Appeals in *Quinn v. Commissioner*, in which debts of an insolvent taxpayer were cancelled for less than full payment.[35] The Board held that "[T]he cancellation of the mortgage in this case did not, as in *Kirby Lumber Co.*, supra, make available any assets to petitioner, and we hold that there was no realization of income from the transaction."[36]

Lakeland Grocery Co. v. Commissioner further developed the analysis of this branch of the *Kirby Lumber Co.* reasoning.[37] In *Lakeland Grocery*, the Board of Tax Appeals characterized the earlier cases as having found that income was not required to be recognized upon the forgiveness of debt where the taxpayer was insolvent both before and after the cancellation of debt. However, in *Lakeland Grocery*, although the taxpayer was insolvent before the forgiveness of indebtedness, it was solvent immediately thereafter. The Board of Tax Appeals limited the exclusion from gross income of cancellation of debt income to the amount of the taxpayer's insolvency. Thus, cancellation of debt income was realized to the extent the taxpayer's assets exceeded its liabilities after the cancellation—the extent to which it had assets freed from the claims of creditors that were no longer offset by its liabilities.[38]

Collins v. Commissioner is another example of a case that arguably applied the freeing of assets theory branch of the *Kirby Lumber Co.* rationale.[39] In that case, the taxpayer borrowed $15,000, and the loan was secured by a lien on corporate stock owned by the taxpayer having a value of only $300. The terms of the promissory note executed by the taxpayer limited the creditor's rights to foreclosure of the lien on the note and expressly provided that no deficiency action could be brought. Subsequently, at a time when the collateral

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[33] 70 F.2d 95, 96 (5th Cir. 1934).
[34] *Id.*
[35] 31 B.T.A. 142 (1934).
[36] *Id.* at 145.
[37] 36 B.T.A. 289 (1937).
[38] *Id.* at 292.
[39] 22 T.C.M. (CCH) 1467, T.C.M. (P-H) ¶ 63,285 (1963).

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was worth only $100, the debt was forgiven and collateral was returned. The Tax Court found that although there was no expectation by either the taxpayer or the creditor that the taxpayer would repay the amount advanced, the original receipt was not a gift. Nevertheless, the court held that the amount of cancellation of debt income was limited to the value of the collateral released. The court reasoned as follows:

> The indebtedness on this note was limited as to collectibility to the collateral given and therefore did not create a personal debt from petitioner to Roth Steel. For this reason the return of the note to petitioner in 1959 did not result in the cancellation of any personal indebtedness of petitioner. The return of the collateral did result in freeing that collateral for petitioner's use as he saw fit. If a note representing a valid personal indebtedness of a solvent taxpayer is returned and the debt represented thereby canceled under circumstances resulting in income to that taxpayer, the amount of income is measured by the indebtedness released irrespective of the value of the note. It is the cancellation of indebtedness, thus freeing the taxpayer's assets to the extent of the cancellation, which results in the income to the taxpayer whether or not the indebtedness is evidenced by a note. The return of a note which represents no personal liability of a taxpayer does not free any assets except those from which the note might otherwise have been paid.[40]

Accordingly, the court held that the taxpayer realized only $100 of cancellation of debt income, although the court did note that "[s]ince the only year before us is 1959, it is unnecessary for us to consider the effect of the transaction on petitioner's taxable income for the year 1957."[41]

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[40] *Id.* at 1471, T.C.M. (P-H) ¶ 63,285 at 1664.

[41] *Id.* Had the year in which the taxpayer received the loan in *Collins* been in issue, the correct treatment would have been to treat only $300 of the proceeds as a loan—an amount equal to the fair market value of the property securing the loan. *See* Geftman v. Commissioner, 154 F.3d 61, 68 (3d Cir. 1998) ("For 'disbursements to constitute true loans there must have been, at the time the funds were transferred, an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment.' Haag v. Commissioner, 88 T.C. 604, 615–16, *aff'd*, 855 F.2d 855 (8th Cir. 1988)."). *Milenbach v. Commissioner*, 106 T.C. 184 (1996), *rev'd* 318 F.3d 924 (9th Cir. 2003), also supports the inclusion in gross income of the amount by which the proceeds of a purported nonrecourse loan exceed the fair market value of the property securing the loan. In *Milenbach*, the partnership that owned the Oakland Raiders football team received a $6.7 million nonrecourse loan from the Los Angeles Coliseum Commission as an inducement to move the team from Oakland to Los Angeles. The loan was repayable only out of net rents that would be received by the Raiders from leasing luxury skyboxes in the Los Angeles Coliseum and was secured only by the skyboxes that the Raiders promised to build. In the year that loan proceeds were received, the skyboxes had not yet been built, but the Raiders partnership was required by the agreement to construct the skyboxes "as soon as practicable as determined by the Partnership in its reasonable discretion, having in mind . . . considerations deemed . . . important or significant to the partnership." *Id.* at 187. The skyboxes were never built. The Tax Court concluded that the standard for determining when the skyboxes would be built "gave the Raiders great latitude in timing the construction," which amounted to "unlimited discretion," and found that the obligation to construct the skyboxes was illusory. *Id.* at 196. Accordingly, the Raiders were required to include the funds in gross income upon receipt. The

Neither of the two potential rationales for *Kirby Lumber Co.* supports the notion that a taxpayer does not recognize cancellation of debt income if the borrowed funds are applied to a transaction that, when considered as a whole, results in an economic loss. However, prior to its decision in *Kirby Lumber Co.*, this latter principle was applied by the Supreme Court in *Bowers v. Kerbaugh-Empire Co.*, which held that a corporation that borrowed German marks before World War I, converted the borrowed marks into dollars, transferred the dollars to a subsidiary, which was unsuccessful and lost the funds, and then repaid the loans after the war with devalued marks that it purchased for substantially less in dollars than the dollar-value of the borrowed marks when they were received, did not recognize any gross income.[42] The Supreme Court stated: "The loss was less than it would have been if [the] marks had not declined in value; but the mere diminution of loss is not gain, profit, or income."[43]

Kerbaugh-Empire Co. has often has been read for the proposition that there is no cancellation of debt income when the whole transaction results in a loss.[44] This holding of *Kerbaugh–Empire Co.* is questionable because the Court linked the taxpayer's borrowing of German marks to its subsequent investment of the loan proceeds in its subsidiary corporation, failing to recognize the presence of two distinct transactions, the borrowing and repayment of marks, and the investment in stock of a subsidiary.[45] In any event, *Kerbaugh–Empire Co.* is now treated as an anomaly; the Service, the Tax Court, and the Court of Appeals for the Ninth Circuit have concluded that *Kerbaugh-Empire Co.* lacks precedential authority in light of subsequent

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Court of Appeals for the Ninth Circuit reversed the Tax Court's decision on appeal, on the grounds that the obligation to repay the loan was not illusory because, under California law, "a contract is not illusory if the obligated party's discretion must be exercised with reasonableness or good faith . . . . Here the Raiders were required to exercise their discretion reasonably and nothing in the [agreement] indicates that construction of the suites was optional." 318 F.3d 924, 930–31. Thus, even though the Tax Court's decision was reversed, the Ninth Circuit's opinion does not reflect a different view of the effect for tax purposes of an illusory obligation to repay, but only a different conclusion regarding whether the particular obligation in this case was illusory.

[42] 271 U.S. 170 (1926).

[43] *Id.* at 175.

[44] *See, e.g.*, Zarin v. Commissioner, 92 T.C. 1084, 1091 (1989), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990) (debtor realized no income because debt was not enforceable under state law).

[45] Section 988 now expressly requires assigning independent tax consequences to the two transactions. *See* I.R.C. § 988(a)(1)(A).

Supreme Court decisions.[46]

Bradford v. Commissioner is a rare application of the *Kerbaugh–Empire Co.* principle in the context of a debt-only transaction.[47] In *Bradford*, the taxpayer substituted her personal note in the amount of $100,000 for her husband's note to a bank in the same amount. Later, the creditor bank accepted $50,000 in a transaction that was treated by the bank as full satisfaction of the taxpayer's debt. The court rejected the Commissioner's assertion that the taxpayer realized cancellation of indebtedness income from the retirement of the debt for less than its face amount, reasoning that the taxpayer did not realize any economic gain from what was a loss transaction, citing *Kerbaugh-Empire Co.*[48] In *Bradford,* the taxpayer's borrowing did not result in the receipt of assets without realized gain, and thus the offsetting benefit of cancellation of the debt did not produce an overall gain on the transaction. Thus, the result in situations like *Bradford* can be rationalized as an application of the *Rail Joint Co.* principle, without reliance on *Kerbaugh-Empire Co.*

C. *Statutory Codification of Cancellation of Debt Rules*

Section 61(a)(12) was enacted in 1954 to codify the "discharge of indebtedness" as gross income principle. At the same time, Congress added section 108, which, although originally narrow in scope, now provides numerous exceptions to section 61(a)(12) under which a taxpayer may avoid recognizing cancellation of debt income, as well as a number of operating rules for calculating the precise amount of cancellation of debt income. In addition, section 1017 was enacted to require adjustments to the basis of property in certain instances when cancellation of debt income goes unrecognized under section 108.[49]

Recognize that section 61(a)(12) and judicial precedents establish the general principles governing realization of cancellation of debt income, and section 108 provides overriding and supplemental rules. However, because of the extensive detail in section 108, even when not expressly provided by the

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[46] *See* Vukasovich, Inc. v. Commissioner, 790 F.2d 1409, 1415–16 (9th Cir. 1986) (stating that *Kerbaugh-Empire Co.* was decided as a constitutional case and it is inconsistent with the Supreme Court's later decisions; "We have no doubt that an increase in wealth from the cancellation of indebtedness is taxable where the taxpayer received something of value in exchange for the indebtedness."); *Zarin*, 92 T.C. at 1088, 1091, 1096 (settlement for $500,000 of $3.4 million gambling debt owed to casino resulted in $2.9 million cancellation of indebtedness income even though transaction as a whole was a loss; declining to follow *Kerbaugh–Empire Co.*); Rev. Rul. 1992–99, 1992–2 C.B. 35 *(Kerbaugh–Empire Co.* has been discredited by subsequent Supreme Court cases).

[47] 233 F.2d 935 (6th Cir. 1956).

[48] *Id.* at 937.

[49] H.R. Rep. No. 88-1337, at 13 (1954).

statute, the Service and the courts tend to treat section 108 as providing the exclusive rules, supplanting prior judicial decisions with respect to issues that are addressed in the statutory provision.[50] Some judicial exceptions nevertheless survive in cases not addressed by section 108.[51]

D. *Relevance of the Nature of the Debt*

1. *Generally*

In theory, realization of cancellation of debt income does not depend on the nature of the debt. Nonetheless, many of the exceptions to recognition and other special rules under section 108 do depend on the nature of the debt. In addition, apart from specific exceptions in section 108, the use of borrowed funds does not affect whether cancellation of a debt gives rise to income realization. Regardless of the use of borrowed funds, a taxpayer generally realizes no income when funds are borrowed, because an offsetting obligation to pay in accordance with the terms of the loan arises along with the receipt of money or property. The asset is offset by a corresponding liability and the borrower has no increase in net worth as a result of the loan transaction based on the assumption that the taxpayer eventually will repay the debt.[52] The creation of the debt is generally accompanied by some tax favored treatment, which may be in the form of the tax-free cash received in a direct loan, or basis in property in the case of a debt-financed purchase, or a current deduction in the case of an accrual method taxpayer's debt for a deductible expense. In all of these instances, when the debt is discharged, in whole or in part, without payment, inclusion in gross income of cancellation of debt income is required to offset the original favorable tax treatment.

At times, however, the nature of the debt may affect these matters. In some cases, a taxpayer has not received favorable tax treatment when the debt was incurred, for example, a taxpayer who incurs a tort liability that is not connected with a business, which is later discharged for less than full payment. These types of situations give rise to more difficult questions in determining the existence and amount of cancellation of debt income.

2. *Nonrecourse Debts*

If a nonrecourse debt secured by real estate or other property is compromised for less than its principal amount and the borrower retains ownership of the property, the entire amount of the cancelled portion of the debt is realized as cancellation of debt income, without regard to the value of the released

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[50] *See, e.g.*, Gitlitz v. Commissioner, 531 U.S. 206, 215 (2001) (stating that section 108 provides exclusive insolvency exception); Preslar v. Commissioner, 167 F.3d 1323, 1332–33 (10th Cir. 1999) (section 108(e)(5) provides exclusive purchase price reduction exception).

[51] *See infra* Parts III.E., G.

[52] *See* discussion *supra* Part II.A.

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collateral,[53] unless the lender also sold the property to the taxpayer.[54] If, however, property subject to a nonrecourse debt is deeded to the lender in lieu of foreclosure, the entire amount of the nonrecourse debt is included in the amount realized on the sale of the property, even if the debt exceeds the fair market value of the property at the time of the transfer.[55] (In this respect, the transfer of property subject to a nonrecourse debt that is deeded to the lender in lieu of foreclosure is accorded the same treatment as a transfer of the property to a third party who merely takes the property subject to the debt.)

The amount realized through cancellation of a nonrecourse debt might be limited to the value of the collateral if the taxpayer did not receive a tax benefit from the cancelled debt. The regulations provide that relief from acquisition indebtedness is not included in amount realized "to the extent that such liability was not taken into account in determining the transferor's basis in such property."[56] For example, if the taxpayer acquires property subject to a nonrecourse debt that exceeds the value of the property and immediately pays the latter amount to discharge the debt, the taxpayer should not realize cancellation of debt income as long as the cancelled portion of the debt was not included in the taxpayer's basis for the property.[57] But in any case where the property was worth more than the existing debt when received, acquisition of the property subject to the liability is functionally equivalent to buying it with a nonrecourse purchase-money mortgage or purchasing it for cash and then pledging it for a nonrecourse loan; and if the debt is later settled for less

[53] *See* Gershkowitz v. Commissioner, 88 T.C. 984, 1013 (1987) (cancellation of debt income realized on cancellation of nonrecourse debt in consideration of cash payment in an amount less than debt); Rev. Rul. 1991-31, 1991-1 C.B. 19 (reduction to $800,000 of $1 million principal amount of secured nonrecourse debt, when value of collateral was $800,000, resulted in $200,000 cancellation of debt income); Fulton Gold v. Commissioner, 31 B.T.A. 519 (1934) (which permitted basis reduction rather than recognition of income, will not be followed); Rev. Rul. 1982-202, 1982-2 C.B. 35 (cancellation of debt income was realized upon prepayment of a nonrecourse mortgage on taxpayer's home at a discount).

[54] For the section 108(e)(5) "purchase price reduction" exception to the recognition of cancellation of debt income, see *infra* Part V.A.2.

[55] Reg. § 1.1001-2(b), -2(c), Ex. (7); *see* Yarbro v. Commissioner, 737 F.2d 479 (5th Cir. 1984). The same rule applies when property is transferred by the owner-debtor to a third person who takes the property subject to the debt; the transaction is a sale, no part of which is treated as a cancellation of debt. I.R.C. § 7701(g); Commissioner v. Tufts, 461 U.S. 300 (1983). *But see* Cozzi v. Commissioner, 88 T.C. 435 (1987) (holding that cancellation of debt income is realized in year taxpayer-partner abandoned to another partner all rights to a pornographic movie pledged to secure nonrecourse debt).

[56] Reg. § 1.1001-2(a)(3).

[57] *See* Hudson v. Commissioner, 103 T.C. 90 (1994) (holding that cancellation of debt income was not realized on discharge of purchase-money nonrecourse debt that was not included in the property's basis, and thus provided no tax benefit, because the promissory notes lacked economic substance and were not genuine), *aff'd on other issues by order*, 71 F.3d 877 (5th Cir. 1995); *see also* Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988) (holding that the portion of nonrecourse debt in excess of fair market value of property is not included in basis).

than its face amount, there is no sound reason for excluding the difference from income.

III. When Has a Debt Been Cancelled?

There are a variety of methods by which a debt can be discharged, in whole or in part, without full payment, and these alternatives complicate identifying cancellation of debt income. The discharge from liability on a debt for less than full payment in cash does not necessarily give rise to cancellation of debt income. The debt might have been discharged in exchange for full payment in another medium. For example, "if an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income [under section 61(a)(1)] in the amount of the debt as compensation for services."[58]

A. *Reduction of Amount Due*

Any reduction in the principal amount of a debt results in realization of cancellation of debt income, regardless of whether a new debt instrument has been substituted or the creditor simply agrees to accept a lesser amount in satisfaction of the debt.[59] This is true even if the debtor's obligation that was cancelled is subject to revival upon the occurrence of a contingent future event. In *Jelle v. Commissioner*, the taxpayers owed $269,829 to the Farmers Home Administration (FmHA) on a mortgage loan secured by the taxpayers' farm, which was appraised at a value of $92,057.[60] The taxpayers paid the FmHA the $92,057 "net recovery value" of the loan in exchange for cancellation of the remaining $177,772 of debt, but the cancellation was subject to a "net recovery buyout recapture agreement" under which the taxpayers agreed to repay *pro tanto* the amounts written off by the FmHA in the event they disposed of the farm within a 10–year period for a price that exceeded the $92,057 net recovery value.[61] The taxpayers argued that the debt had not been cancelled before the end of the 10–year period because the "net recovery buyout recapture agreement" was a continuing obligation. The Tax Court disagreed and held that the overall agreement resulted in immediate cancellation of indebtedness income of $177,772 because the obligation to pay the recapture amount was "highly contingent." The recapture agreement was not

[58] Reg. § 1.61-12(a). For other examples of debt cancellation in which the transaction served as a medium of payment, see *OKC Corp. v. Commissioner*, 82 T.C. 638 (1984) (reduction of pre-existing debt in settlement of litigation not cancellation of debt income because litigated claim was for recovery of lost profits, not for adjustment of the debt), and Revenue Ruling 1984-176, 1984-2 C.B. 34 (creditor's agreement to forgive taxpayer's debt in exchange for release of taxpayer's contract claim was "simply the medium of payment for some other form of income").

[59] *See* I.R.C. § 108(e)(10); Reg. § 1.1001-3(b); Michaels v. Commissioner, 87 T.C. 1412 (1986) (holding that a discount of principal balance due granted by lender on prepayment of home mortgage constitutes cancellation of debt income).

[60] 116 T.C. 63 (2001).

[61] *Id.* at 65–66.

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a substitute for the taxpayers' former obligation. "[T]he mere chance of some future repayment" that is either highly contingent or of a fundamentally different nature will not delay the recognition of cancellation of debt income.[62]

Taxpayers have sometimes argued that there was no cancellation of debt income because the existence of a debt was itself uncertain, so that the taxpayer's payment of an amount less than the creditor claimed represented the settling of a dispute over the debt, not cancellation of debt income. This so-called "disputed debt" or "contested liability" doctrine is explored later in this Article.[63]

B. *Significant Modification of Debt Instrument*

1. *Generally*

In many cases, a debtor's obligation will be modified with respect to terms other than the principal amount, for example, the time for payment may be extended, the interest rate reduced, the collateral released, or restrictions imposed by a loan agreement released, without reducing the principal amount due. Historically, changes of this type did not result in the realization of cancellation of debt income even if the fair market value of the resulting new debt obligation was less than the face amount of the old debt obligation.[64] Since 1990, however, section 108(e)(10) has provided that cancellation of debt income is realized whenever a new debt instrument is issued in satisfaction of an existing debt instrument if the "issue price" of the new instrument, determined under the original issue discount rules, is less than the principal amount of the old debt obligation. Under the regulations, whether a new debt instrument has been issued is determined with reference to the principles applied to determine whether a modification is sufficient to treat the creditor as realizing gain or loss on an exchange under section 1001.[65] Generally speaking, the result under the regulations is that the debtor realizes cancellation of debt income whenever the creditor realizes a bad-debt deduction or loss on the exchange.

An exchange, and thus a realization event, occurs whenever there is a "modification" that is "significant," whether through an agreement of the debtor and creditor or a unilateral waiver of rights.[66] Significant modifica-

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[62] *Id.* at 69.

[63] *See infra* Parts III.E. and V.A.2.

[64] *See, e.g.*, Rev. Rul. 1958–546, 1958-2 C.B. 143 (holding that in a bond-for-bond exchange, which changed interest rates and maturities, but not face amount, the debtor realized income only to the extent of cancellation of liability for accrued interest previously deducted with tax benefit); *see generally* James S. Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 238–42 (1959).

[65] Reg. § 1.1001–3. The regulations provide that any significant modification of a debt instrument under Regulation section 1.1001-3 generally is treated as an exchange of the original debt instrument for a modified instrument. Reg. § 1.1001-3(b).

[66] Reg. § 1.1001-3(b), (c)(1)(i), (e), (f); *see* Reg. § 1.1001-3(d), Ex. (7) (creditor's unilateral reduction of interest rate to deter debtor from refinancing with another lender).

tions include: (1) changing the annual yield of a fixed principal debt instrument, either through an adjustment to the interest rate or a reduction of the principal, by an amount in excess of the greater of one-fourth of one percent or five percent of the yield of the unmodified instrument (unless attributable to a formula in the original instrument);[67] (2) changing the timing or amount of payments to materially defer payment, either through an extension of final maturity or rescheduling of payments;[68] (3) substituting a new obligor on a recourse debt;[69] (4) altering collateral or guarantees securing a nonrecourse note (unless the collateral is fungible); (5) altering collateral or guarantees securing a recourse debt if the alteration changes payment expectations;[70] and (6) changing a debt from recourse to nonrecourse or vice versa (other than changing a secured debt from recourse to nonrecourse without a change in repayment expectations).[71] Two or more modifications occurring at different times may be treated as a single modification to be tested for significance.[72] However, two or more modifications of different terms that are not individually significant cannot be combined to result in a significant modification.[73] In addition, any modification that, based on all of the facts and circumstances, alters the legal rights or obligations of the parties, to the extent the alterations are "economically significant," triggers a realization event.[74]

Notwithstanding the general rules regarding significant modifications, a creditor's unilateral forbearance of acceleration or collection following a default is not a modification unless it continues for more than two years.[75]

Changes of legal rights or responsibilities pursuant to the original terms of the debt instrument generally are not modifications.[76] For example, the conversion of a variable rate mortgage to a fixed rate mortgage at the borrower's option as provided in the original instrument is not a significant modification.

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[67] Reg. § 1.1001-3(e)(2), (g), Ex. (3). Special rules apply to changes in the formula for determining interest under variable rate debt instruments. Reg. § 1.1001-3(e)(2)(iv).

[68] Reg. § 1.1001-3(e)(3), (g), Exs. (2), (4). Deferral of payments is not material unless the extension exceeds the lesser of five years or fifty percent of the original term of the instrument. Reg. § 1.1001-3(e)(3)(ii).

[69] Reg. § 1.1001-3(e)(4)(i), (g), Ex. (6). Addition or deletion of a co-obligor is material if it results in a change in payment expectations. Reg. § 1.1001-3(e)(4)(iii). Substitution of a new obligor is not material if it results from a corporate reorganization or the acquisition of substantially all of the assets of the original obligor (unless the change alters the repayment expectations), as long as there are no other changes. Reg. § 1.1001-3(e)(4)(i)(B), (e)(4)(i)(C), (g), Exs. (2), (4).

[70] Reg. § 1.1001-3(e)(4)(iv), (g), Ex. (9).

[71] Reg. § 1.1001-3(e)(5)(ii).

[72] Reg. § 1.1001-3(f)(3).

[73] Reg. § 1.1001-3(f)(4).

[74] Reg. § 1.1001-3(e)(1).

[75] Reg. § 1.1001-3(c)(4)(ii).

[76] Reg. § 1.1001-3(c)(1)(ii), (c)(2)(i).

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However, certain alterations pursuant to the original instrument are designated as modifications by the regulations.[77] These modifications include a change of the obligor, a change of the debt from recourse to nonrecourse, conversion of debt into another property right (other than conversion of debt into equity in the issuer pursuant to the holder's option), and the exercise of certain other options.[78]

If a modification results in a deemed exchange, the obligor's cancellation of debt income is the excess of the adjusted issue price of the original obligation (determined under the original issue discount rules) over the issue price of the new obligation determined under section 1273 or section 1274;[79] it is not merely the reduction in the face amount of the debt. For example, if a substantial modification occurs because of a reduction in principal, the amount of the discharge of indebtedness income realized by the debtor will be more than the amount of nominal principal reduction if the adjusted issue price of the new instrument, determined under section 1274, is less than its stated principal amount. Any excess of the stated principal amount over the issue price will be treated as original issue discount. As a result, over the remaining term of the debt, the debtor will be treated as accruing interest obligation and the creditor will be treated as accruing interest income under the original issue discount rules.[80]

The application of these rules can produce surprising results. Under the original issue discount rules, if the original debt instrument is traded on a public market, the issue price of the new debt instrument is the trading price of the original debt instrument.[81] Because the regulations provide that a debt instrument is considered to be traded on a public market not only if it is traded on an established securities market, but also if (1) it is traded on a board of trade or interbank market, (2) it appears in a quotation medium, or (3) quotations are readily available,[82] many routine bank loans can be considered to be publicly traded, even if held by the original lender. As a result, the simple extension of the due date of a note coupled with an *increase* in the interest rate can give rise to cancellation of debt income. An example of such a situation is provided in Part IV.A.

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[77] Reg. § 1.1001–3(c)(2).

[78] Reg. § 1.1001-3(c)(2); *see* Reg. § 1.1001-3(d), Ex. (4) (substitution of new obligor through transfer of property with transferee assuming debt as permitted by the instrument).

[79] I.R.C. §§ 1271–1274. For the original issue discount rules, *see generally*, Bittker, McMahon & Zelenak, *supra* note 10, ¶¶ 42.1–42.3.

[80] *See* I.R.C. §§ 1272–1275 (original issue discount rules, which determine the exact amount to be take into account in each year); Reg. §§ 1.61-12(c)(2), 1.163-4 (bond premium and discount).

[81] *See* Reg. § 1.1273-2(c).

[82] Reg. § 1.1273-2(f).

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2. *Creditor's Advance Agreement to Discharge Debt for Less than Full Payment*

A creditor might agree when a loan is made that the amount ultimately to be repaid by the debtor will be determined with respect to future events. In certain circumstances, when the reduction in the amount to be paid by the debtor is pursuant to the original terms of the obligation, rather than the result of a negotiated release of a legal obligation, the amount of reduction may constitute income to the debtor, but not cancellation of debt income. In this situation, the debtor will recognize income, but will not be permitted to take advantage of the provisions in section 108, which only apply to cancellation of debt income. For example, when an individual purchases a bank certificate of deposit, a portion of the interest provisionally credited typically will be forfeited if the depositor surrendered the certificate for payment prior to maturity. If the debtor-bank provisionally credits interest to the depositor and claims a tax deduction for the provisionally credited interest, but a portion of the interest is forfeited because the creditor-depositor redeems the certificate before maturity, the debtor bank recognizes income in the amount of the forfeited interest previously credited and deducted.[83] However, in *United States v. Centennial Savings Bank FSB*, the Supreme Court held that the forfeited interest was not cancellation of debt income, because the bank was not "discharged" from any debt.[84] The reduced amount paid was the amount the creditor was entitled to under the original agreement. Because the Court also held that section 108 applies "only to debt reductions stemming from a negotiated forgiveness of a duty to repay," which does not include "'anticipatory discharge' terms in the credit agreement at the outset," none of the section 108 exclusion provisions were available to the debtor-bank.[85]

3. *Modification of Debt in Connection With Sale of Property*

If a debt instrument is modified in connection with a sale or exchange of property, pursuant to which the buyer assumes the debt or takes the property subject to the debt, and the modification triggers exchange treatment, the modification is treated as a transaction between the seller-debtor and the creditor occurring immediately before the sale or exchange if the seller knew, or had reason to know, about the modification, even though the actual modification occurs after the exchange pursuant to an agreement between the purchaser and the creditor.[86] However, the seller and purchaser may jointly elect to treat the transaction as one in which the purchaser first assumed the original unmodified debt instrument and then entered into a transaction with the creditor to modify the debt instrument.[87] Under the general rule, any cancel-

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[83] United States v. Centennial Sav. Bank FSB, 499 U.S. 573, 579 (1991).
[84] *Id.* at 579.
[85] *Id.* at 583.
[86] Reg. § 1.1274-5(b)(1).
[87] Reg. § 1.1274-5(b)(2).

lation of debt income under section 61(a)(12) or basis reduction under section 108(e)(5) or sections 108(a)(1)(D) and 108(c) occurs with respect to the seller.[88] Under the election, any such cancellation of indebtedness income or basis reduction occurs with respect to the buyer.

C. *Acquisition of Debt by a Related Party*

Section 108(e)(4) provides that when a debt is acquired by a person related to the debtor from a person who is not related to the debtor, the acquisition is imputed to the debtor and results in cancellation of debt income, to the extent provided by regulations under section 108(e)(4).[89] Section 108(e)(4) most often applies to the acquisition of corporate debt originally held by an unrelated creditor by a corporation (or partnership) affiliated with the debtor corporation. However, the definition of related parties includes any person that is related under the rules of either section 267(b) or section 707(b)(1), and thus catches individuals as well as business entities.[90] Among the more important relationships in section 267(b) are as follows: (1) sections 267(b)(1) and 267(c)(4) treat as related any family member who is a spouse, ancestor, lineal descendant, or sibling (whether by the whole or the half-blood); (2) section 267(b)(2) treats a shareholder and a corporation as related if the shareholder owns, directly or indirectly, more than 50% of the value of the corporation's stock;[91] (3) section 267(b)(3) treats two corporations as related if they are members of the same "controlled group" as defined in section 1563(a), except that 50% stock ownership (rather than 80%, as in the usual application of section 1563) is sufficient to link corporations together in a controlled group—this provision catches both parent-subsidiary corporate relationships and brother-sister corporate relationships;[92] (4) sections 267(b)

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[88] *See* Reg. § 1.1274-5(b)(1).

[89] *See* Reg. § 1.108-2. For law predating section 108(e)(4), see *Forrester v. Commissioner*, 4 T.C. 907, 920–21 (1945), *acq.* 1945-4 C.B. 907 (husband and wife treated as separate taxpayers, so wife's acquisition from a creditor of a debt owed by her husband merely effected a substitution of creditors).

[90] Regulation section 1.108-2(d)(2) treats as related any person related within the meaning of section 267(b) or section 707(b), except that the term "family" means an individual's spouse, children, grandchildren, parents, and any spouse of the individual's children or grandchildren, and entities treated as a single employer under section 414(b) or section 414(c) are treated as related. *See* Rev. Rul. 1991-47, 1991-2 C.B. 16 (finding that a corporate debtor realized discharge of indebtedness income when unrelated person formed a new corporation that acquired debtor's outstanding obligations at less than their principal amount and then sold the stock of the newly formed corporation to the debtor).

[91] Ownership of the requisite amount of stock is determined by reference to the constructive ownership rules in section 267(c), which, in a wide variety of relationships, treat taxpayers as owning stock where that stock is actually owned by other persons and entities.

[92] For purposes of applying section 108(e)(4), a parent-subsidiary controlled group is one or more chains of corporations connected through stock ownership with a common parent if at least 50% of the total combined voting power or value of all classes of stock of each corporation (except the common parent) is owned by another member of the group, and the common parent owns at least 50% of the voting power or value of all classes of stock of at least one of the

(4) and 267(b)(6) treat the grantor of a trust and its beneficiaries as related to the fiduciary;[93] and (5) section 267(b)(13) treats a beneficiary of an estate and the estate as related. Under section 707(b), a partner and a partnership, in which the partner owns more than 50% of either the profits or capital interests, are related, as are two partnerships, in which the same partners own more than 50% of the profits or capital interests.[94]

If the taxpayer's obligation is acquired by a related party, the measure of cancellation of debt income generally is the excess of the principal amount of the obligation over the cost to the related party.[95] For example, the acquisition of a $1,000 debt for $600 would give rise to $400 of cancellation of debt income if the debt was owed to a third party and was acquired from the creditor by a person related to the obligor. After the acquisition, the indebtedness is treated as a new obligation issued by the debtor for the amount paid by the related party.[96] As such, the debt will bear original issue discount. As a result, over the remaining term of the debt, the related party creditor will recognize original issue discount income, and the debtor will be entitled to an interest deduction, subject to any applicable limitations under section 163 (or any other provision).

However, an acquisition by a related party is not treated as a discharge of indebtedness if the debt is due within one year after its acquisition and it is retired on or before the stated maturity date.[97]

D. *Lapse of Creditor's Rights*

The debtor realizes cancellation of debt income if a debt becomes unenforceable by the creditor through operation of law. In *Estate of Bankhead v.*

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other corporations (determined by excluding stock of any member of the group held directly by another member of the group). I.R.C. §§ 108(e)(4)(A), 267(f), 1563(a)(1). A brother-sister controlled group exists under section 1563(a)(2) if five or fewer persons who are individuals, estates, or trusts own (or constructively own) stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation. Section 1563(e) provides constructive ownership rules for determining control.

[93] *See* Wyly v. United States, 662 F.2d 397 (5th Cir. 1981) (holding that no exception to section 267(b)(6) exists for remote contingent beneficiary); Dillard Paper Co. v. Commissioner, 341 F.2d 897 (4th Cir. 1965) (holding that the provision in section 267(b)(4) treating a grantor as being related to the fiduciary of any trust is not limited to a taxable trusts, and, as a result, section 267(a)(1) applies to losses on sales by corporation to employee benefit trust).

[94] *Davis v. Commissioner*, 866 F.2d 852 (6th Cir. 1989), held that for section 707(b)(1)(B) to apply, it is not necessary that the commonly owned interests of each partner in each partnership total more than 50%. Thus, for example, under section 707(b)(1)(B), the A-B partnership, in which A holds a 99% interest and B holds a one percent interest, that sells property at a loss to the B-A partnership, in which B owns a 99% interest and A owns a one percent interest, are related).

[95] Reg. § 1.108-2(f).

[96] Reg. § 1.108-2(g)(1).

[97] Reg. § 1.108-2(e)(1).

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Commissioner, the taxpayer was required to recognize cancellation of indebtedness income on loans that became unenforceable because the creditor failed to file necessary claims in the probate of the deceased taxpayer's estate.[98] The court pointed out that the debtor was "enriched by the abolition of a duty to repay money he has previously received and had the unlimited use of. It is this undeniable economic benefit that creates income . . . ."[99] In a similar vein, *In re Higgins* held that the debtor taxpayer realized cancellation of indebtedness income because a secured creditor's failure to seek judicial confirmation of a nonjudicial foreclosure sale within 30 days of the sale, pursuant to state law, barred the creditor from seeking a deficiency against the debtor taxpayer.[100]

E. *Compromise of Disputed Liabilities*

Neither the Code nor regulations precisely define the term "indebtedness" for purposes of determining when there is cancellation of debt income under section 61(a)(12). A now revoked regulation under section 108 previously defined indebtedness as "an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount."[101] Although that regulation no longer is in force, the principle generally is applied in determining when there has been a cancellation of debt for purposes of section 61(a)(12). Thus, settlement of a claim does not result in realization of cancellation of debt income if there is a bona fide dispute regarding the debtor's liability for the amount claimed by the creditor.[102] In such a case, the amount of the debt is viewed *ab initio* as whatever amount the parties agree upon or a tribunal determines is the amount due.[103] Application of the "disputed debt" (or "contested liability") doctrine requires a bona fide dispute, but does not necessarily require a valid defense.[104]

The judicial disputed debt doctrine clearly applies, where appropriate, to

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[98] 60 T.C. 535 (1973).

[99] *Id.* at 540; *see also* Carl T. Miller Trust v. Commissioner, 76 T.C. 191 (1981) (same result).

[100] 403 B.R. 537 (Bankr. E.D. Tenn. 2009).

[101] Reg. § 1.108(b)-1(c) (issued under § 108(b)), removed *by* T.D. 8787, 63 1998-2 C.B. 621.

[102] *See* N. Sobel, Inc. v. Commissioner, 40 B.T.A. 1263 (1939), *nonacq.* 1940-1 C.B. 8.

[103] *See* Estate of Smith v. Commissioner, 198 F.3d 515, 530–31 (5th Cir. 1999), *nonacq. on other issues*, 2000-1 C.B. 16 (The issue was whether an estate realizes discharge of indebtedness income when it settles a disputed claim for less than the amount deducted on the estate tax return under section 2053(a)(3). The court rejected the Commissioner's argument that discharge of indebtedness income resulted from the settlement, holding that both the fact of the liability and its amount were not determined until the case was settled).

[104] *Compare* Zarin v. Commissioner, 916 F.2d 110, 113, 117 (3d Cir. 1990) (settlement for $500,000 of $3.4 million gambling debt owed to casino did not give rise to cancellation of debt income because taxpayer contested enforceability under state law when the casino sought enforcement), *with* Marcaccio v. Commissioner, 69 T.C.M. (CCH) 2420, 2427, 1995 T.C.M. (RIA) ¶ 95,174, at 1072 (settlement of suit for deficiency following mortgage foreclosure resulted in realization of cancellation of debt income because taxpayer never raised a legitimate dispute about the amount of the debt prior to the tax proceeding).

adjustments of the price of services. For example, suppose a taxpayer hires a painter to repaint the taxpayer's residence for $5,000. Upon presentation of the bill for $5,000, the taxpayer claims that because the painter did a sloppy job, the services were worth only $4,000. If the debt is settled for $4,300, the $700 difference between the original contract price and the actual payment is not gross income. As long as the taxpayer never claimed a tax benefit (deduction or basis) grounded on a $5,000 debt, the taxpayer should not be treated as realizing $700 of income when the debt is compromised. On the other hand, if the taxpayer was an accrual method taxpayer and had hired the painter to repaint the taxpayer's business premises, the taxpayer claimed a $5,000 deduction in the year the painter presented the bill for the painting services, notwithstanding the dispute over the amount, and, in a subsequent year, the debt was compromised for $4,300, the taxpayer ordinarily would recognize $700 of gross income under the tax benefit rule.[105]

The judicial disputed debt doctrine also should apply to the purchase of goods or property on credit followed by the payment of a reduced amount to satisfy the purchase price obligation as a result of a dispute over the nature or value of the property originally received.[106] The seminal disputed debt doctrine case involved cancellation of a portion of a debt due to the vendor of property. In *N. Sobel, Inc. v. Commissioner*, the taxpayer purchased 100 shares of stock in a bank from the bank, in exchange for a promissory note.[107] Subsequently, the taxpayer sued for rescission on the grounds that the sale of the stock on credit violated state law and that the seller-bank had failed to perform certain promises. The suit was settled by the taxpayer's agreement to pay half of the principal amount of the note. The Board of Tax Appeals held that the amount of the debt forgiven by the bank "was not the occasion for a freeing of assets and that there was no gain" and that the taxpayer thus did not recognize any cancellation of debt income.[108] However, one court of appeals—erroneously, in our view—has suggested that since the enactment of section 108(e)(5), which provides a statutory purchase price adjustment exception, the tax consequences of an adjustment to the purchase price of property now is governed exclusively by the rules of that statutory provision.[109] We believe that the language of section 108(e)(5) calls for its application where the cancellation of the debt otherwise would result in the recognition of gross income under section 61(a)(12), and that under the disputed debt doctrine, the compromise of purchase money debt owed to the seller of property would not otherwise

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[105] For the tax benefit rule, see generally, BITTKER, MCMAHON & ZELENAK, *supra* note 10, ¶ 3.7[2].

[106] *See* BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 4.05[3][c] (2d ed. 1995).

[107] 40 B.T.A. 1263, 1265 (1939).

[108] *Id.*

[109] *See* Preslar v. Commissioner, 167 F.3d 1323, 1328 n.3 (9th Cir. 1999).

require recognition of gross income under section 61(a)(12). Under this view, section 108(e)(5) is necessary only to, and operates to, exclude cancelled purchase money debt from gross income when the debt is cancelled for a reason other than a dispute regarding the amount due.

In *Zarin v. Commissioner*, the Third Circuit Court of Appeals extended the disputed debt exception to a situation in which there was no question regarding the amount of the debt or what the taxpayer-debtor received.[110] The taxpayer incurred a $3.4 million debt to a gambling casino to purchase chips, which he lost at the gaming tables. The casino filed a state action to collect the funds and eventually settled for only $500,000. Resolution of *Zarin* depends largely upon the conclusion regarding the consideration that the taxpayer received in exchange for the debt. The Tax Court held that Zarin realized $2.9 million of cancellation of debt income because he had received value, in the form of chips, in the year the debt was incurred, and only his obligation to repay had prevented taxation of the value of the chips in that year.[111] The Third Circuit reversed, holding that receipt of chips was not receipt of value because they had no use other than as a medium of exchange for gambling in the casinos and, since the debt was unenforceable under state law, Zarin had merely settled a disputed debt, realizing no income. The court reasoned that "[w]hen a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute."[112] Therefore, the $500,000 settlement "fixed the amount of loss and the amount of debt cognizable for tax purposes."[113]

Quite simply, *Zarin* was erroneously decided and is unlikely to be generally followed. Under accepted principles that gross income includes the objective, rather than subjective, value of items received in a market transaction, the effect of the Third Circuit's opinion was to allow Zarin to receive $2.9 million tax-free, even though none of the exceptions to section 61(a)(12) or section 108 applied.

In *Preslar v. Commissioner*,[114] the Tenth Circuit dismissed *Zarin* as an erroneous application of the contested debt doctrine and explained the fallacy of its reasoning. Preslar borrowed $1 million from a bank to purchase land. Although the loan documents required payment in cash, Preslar claimed that

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[110] 916 F.2d 110 (3d Cir. 1990), *rev'g* 92 T.C. 1084 (1989). The *Zarin* case has been the subject of much commentary. *See, e.g.*, Theodore P. Seto, *Inside* Zarin, 59 SMU L. Rev. 1761 (2006); Daniel Shaviro, *The Man Who Lost Too Much:* Zarin v. Commissioner *and the Measurement of Taxable Consumption*, 45 Tax L. Rev. 215 (1990); I. Jay Katz, *Did* Zarin *Have a* Tufts *Day at a Casino Made Out of* Kirby Lumber?, 26 U.C. Davis L. Rev. 261, 265 (1993).

[111] *Zarin*, 92 T.C. at 1084.

[112] *Zarin*, 916 F.2d at 116.

[113] *Id.*

[114] 167 F.3d 1323, 1328 (10th Cir. 1999).

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the bank permitted him to repay the loan through the assignment to the bank of land sales contracts. Subsequently, the FDIC took over the bank and demanded payment in cash. After Preslar sued for breach of contract, he eventually settled with the FDIC by paying $450,000 less than the loan balance. The court held that the disputed debt doctrine did not apply. The *Preslar* court's reasoning explained why *Zarin* is wrong:

> The problem with the Third Circuit's holding [in *Zarin*] is it treats liquidated and unliquidated debts alike. The whole theory behind requiring that the amount of a debt be disputed before the contested liability exception can be triggered is that only in the context of disputed debts is the Internal Revenue Service (IRS) unaware of the exact consideration initially exchanged in a transaction. . . . The mere fact that a taxpayer challenges the enforceability of a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute. To implicate the contested liability doctrine, the original amount of the debt must be unliquidated. A total denial of liability is not a dispute touching upon the amount of the underlying debt.[115]

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[115] *Id.* at 1328. The fallacious reasoning of the Third Circuit in *Zarin* is further illustrated by an absurd analogy that it drew in reaching its conclusion. The court stated:

> [I]f a taxpayer took out a loan for $10,000, refused in good faith to pay the full $10,000 back, and then reached an agreement with the lendor (sic) that he would pay back only $7000 in full satisfaction of the debt, the transaction would be treated as if the initial loan was $7000. When the taxpayer tenders the $7000 payment, he will have been deemed to have paid the full amount of the initially disputed debt. Accordingly, there is no tax consequence to the taxpayer upon payment.

Zarin v. Commissioner, 916 F.2d 110, 115 (3rd Cir. 1990).

The fact that the obligation is not enforceable should not disguise an accession to wealth in such a case. If the taxpayer initially borrowed $10,000 of *cash*, the presence of a dispute over the enforceability of the debt does not change the fact that the taxpayer has received a $3,000 accession to wealth on this transaction. In *Preslar*, the Tenth Circuit had no difficulty in finding gross income in this situation. A dispute over enforceability or the amount of a debt should affect the recognition of gain on cancellation only if the debt is incurred in exchange for the receipt of something other than cash, such as goods or services that the taxpayer later claims were not worth the original purchase price. In the case of the receipt of cash (or a cash equivalent) there is no room for a dispute regarding the presence of an accession to wealth on cancellation of the debt for less than the amount of cash received.

It is settled law that the discharge of a debt that has become unenforceable under state law because the creditor has failed properly to pursue enforcement produces cancellation of debt income. Estate of Bankhead v. Commissioner, 60 T.C. 535, 539–40 (1973) (cancellation of debt income arose when the creditor failed to file necessary claims in the probate of the deceased taxpayer's estate and the loans therefore became unenforceable); Carl T. Miller Trust v. Commissioner, 76 T.C. 191, 196–97 (1981) (same); *In re* Higgins, 08-1 U.S.T.C. ¶ 50,220, 101 A.F.T.R.2d 910, 913 (Bankr. E.D. Tenn. 2008) (expiration of 30-day statutory period for pursuing a deficiency judgment following a mortgage foreclosure "was an 'identifiable event' giving rise to the discharge of indebtedness . . . taxable to the debtors as income").

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Because the debt was for the loan of cash, the amount of the debt was liquidated, and there was no "contest" regarding the amount owed, Preslar realized cancellation of debt income.[116]

Recognize that the fact that a debt was compromised, standing alone, does not establish the existence of a dispute over its amount or validity. To successfully involve the disputed debt doctrine, the taxpayer must introduce direct evidence that he disputed the debt with the creditor in reaching the compromise.[117]

F. *Transfer of Property*

If a debtor transfers property to satisfy a recourse debt owed to the transferee, the transfer is treated as a sale or exchange of the property.[118] The debt is included in the amount realized under section 1001. The debtor-transferor realizes either a gain includable under section 61(a)(3) or a loss, which might be deductible under section 165, as long as the fair market value of the property transferred is at least equal to the amount of the debt satisfied.[119] The same result occurs if property subject to the lien is sold through a foreclosure sale.[120] When a recourse debt secured by a lien is reduced to judgment in a foreclosure suit, the amount realized on a subsequent sale of the property is the actual sales price.[121] Any deficiency resulting from a sales price less than the judgment is a continuing obligation of the debtor, the discharge from which for less than full payment will give rise to cancellation of debt income.

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[116] *See also* Waterhouse v. Commissioner, 68 T.C.M. (CCH) 744, 748, 1994 T.C.M. (RIA) ¶ 94,467, at 2476 (disabled veteran realized cancellation of debt income when the Veterans' Administration waived its claim for reimbursement of disability benefits, previously received tax-free under section 104(a)(4) but to which taxpayer was not entitled, following administrative determination that the claim was a valid debt and he was obligated to repay amounts).

[117] *See* Rood v. Commissioner, 71 T.C.M. (CCH) 3125, 3125, 1996 T.C.M. (RIA) ¶ 96,248, at 1785 ("disputed debt" exception did not apply because taxpayer failed to prove existence of any bona fide dispute), *aff'd per curiam*, 122 F.3d 1078 (11th Cir. 1997); Melvin v. Commissioner, 98 T.C.M. (CCH) 159, 2009 T.C.M. (RIA) ¶ 2009-199 (none of the documentary evidence indicated that the debt was "disputed" before it was compromised).

[118] Reg. § 1.1001-2(a)(1). *But see* I.R.C. § 1398(f) (transfer of assets from bankrupt individual to bankrupt estate, or vice versa, is not a disposition of property, unless effected by sale or exchange).

[119] *See* Yarbro v. Commissioner, 737 F.2d 479, 484 (5th Cir. 1984).

[120] Helvering v. Hammel, 311 U.S. 504, 505, 511 (1941).

[121] Aizawa v. Commissioner, 99 T.C. 197, 202 (1992), *aff'd by order*, 29 F.3d 630 (9th Cir. 1994); *see also* Frazier v. Commissioner, 111 T.C. 243 (1998) (where mortgagee bids-in property at an arbitrary amount at a foreclosure sale, the fair market value of property can be established by extrinsic evidence; the sales price is fair market value, not the bid price, and the excess of recourse debt over fair market value is cancellation of debt income, which might be excludable under section 108(a)(1)(B)). *But see* Chilingirian v. Commissioner, 918 F.2d 1251, 1254 (6th Cir. 1990) (treating the entire amount of recourse debt discharged as a result of foreclosure as the amount realized on disposition of the property, without any discussion of the fair market value of the property).

However, the regulations provide that the recourse debt is included in the amount realized only to the extent of the fair market value of the property.[122] Any amount by which the cancelled recourse debt exceeds the fair market value of the property constitutes cancellation of debt income under section 61(a)(12).[123] The regulations provide the following example: A taxpayer "transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of debt on which [the taxpayer] is personally liable."[124] The regulations bifurcate the transaction into: (1) a disposition of the property with an amount realized of $6,000 (the fair market value of the property); and (2) cancellation of debt income of $1,500 ($7,500 minus $6,000).[125] This distinction is important because, depending on the property involved, any gain might be capital gain or section 1231 gain, taxed at a preferential rate, while cancellation of debt income is ordinary income, but might be excludable under section 108.[126]

If the debt is nonrecourse, then the full amount of the debt is treated as the amount realized on the transfer of the property, regardless of the value of the property, and no cancellation of debt income is realized.[127] However, the amount realized through cancellation of a nonrecourse debt will be limited to the extent the debt was incurred by reason of the acquisition of the encumbered property (*i.e.*, the debt was purchase money debt) and the debt was not taken into account in determining the taxpayer's basis in the property.[128]

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[122] Reg. § 1.1001–2(a), (c), Ex. (8).

[123] Reg. § 1.1001–2(c), Ex. (8); *see* Bressi v. Commissioner, 62 T.C.M. (CCH) 1668, 1674–75, T.C.M. (P-H) ¶ 91,651, at 3228–29 (1993) (applying the bifurcation rule of Regulation section 1.1001-2(a)(2), the excess of the discharged recourse debt over the fair market value of encumbered property transferred to lender in satisfaction of debt was ordinary income; none of the section 108 exceptions applied), *aff'd by order*, 989 F.2d 486 (3d Cir. 1993); Gehl v. Commissioner, 102 T.C. 784 (1994) (applying Treasury Regulation section 1.1001–2(c), only the amount by which a cancelled debt exceeded the fair market value of property transferred to creditor by an insolvent taxpayer in satisfaction of debt could be excluded under section 108(a)), *aff'd by order*, 50 F.3d 12 (8th Cir. 1995); Martin v. Commissioner, T.C. Summ. Op. 2009-121, 2009 WL 2381577 (T.C. Aug. 4, 2009) (taxpayer did not realize any COD income upon foreclosure of lien on an automobile, despite lender's filing of Form 1099-C reporting that taxpayer realized $6,704.92 of COD income, because taxpayer proved that the value of the automobile at least equaled the amount of the $6,704.92 debt that was charged off by the lender).

[124] Reg. § 1.1001-2(c), Ex. (8); *see also* Reg. § 1.1001-2(a)(2) (excluding from amount realized discharged recourse mortgage debt in excess of the fair market value of the encumbered property, but cross-referencing section 108).

[125] Reg. § 1.1001-2(c), Ex. (8).

[126] Reg. § 1.1001-2(a)(2).

[127] Reg. § 1.1001–2(a)(4)(i), (b); Commissioner v. Tufts, 461 U.S. 300, 312 (1983).

[128] Reg. § 1.1001-2(a)(3). This provision is intended to deal with what is commonly called "the purchaser's basis in *Tufts*" issue. For the basis issue, see Erik M. Jensen, *The Unanswered Question in* Tufts*: What Was the Purchaser's Basis?*, 10 VA. TAX REV. 455 (1991).

G. *Compromise of Loan Guarantees*

Notwithstanding that *Kerbaugh–Empire Co.* generally has been discredited as precedent, in some cases the nature of the origin of the debt might be important in determining whether cancellation of debt income has been realized. Generally, cancellation of debt income is not recognized by a guarantor when the obligation is reduced or satisfied for less than full value.[129] In *Payne v Commissioner*, the taxpayer had guaranteed a debt owed by a corporation of which he was a shareholder.[130] Following a default on the loan by the corporation, the taxpayer made a partial payment and the debt was restructured, reducing the debt and, accordingly, his obligation on the guarantee by several hundred thousand dollars. The Tax Court rejected the Commissioner's argument that the taxpayer realized cancellation of debt income and held that the guarantor of a promissory note does not recognize any cancellation of debt income when the amount of the debt is compromised.[131]

When a loan is satisfied by a guarantor, the primary obligor can realize cancellation of debt income. In *Miller v. Commissioner*, the taxpayer-debtor realized cancellation of debt income upon the guarantor's payment of the debt to the creditor because the guarantor had waived any right to reimbursement from the taxpayer-debtor in advance.[132] However, if the guarantor has a right of subrogation, the primary obligor does not realize cancellation of debt income until the resulting obligation to the guarantor is cancelled or

[129] *See* Payne v. Commissioner, 75 T.C.M. (CCH) 2548, 1998 T.C.M. (RIA) ¶ 98,227, *rev'd on other grounds*, 224 F.3d 415 (5th Cir. 2000).

[130] *Id.* at 2553, 1998 T.C.M. (RIA) ¶ 98,227 at 1279.

[131] In reaching its holding, the Tax Court relied on an earlier case that discussed the implications of a release from a loan guarantee.

> In Landreth v. Commissioner, 50 T.C. 803, 812–813 (1968), we distinguished the situation involving a guarantor of a debt from that of a primary obligor on a debt, and we concluded that a guarantor of a debt, upon the payment of the debt by the primary obligor, does not realize discharge of indebtedness income when relieved of an obligation under a guaranty. We stated as follows:
>
> > The situation of a guarantor is not like that of a debtor who as a result of the original loan obtains a nontaxable increase in assets. . . . Where a debtor is relieved of his obligation to repay the loan, his net worth is increased over what it would have been if the original transaction had never occurred. This real increase in wealth may be properly taxable. However, where the guarantor is relieved of his contingent liability, either because of payment by the debtor to the creditor or because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth.
>
> . . . When petitioner's contested liability as guarantor of the debt obligation was settled, petitioner did not realize an increase in net worth, and petitioner is not to be charged with discharge of indebtedness income with regard thereto.

Id. at 2561, 1998 T.C.M. (RIA) ¶ 98,227 at 1290.

[132] 91 T.C.M. (CCH) 1267, 1277–78, 2006 T.C.M. (RIA) ¶ 2006-125, at 921–22.

compromised.[133]

Friedland v. Commissioner involved a related issue.[134] In that case, the taxpayer made an accommodation pledge of appreciated stock in a closely held corporation to secure a debt owed to the bank by a corporation in which his adult son was a majority shareholder. When the debtor corporation defaulted on the loan, the taxpayer's stock was transferred to the bank in satisfaction of the debtor-corporation's debt. The Tax Court held that the taxpayer did not recognize any gain because no amount was realized on the transfer.[135] The regulations treat as an amount realized only the amount of the taxpayer's own indebtedness that is discharged by the transfer of property—not the amount of indebtedness of a third party.[136]

In these situations the primary debtor (not the guarantor) may incur cancellation of indebtedness income. In a guarantee situation, satisfaction of the debt obligation by a guarantor creates a debt from the original debtor to the guarantor. Thus, the failure of the primary debtor to pay the guarantor generally will produce cancellation of debt income for the primary obligor. In certain instances, however, the cancellation of the debt from the primary obligor to the guarantor might be treated as a nontaxable gift, for example, where a parent guarantees a debt of a child, and after the child defaults and the parent pays the child's debt the parent waives the resulting subrogation claim.[137]

IV. Determination of the Amount of Cancellation of Debt Income

If a debt is simply discharged in exchange for a cash payment of less than the full amount of the debt, the amount of cancellation of debt income is easily determined. It is the amount by which the debt exceeds the cash payment. Unless the taxpayer is in a trade or business, or the debt relates to a transaction entered into for profit, transaction costs incurred to secure the cancellation of the debt are neither deductible nor an offset against the amount of the debt cancellation that must be included under section 61(a)(12).[138] There

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[133] *See id.*

[134] 82 T.C.M. (CCH) 492, 494–95, 2001 T.C.M. (RIA) ¶ 2001-236, at 1717.

[135] *Id.*

[136] Reg. § 1.1001–2(a)(1); *see also* INI, Inc. v. Commissioner, 69 T.C.M. (CCH) 2113, 2124, 1995 T.C.M. (RIA) ¶ 95,112, at 693 (finding that, to the extent property transferred to a lender discharged the debts of another corporation owned by the transferor's shareholder, the transferor was not required to include that portion of the discharged debt in its amount realized because the other corporation, not the transferor, was indebted to lender with respect to such debt).

[137] *Compare* Bosse v. Commissioner, 29 T.C.M. (CCH) 1772, 1777, T.C.M. (P-H) ¶ 70,355, at 1937 (1970) (cancellation of debt treated as a gift), *with* Dosek v. Commissioner, 30 T.C.M. (CCH) 688, 690, T.C.M. (P-H) ¶ 71,160, at 721 (1971) (gift status rejected).

[138] Melvin v. Commissioner, 98 T.C.M. (CCH) 159, 2009 T.C.M. (RIA) ¶ 2009-199 (section 61(a)(12) "manifestly does not provide for any kind of deduction;" taxpayers did not argue for a deduction under section 162 because they acknowledged that the amount was not paid with respect to a business and they did not argue for a section 212 deduction because they were in the AMT).

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are however, a variety of other manners in which the amount of a debt might be reduced, or the debt satisfied for less than full payment in cash, and determining the amount of cancellation of debt income in those situations can be more complicated.

A. *Substitution of New Debt Instruments*

As explained earlier, under the regulations, a significant modification of a debt instrument, whether or not effected by an exchange of instruments, will result in realization of cancellation of debt income if the principal amount of the previously outstanding debt obligation exceeds the principal amount of the new debt obligation.[139] Computing the amount of cancellation of debt income is not complicated if neither the original debt nor new substituted debt is an original issue discount instrument. A simple comparison of the face amount of the two debts suffices. The computation is more difficult if a debt obligation is issued at a discount, which increases the effective interest rate (or premium, which is an indirect way of reducing the nominal interest rate). Section 108(e)(10) provides that cancellation of debt income is realized whenever a new debt instrument is issued in satisfaction of an existing debt instrument if the "issue price" of the new instrument, determined under the original issue discount rules, is less than the principal amount of the old debt obligation.[140] Thus, the debtor taxpayer's cancellation of debt income is the excess of the adjusted issue price of the original obligation, computed over the issue price of the new obligation, both determined under the original issue discount rules in section 1273 or section 1274, rather than merely the reduction in the face amount of the debt.[141]

That having been said, the new debt instrument will be an original issue discount instrument in many surprising circumstances. As noted earlier, under the original issue discount rules, if the original debt instrument is traded on a public market, the issue price of the new debt is the trading price of the original debt instrument,[142] and under the regulations, a debt can be publicly traded merely as a result of it appearing in a quotation medium or quotations being readily available.[143] Thus, for example, if the due date on a $1,000,000, six percent note is extended, and the interest rate is increased to seven percent at a time when the note is being quoted as available for sale or for purchase at $750,000, there has been a deemed exchange of obligations. The issue price of the new debt instrument is $750,000, and the debtor realizes $250,000 of cancellation of debt income. The $250,000 difference between the $750,000 principal amount of the new debt instrument and its $1,000,000 face amount will be taken into account as original issue discount by both the debtor and

[139] See *supra* Part III.B.1.

[140] I.R.C. § 108(e)(10).

[141] For the original issue discount rules, see I.R.C. §§ 1272–1275. *See generally* BITTKER, MCMAHON & ZELENAK, *supra* note 10, ¶¶ 42.01–42.03.

[142] Reg. § 1.1273-2(c).

[143] Reg. § 1.1273-2(f).

creditor over the term of the instrument, giving rise to interest deductions and interest income, respectively.[144]

If a taxpayer issues a debt obligation at a premium (*i.e.*, the proceeds exceed the face amount of the obligation), the issuer does not report the premium as income to the issuer at the time of receipt.[145] Instead, the issuer generally includes bond premium over the term of the bond, using the constant interest method, by reducing the issuer's interest deductions.[146] If a debt instrument issued at a premium is repurchased or otherwise cancelled, section 108(e)(3) requires that any unamortized premium be included in the amount of cancellation of debt income. Thus the cancellation of debt income includes any unamortized premium in addition to the difference between the face amount of the obligation and the lower repurchase price (or amount for which the debt is compromised). If an obligation issued at a discount is repurchased (or compromised), the cancellation of debt income does not include any portion of the original issue discount that has not yet been deducted. But if the obligation is repurchased (or compromised) for an amount less than its adjusted issue price, the amount of cancellation of debt income realized includes all or part of the previously deducted original issue discount previously deducted.[147]

B. *Conversion of Debt into Equity*

1. *Corporate Debtor*

If a corporation issues stock in exchange for outstanding debt obligations, the corporation normally does not recognize cancellation of debt income as long as the value of the newly issued stock is not less than the amount of the debt—section 1032 provides nonrecognition to the corporation. If the debt is represented by a security, the transaction is treated as a tax-free recapitalization under section 368(a)(1)(E).[148] If, however, the corporation is solvent and not in bankruptcy, and the sum of the principal amount of the debt, whether or not represented by a security, plus accrued but unpaid interest exceeds the fair market value of the stock issued in the transaction, then, pursuant to section 108(e)(8), the corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.[149] As a result, the transaction produces cancellation of debt income to the extent the

[144]Note that in certain circumstances the debt instrument might become an "applicable high yield debt obligation" under section 163(i), with respect to which interest deductions will be partially disallowed under section 163(e)(5). See Notice 2010-11, 2010-4 I.R.B. 326 (Suspending ¶ 163(e)(5) through Dec. 31, 2010 for certain debt modifications).

[145]Reg. § 1.61–12(c)(1).

[146]Reg. § 1.163–13(a).

[147]I.R.C. § 108(e)(5)(C).

[148]*See* Reg. §1.368-2(e)(1); Commissioner v. Capento Secs. Corp., 140 F.2d 382, 385 (1st Cir. 1944).

[149]Any cancellation of indebtedness income realized by an insolvent or bankrupt debtor is excluded from gross income pursuant to section 108(a)(1). *See infra* Part V.B.1.a.

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amount of the debt exceeds the value of the stock. Neither section 1032 nor section 361(a), which can apply if a corporation exchanges property for stock in another corporation pursuant to a reorganization, will apply to provide nonrecognition to the corporation.[150]

If a shareholder merely cancels a debt owed by the corporation to the shareholder, the transaction, which otherwise would be treated as a contribution to capital that was tax-free to the corporation under section 118, is treated by section 108(e)(6) as if the corporation satisfied the debt with an amount of money equal to the shareholder's basis in the debt. Cancellation of debt income thus results only if the shareholder's basis in the debt is less than its issue price, which would be unusual. Even if the debt was not originally issued to the shareholder, and the shareholder had subsequently purchased the debt at a discount, section 108(e)(4) would have triggered cancellation of debt income upon the purchase by the shareholder of the corporation's debt at a discount, unless the shareholder was a minority shareholder (and therefore not a related person under section 267(b)(2)).

2. *Partnership Debtor*

Similar principles apply when a partnership's debt is converted into an equity interest in the partnership or increases a pre-existing equity interest in the partnership. The transaction generally is a nonrecognition event under section 721. But if the amount of the debt exceeds the value of the equity interest in the partnership obtained in exchange for the cancellation of the debt, pursuant to section 108(e)(8) the transaction gives rise to cancellation of debt income to the extent the amount of the debt exceeds the value of the partnership interest. The partnership, and thus each partner, realizes cancellation of debt income.[151] Any cancellation of debt income recognized by a partnership under this provision is allocated among the taxpayers who were partners in the partnership immediately before the discharge of the debt.

Proposed regulations would provide that section 721 applies to the creditor's contribution of debt to the partnership in exchange for a partnership interest.[152] Thus, the creditor would not recognize gain or loss on the exchange of partnership debt for a partnership interest. The proposed regulations reflect the Service's belief that a partner or new partner should not recognize an

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[150] Rev. Rul. 1977–437, 1977–2 C.B. 28 (section 361 did not apply to prevent corporation from recognizing cancellation of debt income when, pursuant to a recapitalization, the corporation issued new debt obligations in exchange for old debt obligations with a higher principal amount).

[151] *See* Parker Props. Joint Venture v. Commissioner, 71 T.C.M. (CCH) 3195, 1996 T.C.M. (RIA) ¶ 96,283, *aff'd sub nom.* Twenty Mile Joint Venture v. Commissioner, 200 F.3d 1268 (10th Cir. 1999) (cancellation of approximately $3.5 million of indebtedness to a lender who also held an existing equity interest in the partnership effected through a purported capital contribution of $3.5 million in the form of debt reduction was not respected under substance over form doctrine; partnership recognized discharge of indebtedness income).

[152] Prop. Reg. § 1.721-1(d)(1), 73 Fed. Reg. 64,903, 64,905 (2008).

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immediate loss in a debt-for-equity interest exchange subject to section 721 where the liquidation value of the partnership interest received is less than the outstanding principal balance of the indebtedness surrendered.[153] The creditor's basis in the partnership interest would be determined under section 722. The creditor-partner's capital account would be increased by the liquidation value of the partnership interest, and the outside basis of the creditor would include the amount of the adjusted basis of the indebtedness so exchanged. However, under the proposed regulation, the nonrecognition rule of section 721 would not "apply to a transfer of a partnership interest in satisfaction of a partnership indebtedness for unpaid rent, royalties, or interest."[154]

The proposed regulations also would provide that the fair market value of a partnership interest received by the creditor in exchange for debt, which is the benchmark for determining the amount of cancellation of debt income recognized by the partnership, will be treated as the liquidation value of the partnership interest if the partnership properly maintains capital accounts (thereby increasing the amount of the creditor-partner's capital account by the same amount), and the partnership treats the liquidation value of partnership interest as its fair market value for determining the tax consequences of the exchange.[155] This valuation rule would apply only if the debt for equity exchange is an arm's length transaction and, subsequent to the exchange, the creditor's partnership interest is not redeemed by either the partnership or a person related to the partnership in a transaction that is intended to avoid cancellation of debt income by the partnership. If these requirements are not satisfied, then the value of a partnership interest received in exchange for debt would be determined based on all of the facts and circumstances.

3. *Single Member Limited Liability Company Debtor*

A single member limited liability company that has not elected to be taxed as a corporation is a disregarded entity,[156] and its assets, liabilities, income items, and deduction items will be treated as owned, owed, received, and incurred directly by its owner. If one or more additional memberships are issued by the limited liability company to one or more additional persons, the limited liability company automatically becomes a partnership for tax purposes, unless it elects to be taxed as a corporation.[157] There are no authorities dealing specifically with the issuance of a membership unit in a limited liability company in payment of, or in compromise of, a debt of the limited liability company. However, Revenue Ruling 1999-5 addresses the treatment of the conversion of a disregarded entity into a partnership when a limited liability company issues an additional membership to a new member.[158]

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[153] Prop. Reg. § 1.108-8, 73 Fed. Reg. 64,903, 64,905 (2008).
[154] Prop. Reg. § 1.108-8(b)(1), 73 Fed. Reg. 64,903 (2008).
[155] *Id.*
[156] Reg. § 301.7701-3(a), (b)(1)(ii).
[157] Reg. § 301.7701-3(a), (b)(1)(ii); Rev. Rul. 1999-5, 1999-1 C.B. 434.
[158] 1999-1 C.B. 434.

In Situation 1 in Revenue Ruling 1999-5, the sole member of the limited liability company sells a membership unit to a purchaser. The revenue ruling treats the transaction as the sale and purchase of a partial interest in each of the limited liability company's assets, followed immediately by a contribution of all of the assets to a partnership. The selling member recognizes gain or loss on the asset sale, but pursuant to section 721, no gain or loss is recognized by either member on the subsequent asset contribution. The selling member's basis in the limited liability company membership interest will be the same as the member's basis in the contributed portion of the limited liability company assets.[159] The purchasing member's basis in the limited liability company membership interest will be the same as the purchase price of the assets deemed to have been contributed.[160]

In Situation 2 in the revenue ruling, on the other hand, a new member contributes cash or property to the limited liability company, the transaction is treated as the formation of a new partnership by both the continuing member, who is deemed to contribute the assets of the existing limited liability company, and the new member, who contributes cash, other property or both. The contributions are nonrecognition transactions under section 721, with transferred and exchanged bases under sections 722 and 723.

The principles of Revenue Ruling 1999-5, combined with the general principles that apply in determining the extent to which cancellation of debt income is realized in connection with the transfer of property to a creditor,[161] can be applied to determine the consequences when a disregarded limited liability company issues a membership unit to a creditor in payment of, or in compromise of, a debt of the limited liability company. The proper treatment, however, depends on the particular facts of the structure of the transaction and on whether the original member of the limited liability company has guaranteed the debt owed to the limited liability company's creditor. There are several possible scenarios.

> *Structure 1*: The original single member has guaranteed the debt, with the result that the debt is a recourse debt, and the transaction is structured as the direct issuance to the creditor by the limited liability company of a membership unit in exchange for cancellation of all or part of the debt. In this case the transaction should be treated as Situation 2 in Revenue Ruling 1999-5; the original member recognizes no gain or loss with respect to the assets of the limited liability company. However, the original limited liability company member recognizes cancellation of debt income to the extent the cancelled debt exceeded the value of the interest in the limited liability company issued to the creditor.[162]

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[159] I.R.C. § 722.

[160] I.R.C. §§ 722, 1012.

[161] *See supra* Part III.F.

[162] In addition, the original member may recognize gain under Section 731 as a result of the operation of Section 752(b).

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Structure 2: The original single member has not guaranteed the debt, with the result that the debt is a nonrecourse debt, and the transaction is structured as the direct issuance to the creditor by the limited liability company of a membership unit in exchange for cancellation of all or part of the debt. The results in this instance should be the same as in Structure 1. The original member recognizes no gain or loss with respect to the assets of the limited liability company, but would recognize cancellation of debt income to the extent the cancelled debt exceeded the value of the interest in the limited liability company issued to the creditor.[163]

Structure 3: The original single member has guaranteed the debt, with the result that the debt is a recourse debt, and the transaction is structured as the sale of a membership unit to the creditor by the original single member in exchange for cancellation of all or part of the debt. The transaction should be treated as Situation 1 in Revenue Ruling 1999-5. The original member recognizes gain or loss with respect to a proportionate amount of the assets of the limited liability company, with the amount realized being limited to their fair market value.[164] In addition, the original single member recognizes cancellation of debt income to the extent the cancelled debt exceeded a pro rata portion of the value of the underlying assets of the limited liability company.[165]

Structure 4: The original single member has not guaranteed the debt, with the result that the debt is a nonrecourse debt, and the transaction is structured as the sale of a membership unit to the creditor by the original single member in exchange for cancellation of all or part of the debt. The transaction should be treated as Situation 1 in Revenue Ruling 1999-5, but the results differ from those in Structure 3. The original member recognizes gain or loss with respect to a proportionate amount of the assets of the limited liability company. However, in this situation, the amount realized is the full amount of the cancelled debt, and no cancellation of debt income is realized.[166]

C. *Cancellation of Shareholder's Debt to a Corporation*

If a corporation cancels a debt of a shareholder to the corporation (or distributes the instrument to the shareholder), the transaction is not ordinarily treated as a cancellation of debt under section 61(a)(12); the transaction is a distribution from the corporation under section 301, which ordinarily will be taxed as a dividend. The amount of the distribution will be equal to the fair market value of the debt instrument.[167] As a result, none of the exclusions in section 108 will apply to avoid recognition. However, because the distribu-

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[163] *See* Rev. Rul. 1991-31, 1991-1 C.B. 19 (reduction to $800,000 of $1 million principal amount of secured nonrecourse debt when value of collateral was $800,000, resulting in $200,000 cancellation of debt income).

[164] Reg. § 1.1001–2(a), (c), Ex. (8).

[165] Reg. § 1.1001–2(c), Ex. (8); *see supra* note 123.

[166] Reg. § 1.1001-2(b), (c), Ex. (7).

[167] Reg. § 1.301-1(d).

tion is treated as a repurchase by the shareholder of the debt instrument for an amount equal to its fair market value, the shareholder realizes cancellation of debt income to the extent the issue price of the debt instrument exceeds its fair market value on the date of the distribution.[168] Similarly, if a corporation cancels a shareholder's debt to the corporation in connection with the liquidation of the corporation, the transaction is not treated as cancellation of debt, but instead the amount of the debt is treated as an additional amount distributed to the shareholder in the liquidation, which under section 331 results in capital gain (or loss).[169]

V. Statutory Exceptions to Recognition of Cancellation of Debt Income

Section 108 provides a significant number of exceptions to recognition of cancellation of debt income. The exceptions that originated as judicial exceptions to the *Kirby Lumber Co.* principle prior to the codification of the cancellation of debt rules are mostly grounded on tax theory. Exceptions that have been enacted by Congress to relieve perceived hardships are not so grounded. This dichotomy has led to differences in the operation of the exceptions. Those exceptions that are grounded in tax theory largely provide permanent nonrecognition; indeed they might better be described as nonrealization rules. On the other hand, most of the exceptions providing nonrecogniton that are grounded on hardship relief are accompanied by a companion rule requiring a reduction of favorable tax attributes. These exceptions are best understood as deferred recognition rules. There are, however, outlier rules on both sides of the dichotomy.

Most of the exceptions in section 108 are permanent features of the Code, but two are temporary rules, enacted in response to the recession that began in 2008. The permanent exceptions are as follows:

1. The section 108(a)(1)(A) exception for discharges in bankruptcy cases.
2. The section 108(a)(1)(B) exception for insolvency situations.
3. The section 108(a)(1)(C) exception for "qualified farm indebtedness."
4. The section 108(a)(1)(D) exception for noncorporate "qualified real property indebtedness."
5. The section 108(e)(2) exception for debts that would have been deductible when paid.
6. The section 108(e)(5) exception for reduction of certain purchase price debt obligations.
7. The section 108(f) exception for certain student loans.

[168] Rev. Rul. 2004-79, 2004-2 C.B. 106; Reg. § 1.61-12(c)(2).

[169] Robson v. Commissioner, 71 T.C.M. (CCH) 2225, 2229, 2000 T.C.M. (RIA) ¶ 2000-201, at 1140 (shareholder-debtor realized a liquidating distribution equal to the amount of the cancelled debt upon the liquidation of a corporation).

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The two temporary exceptions are:

1. The section 108(a)(1)(E) exception for "qualified principal residence indebtedness," which applies if the cancellation occurs on or after January 1, 2007, and before January 1, 2013.
2. The section 108(i) deferral rule allowing cancellation of trade or business debt income realized in 2009 and 2010 to be deferred and included ratably over five tax years beginning in 2014.[170]

A. *Theoretically Grounded Exceptions*

1. *Lost Deductions*

Section 108(e)(2) provides that no cancellation of debt income is realized from the cancellation of a debt that would have given rise to a deduction if it had been paid. Because the taxpayer has not previously received any tax benefit (*i.e.*, a deduction or basis increase) with respect to this type of debt, there is no reason for realization of an offsetting income item when the debt is cancelled. This provision applies primarily to the accounts payable of a cash method trade or business, but it may apply to other items, such as home mortgage interest deductible under section 163(h). It does not apply to accounts payable of accrual method taxpayers because a deduction is allowed when the debt is incurred.[171] No real exclusion is provided by this provision, however, since the deduction is lost by virtue of the debt not having been paid. Section 108(e)(2) simply eliminates the requirement that the discharged amount be included in income and then be treated as constructively paid, thus giving rise to an offsetting deduction.[172]

When a debt for interest due on a loan is cancelled, the application of section 108(e)(2) turns on whether the interest would have been deductible under section 163 if it had been paid. In *Hahn v. Commissioner*, a cash method taxpayer was discharged from an obligation to pay accrued but unpaid interest.[173] The Tax Court held that cancellation of debt income can be realized under the *Kirby Lumber Co.* "freeing of assets" rationale even though the debtor does not receive any cash or other property when he incurred the liability.[174] When a creditor writes off accrued but unpaid interest and fees owed by a cash method debtor, discharge of indebtedness income is realized unless the interest and fees would have been deductible if it had been paid, and section 108(e)(2) thus would have excluded the amount. The court rea-

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[170] I.R.C. § 108(i).

[171] *See* Rev. Rul. 1967–200, 1967–1 C.B. 15 (clarified by Rev. Rul. 1970–406, 1970–2 C.B. 16).

[172] *See* I.R.C. § 108(e)(2).

[173] 93 T.C.M. (CCH) 1055, 2007 T.C.M. (RIA) ¶ 2007-075 (denying taxpayer's motion for summary judgment because the issue of whether the interest expenses incurred in a horse breeding activity were deductible as a trade or business expense was a question of fact on which a trial was necessary).

[174] *Id.* at 1056–57, 2007 T.C.M. (RIA) ¶ 2007-075 at 584.

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soned that "the right to use money represents a valuable property interest," and that when the taxpayer obtained the right to use the money, he incurred liability for interest and fees that accrued.[175] The release of the obligation to pay interest and the other related items resulted in an accession to wealth due to the freeing of the assets that were offset by this liability. A similar result was reached in *Payne v. Commissioner*, where the taxpayer compromised a credit card debt, including nondeductible interest incurred for personal living expenses.[176]

2. *Purchase Price Reduction*

Section 108(e)(5) provides that cancellation of debt income is not recognized as a result of the reduction of an obligation from the purchaser of property to the seller of the property that arose out of the sale of the property.[177] This statutory exception first arose under the pre-1954 case law.

In *Hirsch v. Commissioner*, the taxpayer acquired property for cash plus the assumption of a mortgage held by a third party.[178] The value of the property declined below the face amount of the mortgage and the taxpayer offered to convey the property to the creditor in exchange for cancellation of the debt. The creditor refused the offer but agreed to reduce the amount of the mortgage by $7,000. The Commissioner asserted that the taxpayer realized cancellation of debt income as a result of a $7,000 balance sheet improvement resulting from reduction of the mortgage. The court held that there was no cancellation of debt income, concluding instead that the taxpayer had merely obtained a reduction in the cost of the property.[179] With a reference to the whole transaction approach of *Kerbaugh–Empire Co.*, the *Hirsch* court stated:

> [The taxpayer's] ultimate gain or loss can not be determined until liquidation of his capital investment. When costs go into property, whether one is to gain or lose must of necessity remain undecided until the property is sold. Credits upon the cost of the investment do not become gain until we find that what is realized upon sale exceeds the total cost, after deducting such voluntary reductions.[180]

A similar result was reached in *Commissioner v. Sherman.*[181] The taxpayer had purchased property for cash and assumption of an existing mortgage debt. Subsequently, the mortgagee accepted partial payment on the debt when the taxpayer contested liability on the debt on the grounds that various

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[175] *Id.* at 1057, 2007 T.C.M. (RIA) ¶ 2007-075 at 584.

[176] 95 T.C.M. (CCH) 1253, 2008 T.C.M. (RIA) ¶ 2008-066, *aff'd per curiam*, No. 08-2396, 2009 WL 4909437 (8th Cir. Dec. 22, 2009); *accord* Melvin v. Commissioner, 98 T.C.M. (CCH) 159, 2009 T.C.M. (RIA) ¶ 2009-199.

[177] I.R.C. § 108(e)(5).

[178] 115 F.2d 656 (7th Cir. 1940).

[179] *Id.* at 658.

[180] *Id.*

[181] 135 F.2d 68 (6th Cir. 1943).

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fraudulent misrepresentations had been made to him in connection with the purchase of the property. The *Sherman* court relied on *Hirsh* and *Kerbaugh-Empire Co.* to find only a reduction in the purchase price of the property and no cancellation of debt.

Subsequently, in *Fifth Avenue–Fourteenth Street Corp. v. Commissioner*, the Second Circuit held that the purchase money exception is limited to direct negotiations between the seller and purchaser of encumbered property.[182] The court rejected the logic of various cases, like *Hirsh* and *Sherman*, which had held that *Kirby Lumber Co.* was inapplicable where the debt being reduced was a purchase money obligation incurred by the taxpayer when acquiring property. The court stated that it considered the distinction "irrational . . . and . . ., if valid, . . . limited to a case of a purchase money obligation where the vendor-mortgagee, in negotiations directly relating to the purchase price, agrees to a reduction."[183]

The purchase price reduction exception, as now codified in section 108(e)(5), provides that cancellation of debt income does not include a reduction of an obligation from the purchaser of property to the seller of the property that arose out of the sale of the property. The reduction or cancellation of purchase money debt is treated as a reduction of the purchase price, resulting in a reduction of the basis of the property. The purchase price reduction exception does not apply, however, if the reduction occurred in a Title 11 case or if the purchaser was insolvent. The result of this ordering rule is not to require inclusion in gross income of the discharged indebtedness, but to invoke the reduction of tax attributes rules of section 108(b).[184]

Section 108(e)(5) was enacted to end disputes between the Commissioner and taxpayers over whether cancellation of debt attributable to the purchase of property should be treated as income or as a true reduction in the purchase price of property.[185] The legislative history indicates that the provision applies only to a reduction of debt resulting from direct negotiations between buyer and seller.[186] It is unlikely that *Hirsch* and its progeny represent a more broadly applicable judicial purchase money exception that survived the enactment of section 108(e)(5). Revenue Ruling 1992-99 held that section 108(e)(5) did not apply when a purchase money debt due to a third party lender was reduced through negotiations between the taxpayer-debtor and the creditor.[187] The Service expressly rejected the application of *Hirsch* to a reduction of a nonrecourse debt to a third party lender that was incurred to purchase property that had declined in value.

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[182] 147 F.2d 453 (2d Cir. 1944).
[183] *Id.*
[184] *See* discussion *infra* Part V.B.1.
[185] S. Rep. No. 96–1035, at 16 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, at 7031.
[186] *Id.* at 16–17.
[187] Rev. Rul. 1992-99, 1992-2 C.B. 35.

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> An agreement to reduce a debt between a purchaser and a third-party lender is not a true adjustment of the purchase price paid for the property because the seller has received the entire purchase price from the purchaser and is not a party to the debt reduction agreement. The debt reduction relates solely to the debt and results in discharge of indebtedness income to the debtor.[188]

However, the Service indicated that although it would not follow *Sherman* to the extent that *Sherman* relied on *Kerbaugh-Empire Co.* to permit a purchase price adjustment, the Service would treat debt reduction by a third party lender as a purchase price reduction to the extent that the debt reduction was based on an infirmity that clearly related back to the original sale, such as a misrepresentation of a material fact or fraud. But apart from that narrow situation, the Service will not allow a purchase price exclusion, except as provided by section 108(e)(5).[189] There is a logical inconsistency in Revenue Ruling 1992-99, because although the Service suggested it might follow *Sherman* in an instance where the debtor claimed fraud or misrepresentation by the seller as a defense to the creditor's claim, it also described *Fifth Avenue–Fourteenth Street Corp.*, which expressly rejected *Sherman*, as the common law prior to the enactment of section 108(e)(5).[190]

In *Michaels v. Commissioner*, the taxpayer was required to recognize cancellation of debt income on prepayment at a discount of a purchase money home-mortgage debt to a third party lender.[191] The court rejected the taxpayer's argument that the cancellation of debt income was excludable under section 108.[192] *Preslar v. Commissioner* reached the same conclusion: the enactment of section 108(e)(5) pre-empted any pre-existing common law purchase price adjustment exception.[193] Thus, the taxpayer in *Preslar* recognized cancellation of debt income when his obligation on a purchase money mortgage owed to a bank that financed his purchase of the property from a third party was reduced.[194] Similarly, *Payne v. Commissioner* held that the compromise of consumer credit card debt incurred for personal living expenses, including interest, was cancellation of debt income; section 108(e)(5) was inapplicable because the only relationship between the debtor and creditor was the debtor-creditor relationship and there was no purchase of

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[188] *Id.*
[189] *Id.*
[190] *Id.*
[191] 87 T.C. 1412 (1986).
[192] *Id.* at 1417.
[193] 167 F.3d 1323, 1332–33 (10th Cir. 1999).
[194] *Id.* at 1333; *see also* Sutphin v. United States, 14 Cl. Ct. 545 (1988) (section 108(e)(5) purchase price adjustment rule did not apply to discount on prepayment of debt to third party lender). *Sutphin* discusses *Hirsh* and *Sherman* as if they might have continued viability in certain circumstances, but *Sutphin* predates *Preslar*. *See supra* note 114. Revenue Ruling 1992-99, 1992-2 C.B. 35, is contrary to Hirsh. *See supra* note 187.

property from the creditor.[195] Following these principles, the purchase money reduction exception also should not be available if there has been a transfer of either the debt or the purchased property to a third party.[196]

Revenue Ruling 2004-37 dealt with the problem of distinguishing disguised compensation from a purchase price adjustment with respect to the purchase of stock in the corporation that employed the taxpayer.[197] The employee purchased stock from his employer by giving the employer a promissory note, and the employer and employee subsequently agreed to reduce the principal amount of the note. The ruling held that the employee recognizes compensation income under section 83, rather than cancellation of debt income excluded under section 108(e)(5).

B. *Legislative Grace Statutory Exceptions*

Section 108 provides a variety of statutory exceptions providing for the exclusion of realized cancellation of debt income. Several of the exceptions are accompanied by rules requiring reduction of tax attributes that convert the exceptions from exclusions to deferred recognition rules, but some of the exceptions provide exclusions.

1. *Bankruptcy and Insolvency Exceptions*

a. *Exclusionary Rules.* Section 108(a)(1)(A) excludes from the debtor's gross income any amount that would otherwise be includable as cancellation of debt income by reason of the discharge of the taxpayer's indebtedness if the discharge occurs in a bankruptcy case, including reorganizations, under Title 11 of the United States Code, provided the taxpayer is under the jurisdiction of the court and the discharge is granted either by the court or pursuant to a plan approved by the court.[198]

Section 108(a)(1)(B) excludes cancellation of debt income realized while the debtor is insolvent, as defined by section 108(d)(3).[199] As discussed above, the insolvency exception originated as a judicial rule based on the freeing of

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[195] 95 T.C.M. (CCH) 1253, 2008 T.C.M. (RIA) ¶ 2008-066, *aff'd per curiam*, No. 08-2396, 2009 WL 4909437 (8th Cir. Dec. 22, 2009); *see also* Melvin v. Commissioner, 98 T.C.M. (CCH) 159, 2009 T.C.M. (RIA) ¶ 2009-199 (compromise of consumer credit card debt gave rise to COD income; "[taxpayers] received goods and services (and cash advances) on credit; when Chase relieved them of their corresponding obligation to pay, petitioners without question received an 'accession to income'").

[196] S. Rep. No. 96–1035, at 16–17 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, at 7031.

[197] Rev. Rul. 2004-37, 2004-1 C.B. 583.

[198] I.R.C. § 108(a)(1)(A), (d)(2); *see generally* Paul H. Asofsky, *Discharge of Indebtedness Income in Bankruptcy After the Tax Act of 1980*, 27 St. Louis U. L.J. 583 (1983).

[199] When the year in which a debt is cancelled is important, the fact that a corporation is insolvent and being administered by a trustee in bankruptcy does not in and of itself effect a cancellation of those of the corporation's debts that are highly unlikely to be paid. In addition to the improbability of payment, there must be some identifiable event that fixes the loss with certainty to evidence the cancellation. *See* Friedman v. Commissioner, 216 F.3d 537 (6th Cir. 2000).

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assets theory of cancellation of debt income in *Kirby Lumber Co.*[200] *Lakeland Grocery Co. v. Commissioner*, probably the most frequently cited early judicial decision regarding cancellation of debt income, held that an insolvent taxpayer did not recognize cancellation of its debt income only to the extent of the taxpayer's insolvency, but that cancellation of debt income was realized to the extent the taxpayer's assets exceeded its liabilities after the cancellation.[201] The principles of *Lakeland Grocery* are now incorporated into the relevant provisions of section 108. Section 108(a)(3) limits the exclusion of cancellation of debt income under the insolvency exception to the amount by which the taxpayer is insolvent, thus requiring inclusion to the extent that the cancellation of indebtedness renders the taxpayer solvent.[202]

Insolvency is defined in section 108(d)(3) as the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets.[203] *Carlson v. Commissioner* held that the definition of "insolvent" in section 108(d)(3) requires that all of the taxpayer's assets, including assets exempt from the claims of creditors under state law, be included in determining whether the taxpayer's liabilities exceed his assets.[204] The taxpayer had argued that assets exempt from creditors' claims under state law should be excluded from the calculation, thus making it easier for a taxpayer to demonstrate insolvency. The court rejected this argument. It compared the definition of "insolvent" under the Bankruptcy Code,[205] which expressly excludes exempt property from the calculation, with the definition under section 108(d)(3), which does not do so, and concluded that the difference was intentional.[206] By using the different definition, Congress intended exempt assets not to be excluded from the calculation in determining whether the taxpayer is insolvent for purposes of section 108.

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[200] *See supra* text accompanying note 37.

[201] 36 B.T.A. 289, 292 (1937).

[202] If an insolvent taxpayer transfers property to a lender in satisfaction of a recourse debt, the transferor recognizes gain or loss to the extent of the difference between the fair market value of the transferred property and its basis; only the excess of the cancelled debt over the fair market value of the transferred property is cancellation of debt income that can be excluded under section 108(a). *Compare* Rev. Rul. 1990-16, 1990-1 C.B. 12 (transfer to mortgagee by insolvent taxpayer of property encumbered by recourse debt resulted in realization of gain to the extent the fair market value of property exceeded basis; to the extent debt exceeded fair market value of property, taxpayer realized cancellation of debt income excludable under section 108(a)(1)(B)), *with* Gehl v. Commissioner, 102 T.C. 784 (1994), *aff'd by order*, 50 F.3d 12 (8th Cir. 1995) (applying Treasury Regulation section 1.1001–2(c), only the amount by which a cancelled debt exceeded the fair market value of property transferred to creditor by an insolvent taxpayer in satisfaction of debt could be excluded under section 108(a)).

[203] *See* Rev. Rul. 1992-53, 1992-2 C.B. 48 (amount by which a nonrecourse debt exceeds the value of the secured property is taken into account in determining insolvency only to the extent that the excess nonrecourse debt is discharged).

[204] 116 T.C. 87 (2001).

[205] 11 U.S.C. § 101(26).

[206] *Carlson*, 116 T.C. 87 (2001).

The requirement that all of the taxpayer's assets be taken into account in determining whether the taxpayer is insolvent (and the amount by which the taxpayer is insolvent) can present difficult factual issues if the taxpayer is engaged in a trade or business, because the value of all the taxpayer's intangible assets, such as goodwill and going concern vale of the business, must be included in the calculation.[207]

The original judicial logic still influences the application of the insolvency exception, even though the Supreme Court has held that the statutory insolvency exception is exclusive and prior judicial principles cannot be applied to expand or narrow the statutory rules.[208] Under the logic of *Lakeland Grocery*, only obligations that are certain to offset assets should be taken into account. As a result, contingent liabilities are not taken into account, even at a discounted value that reflects the probability that they will become due and owing. In *Merkel v. Commissioner*, the taxpayers attempted to exclude cancellation of debt income under the insolvency exclusion by including contingent liabilities in the insolvency calculation.[209] Most of the contingent liabilities were in the form of guarantees made by the taxpayers. Under a compromise settlement, about one-third of the amount due to a creditor of a corporation owned by the taxpayers was paid, and the creditor agreed not to exercise any remedies against the corporation or the taxpayers' guarantees with respect to the remaining portion of the loan if a voluntary or involuntary bankruptcy was not filed with respect to the corporation within 400 days. However, the remaining portion of the obligation would become due, and the guarantees could be enforced if taxpayers or their corporation filed for bankruptcy within 400 days of the settlement. The taxpayers also attempted to include corporate debts for uncollected state sales taxes that had been asserted against the corporation, but were being protested by the corporation, for which they might have been contingently liable as corporate officers. Neither the creditors nor the state had yet asserted claims against taxpayers.

The Tax Court held that the taxpayers were not insolvent as defined in section 108(d)(3), and that contingent liabilities are not taken into account in determining whether the taxpayer is insolvent for purposes of section 108(d)(3). The court reasoned that the analytical framework underlying the insolvency exception is based on the freeing of assets theory of discharge of indebtedness income. Under this analytical framework, if all of the debtor's assets are subject to the claims of creditors after the cancellation of a debt, the taxpayer is no better off by reason of the debt cancellation, and thus realizes no income. To meaningfully apply this analysis, only obligations that offset

[207] *See* Conestoga Transp. Co. v. Commissioner, 17 T.C. 506 (1951) (going concern value); J.A. Mauer, Inc. v. Commissioner, 30 T.C. 1273 (1958) (goodwill; semble). However, an individual's business "experience" and business relationships that do not amount to going concern value or goodwill are not valued and taken into account. Davis v. Commissioner, 69 T.C. 814 (1978).

[208] Gitlitz v. Commissioner, 531 U.S. 206 (2001).

[209] 109 T.C. 463 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999).

assets with a sufficient degree of certainty should be taken into account. The opinion noted that the insolvency exception does not necessarily produce the same result as the bankruptcy exception. On appeal, the Court of Appeals for the Ninth Circuit affirmed the Tax Court and held that for the purposes of determining insolvency under section 108(d)(4), a contingent liability would be included as a liability only if the taxpayer could prove by a preponderance of the evidence that he or she would be called upon to pay the contingent liability—a more-likely-than-not test.[210] The contingent liabilities could not be taken into account at a discounted value reflecting the probability of that the liability ripening.

On the other hand, if the taxpayer is unconditionally obligated to repay a debt, the fact that it is unlikely that the taxpayer ever actually will be called upon to pay the debt does not prevent the debt from being taken into account. In *Miller v. Commissioner*, the taxpayer's liabilities, the cancellation of which give rise to cancellation of debt income, were counted in full as liabilities in determining whether the taxpayer was insolvent, even though, because the taxpayer was insolvent and the loan was guaranteed by a solvent third party, there was virtually no likelihood that taxpayer would be called upon to pay the debt and the guarantor had waived his right to indemnification in advance.[211]

Nonrecourse debt presents yet another problem in determining insolvency because it reduces the net value of the encumbered property, but does not otherwise reduce the taxpayer's net worth. Thus, the Service has ruled that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent, but only with respect to a cancellation of the nonrecourse debt.[212] For example, if a taxpayer has an asset worth $1,000, which is encumbered by a $900 recourse liability, and a second asset worth $2,000, which is encumbered by a $2,300 nonrecourse liability, and a portion of the nonrecourse liability is cancelled, the taxpayer is insolvent before the cancellation. The taxpayer's liability is determined to be the sum of the $900 recourse liability, the $2,000 fair market value of the property encumbered by the nonrecourse debt, and the amount of the excess nonrecourse debt to the extent that it has been cancelled. The taxpayer has assets worth $3,000 ($2,000 plus $1,000) and liabilities of up to $3,200. Cancellation of up to $200 of the nonrecourse debt will be excluded from cancellation of debt income under the insolvency exception. But if the recourse liability is cancelled, the taxpayer is not insolvent before the cancellation. In this case, the nonrecourse liability in excess of the fair market value of the encumbered property is not counted. So the taxpayer again has $3,000 of assets, but only $2,000 of liabilities ($900 recourse and only $2,000 nonrecourse).

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[210] *Merkel*, 192 F.3d at 851–52.

[211] 91 T.C.M. (CCH) 1267, 2006 T.C.M. (RIA) ¶ 2006-125.

[212] Rev. Rul. 92-53, 1992-2 C.B. 48.

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b. *Attribute Reduction Rules.* When cancellation of debt income is excluded under section 108(a)(1), the taxpayer is required to reduce certain tax attributes by the amount of income excluded under section 108. Thus, to the extent tax attributes are reduced, sections 108(a)(1)(A) and (B) operate only to defer tax liability, rather than as an absolute exclusion. Section 108(b)(2) requires the taxpayer to reduce favorable tax attributes in the following order: (1) net operating losses,[213] (2) general business credit carryovers, (3) minimum tax credits, (4) net capital loss carryovers, (5) basis of property, (6) passive activity loss and credit carryovers, and (7) foreign tax credit carryovers. The affected tax attributes are reduced by one dollar for each dollar of excluded cancellation of debt income, except for credits, which are reduced by one-third of excluded cancellation of debt income.[214] These attribute reductions will increase the taxpayer's taxable income or gain (or decrease the taxpayer's loss) on the disposition of property in future years.[215] To the extent the basis of depreciable property is reduced, the attribute reduction results in lesser depreciation deductions in future years thereby increasing future taxable income by the amount of the deferred cancellation of debt income. If the amount of excluded cancellation of debt income cannot be absorbed by the taxpayer's tax attributes, the excess is effectively exempt from tax.

In lieu of the attribute reductions mandated by section 108(b)(2), the taxpayer may elect under section 108(b)(5) to first reduce the basis of depreciable property.[216] (A basis reduction under section 108(b)(2)(E) attributable

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[213] The amount of net operating loss (NOL) carryovers to which a taxpayer succeeds from his bankruptcy estate pursuant to section 1398(i) may be limited because of this rule. *See* Firsdon v. United States, 95 F.3d 444 (6th Cir. 1996) (the taxpayer failed to prove that the bankruptcy estate's NOL carryover of $345,424 was the NOL remaining after reduction under section 108(b)); *see also* Kahle v. Commissioner, 73 T.C.M. (CCH) 2080, 1997 T.C.M. (RIA) ¶ 97,091 (taxpayer's bankruptcy estate succeeded to prebankruptcy NOL because taxpayer did not make a short year election under section 1398(d), and pursuant to sections 108(b) and 108(d)(8), as a result of nonrecognition of cancellation of indebtedness income arising from bankruptcy, the NOL was eliminated and thus unavailable to the taxpayer for postbankruptcy years).

[214] I.R.C. § 108(b)(3).

[215] In *Williams v. Commissioner*, the bankrupt taxpayer owned all of the shares of an S Corporation. 123 T.C. 144 (2004). The Tax Court held that under section 1398(f)(1), "a transfer of an asset from the debtor to the bankruptcy estate when the debtor files for bankruptcy is not a disposition triggering tax consequences, and the estate is treated as the debtor would be treated with respect to that asset." *Id.* at 148–49. Thus, the bankruptcy estate was treated as if it had owned all of the shares of the S corporation for the entire year and was entitled to all of the passed-through losses. Furthermore, pursuant to section 108(b)(2), any passed-though losses to which the bankruptcy estate succeeded, or losses that were passed through to the bankruptcy estate and which were not used to offset income realized by the bankruptcy estate, were reduced by the amount of cancellation of debt income that was not recognized under section 108(a) before being passed on to the taxpayer upon termination of the bankruptcy proceeding pursuant to section 1398(i).

[216] I.R.C. § 1017(b)(3); *see* Reg. §§ 1.108-4, 1.1017-1 (operating rules governing the election to reduce the basis of depreciable property); *see also* Rev. Proc. 1985-44, 1985-2 C.B. 504 (procedures for closing agreements).

to cancellation of debt income excluded under section 108(a) can apply to property that is not depreciable.)

Section 1017 and the regulations thereunder provide complex rules regarding basis reductions, whether under section 108(b)(2) or section 108(b)(5). If the basis of property is reduced under section 108(b)(2)(E) by virtue of the taxpayer's insolvency or bankruptcy, the aggregate basis reduction cannot exceed the amount by which the aggregate of the bases of the property held by the taxpayer immediately after the debt cancellation exceeds the aggregate of the liabilities of the taxpayer immediately after the cancellation.[217] This limitation does not apply, however, if the taxpayer elects under section 108(b)(5) to bypass the section 108(b)(2) attribute reduction rules and reduce only the basis of depreciable property.[218]

Section 1017(d) requires that basis reductions under section 108(b)(2) and section 108(b)(5) be treated as depreciation adjustments to basis, which will be subject to recapture as ordinary income under sections 1245 and 1250. As a result, whenever the basis of depreciable real property is reduced, the property will carry with it until the end of its cost recovery period some amount of section 1250 ordinary income recapture taint. Furthermore, any property for which the basis is reduced under section 1017 that is neither section 1245 property nor section 1250 property is treated as section 1245 property.[219] As a result, assets such as land and corporate stock, which otherwise would be a capital asset (or in the case of land, often a nondepreciable section 1231 asset), the basis of which has been reduced under section 1017, will carry with them a permanent section 1245 ordinary income recapture taint.

The regulations under section 1017 prescribe the rules regarding basis reductions under section 108(b)(2)(E) that are required if the bankruptcy or insolvency exception applies. To the extent of the excluded cancellation of debt income, the adjusted bases of property held on the first day of the taxable year following the taxable year that the taxpayer excluded the income are reduced (but not below zero) in the following order: (1) real property used in a trade or business or held for investment (other than real property described in section 1221(a)(1) (*i.e.*, property held for sale primarily to customers in the ordinary course of business)) that secured the cancelled debt immediately before the cancellation; (2) personal property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable) that secured the cancelled debt immediately before the cancellation; (3) any remaining property used in a trade or business or held for investment (other than inventory, accounts receivable, notes receivable, and real property described in section 1221(a)(1)); (4) inventory, accounts receivable, notes receivable, and real property described in section 1221(a)(1); and (5)

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[217] I.R.C. § 1017(b)(2).
[218] *Id.*
[219] I.R.C. § 1017(d)(1)(A).

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property not used in a trade or business nor held for investment.[220] Within each category, the bases of the properties are reduced in proportion to their respective bases.[221] Section 1017(b)(3)(F) allows the taxpayer to elect to treat real property held for sale to customers in the ordinary course of business as depreciable property for purposes of applying the basis reduction rules.[222]

When the bankruptcy exception of section 108(a)(1)(A) applies to an individual, the attribute reduction rules apply to the bankruptcy estate, not to the individual.[223] However, the basis reduction rules of section 1017 apply to the individual bankrupt taxpayer to the extent property is transferred by the bankruptcy estate to the individual.[224]

The taxpayer's tax liability for the year of cancellation is determined without any reduction under section 108(b) in attributes that carryover to the current year or that carryback to prior years, before such tax attributes are reduced.[225] "This ordering rule affords the taxpayer the use of certain of its tax attributes described in section 108(b)(2), including any losses carried forward to the taxable year of cancellation, for purposes of determining its tax for the taxable year of discharge, before subjecting those attributes to reduction."[226] Basis reductions under section 1017 occur at the beginning of the taxable year following the year in which the cancellation occurred.[227]

An interesting—and for the taxpayer, unpleasant—result occurs when the section 108(a)(1)(A) bankruptcy exception applies and a mortgage lien survives the bankruptcy. When personal liability on the debt is discharged but the lien survives, the debt is transformed into a nonrecourse debt. When the property is sold or foreclosed upon, the amount of any remaining nonrecourse debt encumbering the property is included in the amount realized by the taxpayer along with any cash received.[228]

c. *Special Issues Regarding Cancellation of Debt Income of Pass-Through Entities.*

i. *Partnerships and Limited Liability Companies.* Section 108(d)(6) requires that the bankruptcy and insolvency exceptions to cancellation of debt income be applied at the individual partner level rather than at the partnership level.[229] Thus, cancellation of debt income realized by an insolvent or bankrupt partnership or limited liability company may be excluded only by those part-

[220] I.R.C. § 108(b)(4)(A); Reg. § 1.1017-1(a).
[221] Reg. § 1.1017-1(a).
[222] I.R.C. § 1017(b)(3)(F).
[223] I.R.C. § 108(d)(8).
[224] I.R.C. § 108(d)(8).
[225] Reg. § 1.108-7(b).
[226] T.D. 9080, 2003-2 C.B. 696 (Reduction of Tax Attributes Due to Discharge of Indebtedness).
[227] *See* Reg. § 1.1017-1(a), (b)(4).
[228] *See* Neighbors v. Commissioner, 76 T.C.M. (CCH) 128, 1998 T.C.M. (RIA) ¶ 98,263.
[229] Thus, partnership cancellation of debt income is a separately stated item under section 702(a). Rev. Rul. 1992-97, 1992-2 C.B. 124.

ners that are themselves insolvent.[230] Concomitantly, the attribute reduction rules of section 108(b) are applied at the individual partner level. However, the Service will not challenge the treatment by an insolvent or bankrupt partnership of a discharge of a purchase money indebtedness as an adjustment to purchase price under section 108(e)(5), rather than as separately stated cancellation of indebtedness income, if the cancellation otherwise would have qualified as a purchase price adjustment, as long as all partners report the treatment consistently.[231] In effect, this permits an insolvent partnership to elect whether to treat the debt cancellation as a purchase price reduction under section 108(e)(5) or to pass through cancellation of debt income, which could be excluded only by insolvent partners.

ii. *S Corporations.* In the case of an S Corporation, the insolvency and bankruptcy exceptions in section 108(a) are applied at the corporate level.[232] However, section 108(d)(7), which was enacted in 1992 to overturn the Supreme Court's decision in *Gitlitz v. Commissioner*,[233] provides that amounts excluded under section 108(a) will not be taken into account as a separately

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[230] Revenue Ruling 1992-97, 1992-2 C. B. 124, held that under Regulation section 1.731-1(a)(1)(ii) the deemed distribution to a partner under section 752(b) resulting from the cancellation of a partnership debt that gave rise to cancellation of debt income under section 61(a)(12) is treated as occurring after the increase in the partners' bases in their partnership interests resulting from the cancellation of debt income. Thus, if the partners share income and loss in the same percentages as they shared the cancelled debt, each partner will take into account a pro rata share of the cancellation of debt income, and the basis adjustments for the passed-though income and the deemed distribution exactly offset each other, with no gain resulting under section 731. If, however, a particular partner's share of partnership liabilities exceeds the partner's distributive share of partnership income from the cancellation of the debt, the constructive distribution might exceed the partner's basis for his partnership interest, resulting in recognition of gain under section 731.

[231] Rev. Proc. 1992-92, 1992-2 C.B. 505.

[232] I.R.C. § 108(d)(7)(A).

[233] 531 U.S. 206 (2001). In *Gitlitz*, the taxpayer was the sole shareholder of an S corporation that realized cancellation of debt income while it was insolvent. Under section 108(a), the corporation properly excluded the cancellation of debt income. Upon the subsequent disposition of the stock (in the same year), the taxpayer shareholder claimed an increase in the basis of his stock in the corporation pursuant to sections 1367(a)(1)(A) and 1366(a)(1)(A) on the theory that the cancellation of debt income was passed-through "exempt" income, and reported a long-term capital loss. Reversing the lower courts, the Supreme Court concluded that cancellation of the debt was "income" within the meaning of section 1366(a)(1)(A), which increases shareholder basis under section 1367(a)(1)(A). In addition, although section 108(d)(7)(A), as in effect for the year in question, provided that the exclusions of section 108(a) and the attribute reductions required by section 108(b) were to be applied to an S corporation at the corporate level, the Supreme Court concluded that section 108(b)(4)(A), which provides that attribute reduction under section 108(b)(2) takes place "after the determination of the tax imposed by this chapter," expressly requires that the S corporation's shareholder's pass-through of income and basis adjustment must be taken into account before the cancellation of debt income is reduced by corporate level net operating losses. As a result of this reasoning, the S corporation shareholder in *Gitlitz* received a tax-free step-up in basis that he was able to convert into a deductible capital loss.

stated item of tax exempt income under section 1366(a)(1)(A).[234] As a result, the S corporation's shareholders do not receive any step-up in the basis of their shares under section 1367.

2. *Qualified Farm Debt Exception*

Section 108(a)(1)(C) excludes cancellation of "qualified farm indebtedness," which is defined in section 108(g). Qualified farm indebtedness is a debt that was incurred directly in connection with the taxpayer's operation of a farming trade or business. To qualify, fifty percent or more of the taxpayer's aggregate gross receipts for the three taxable years preceding the taxable year in which the cancellation of the debt occurs must be "attributable to the trade or business of farming".[235] Furthermore, to qualify the debt must be owed to a "qualified person," which generally speaking is a person actively and regularly engaged in the business of lending money other than a person related to the taxpayer, a person from which the taxpayer acquired the property (or a related person to such person), or a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).[236]

The amount excluded under the qualified farm debt exception cannot exceed the sum of: (1) the taxpayer's "adjusted" tax attributes described in section 108(b)(2), excepting the basis of property, and (2) the aggregate adjusted bases of the taxpayer's "qualified property." Qualified property is defined as any property that is used or is held for use in a trade or business or for the production of income as of the beginning of the taxable year following the taxable year in which the cancellation occurred.[237] "Adjusted tax attributes" are the sum of the tax attributes described in section 108(b)(2), excepting the basis of property, redetermined by taking into account $3 for each $1 of general business credit, minimum tax credit, foreign tax credit carryover, and passive activity credit carryover.[238]

If the qualified farm indebtedness exception applies, any basis reduction under section 108(a)(2)(B) is made only with respect to qualified property, in the following order: (1) depreciable property; (2) land used or held for use in

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[234] *See also* Reg. § 1.1366-1(a)(2)(viii).

[235] I.R.C. § 108(g)(2). *See* Lawinger v. Commissioner, 103 T.C. 428 (1994) (cancellation of debt income could not be excluded under section 108(a)(1)(C) because less than one half of taxpayer's gross receipts, including proceeds from sale of farming equipment, were from farming; rents and credits from the State of Wisconsin for preserving land as farmland were not taken into account as farm income).

[236] I.R.C. §§ 108(g)(1), 49(a)(1)(D)(iv). Through a string of cross-references, "related person" is defined as a person in a relationship described in section 267(b) or section 707(b)(1), or persons engaged in trades or business under common control.

[237] I.R.C. § 108(g)(3). For purposes of determining the ceiling on qualified farm indebtedness, the adjusted basis of any qualified property and the amount of the adjusted tax attributes are determined after any reduction under section 108(b) resulting from application of the insolvency exclusion. I.R.C. § 108(g)(3)(D).

[238] I.R.C. § 108(g)(3)(B).

farming; and (3) other qualified property.[239]

With respect to partnerships, as in the case of the bankruptcy and insolvency exceptions, section 108(d)(6) requires that the qualified farm indebtedness exception in section 108(a)(1)(C) and (g), and the concomitant attribute reduction rules, be applied at the individual partner level. In the case of cancellation of debt of an S Corporation, the qualified farm indebtedness exception in section 108(a)(1)(C) and (g) and the concomitant attribute reduction rules are applied at the corporate level.[240]

3. *Real Property Business Debt*

Sections 108(a)(1)(D) and 108(c) allow noncorporate taxpayers to elect to exclude income arising from cancellation of "qualified real property business indebtedness."[241] Qualified real property business indebtedness is indebtedness incurred in connection with, and secured by, real property used in a trade or business.[242] This provision is intended to facilitate refinancing for distressed real estate projects. Accordingly, the exclusion is limited to the amount by which qualified real property indebtedness exceeds the fair market value of property secured by the debt.[243] This limitation has the effect of limiting the exclusion under section 108(a)(1)(D) to so-called "phantom gain." To assure that the exclusion results only in deferral and not permanent exclusion, section 108(c)(2)(B) further limits the amount of the exclusion to the aggregate adjusted basis of depreciable real property held by the taxpayer immediately before the cancellation.

"Qualified real property business indebtedness" includes only: (1) debt incurred or assumed by the taxpayer before 1993 "in connection with" real property used by the taxpayer in a trade or business and secured by the real property; and (2) debt incurred or assumed after 1992 to acquire, construct, reconstruct, or substantially improve the property secured by the debt or to refinance qualifying pre-1993 indebtedness to the extent the refinancing does not exceed the original debt. Under this definition, the use of the proceeds of pre-1993 indebtedness appears to be irrelevant as long as the debt is secured by real property used in the taxpayer's trade or business.[244]

If the taxpayer elects to apply the qualified real property business indebtedness exception, the taxpayer must reduce the basis of depreciable real prop-

[239] I.R.C. § 1017(b)(4)(A).

[240] I.R.C. § 108(d)(7)(A).

[241] The election must be made on a timely return (including extensions) for the taxable year in which the cancellation of indebtedness income was realized, and it is revocable only with the consent of the Service. Reg. § 1.108-5.

[242] I.R.C. § 108(c)(3) (qualified real property business indebtedness is defined to expressly exclude qualified farm indebtedness).

[243] I.R.C. § 108(c)(2)(A); Reg. § 1.108-6. For this purpose the fair market value of the property is reduced by the principal amount of any other qualified real property business indebtedness secured by the property.

[244] I.R.C. § 108(c)(3), (c)(4).

erty by the excluded amount under the rules of section 1017.[245] In effect, the exception operates as a purchase price reduction. The regulations provide ordering rules under which the basis of the qualifying real property with respect to which the debt was cancelled is reduced first, and any remaining excluded cancellation of debt income is applied to reduce the basis of other real property held by the taxpayer for use in a trade or business or as an investment.[246] The basis reduction applies only to depreciable real property.[247] Generally, the basis reduction occurs at the beginning of the taxable year following the year of the debt cancellation.[248]

If the taxpayer is in the trade or business of farming, the qualified farm indebtedness rules take precedence, if applicable.[249] If a debtor is insolvent at the time of the debt cancellation, the insolvency exception, rather than the qualified real property business indebtedness exception applies.[250]

If the cancelled debt is partnership debt, section 108(d)(6) requires that the qualified real property business indebtedness exception in section 108(a)(1)(D) and section 108(c), and the concomitant attribute reduction rules be applied at the individual partner level, rather than at the partnership level.[251] Because the required basis reduction must be made only with respect to real property, and the exclusion is available only if the basis of depreciable real property is reduced, section 1017(b)(3)(C) permits a partner to treat the partner's interest in a partnership as depreciable property to the extent of the partner's proportionate interest in the partnership's depreciable property, provided that the partnership makes a corresponding reduction in its basis in depreciable property with respect to the electing partner.[252] As result of such a basis reduction, section 1250 ordinary income recapture will apply with respect to any real estate the basis of which has been adjusted, and section 751(a) of section 751(b) ordinary income treatment, respectively, will be triggered with respect to the partner upon a subsequent sale or exchange of the partnership interest or upon receipt of a distribution that alters the partner's interest in section 751(c) "hot assets."[253]

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[245] I.R.C. §§ 108(c)(1)(A), 1017(a)(1).

[246] Reg. § 1.1017–1(c)(1).

[247] I.R.C. § 1017(b)(3); Reg. § 1.1017–1(c)(1).

[248] I.R.C. § 1017(a).

[249] I.R.C. § 108(c)(3).

[250] I.R.C. § 108(a)(2)(B).

[251] I.R.C. § 108(d)(6).

[252] A partner's proportionate share of the partnership's basis in depreciable real property equals the sum of (1) the partner's section 743(b) basis adjustments to partnership depreciable real property, and (2) the common basis depreciation deductions (excluding allocations of depreciation deductions under section 1.704-3(d)) that are reasonably expected to be allocated to the partner over the property's remaining useful life. Reg. § 1.1017-1(g)(2)(iv). *See* Reg. § 1.1017-1(g)(2)(i)–(iii) for the procedural rules governing such elections.

[253] I.R.C. §§ 751(a)-(c), 1250(d)(5).

In the case of an S Corporation, the qualified real property business indebtedness exception in section 108(a)(1)(D) and section 108(c) and the concomitant attribute reduction rules are applied at the corporate level.[254]

4. *Election to Defer and Ratably Include Cancellation of Debt Income*

The American Recovery and Reinvestment Tax Act of 2009 added section 108(i), which allows a taxpayer to irrevocably elect to defer and include cancellation of debt income realized in 2009 and 2010 ratably over five tax years, rather than in the year the discharge occurs, if the debt was issued in connection with the conduct of a trade or business or by a corporation.[255] Although the statute refers to cancellation of debt income arising from "reacquisition" of an "applicable debt instrument," the statutory definitions of "reacquisition" and "an applicable debt instrument," respectively, are broad enough for the provision to apply regardless of the manner in which the debt is cancelled. Section 108(i)(4)(B) defines "acquisition" to include: (1) an acquisition of the debt instrument for cash; (2) the exchange of the debt instrument for another debt instrument, including an exchange resulting from a modification of the debt instrument (which includes a reduction of the principal amount of the debt); (3) the exchange of the debt instrument for corporate stock or a partnership interest; (4) the contribution of the debt instrument to capital; and (5) the complete forgiveness of the indebtedness by the holder of the debt instrument. In addition, published Service guidance provides that "the term 'acquisition' also includes an acquisition of the debt instrument for other property."[256] Thus, for example, the cancellation of a debt in connection with a deed in lieu of foreclosure qualifies as a reacquisition. Section 108(i)(3)(B) broadly defines "applicable debt instrument" to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of section 1275(a).

The section 108(i) election is made separately for each debt instrument. An election may be made for one debt instrument, but not for another.[257] A taxpayer may elect to defer only a portion of the cancellation of debt income realized from the reacquisition of any applicable debt instrument.[258] Thus, for example, if a taxpayer realized $1,000 of cancellation of debt income eligible for deferral under section 108(i), the taxpayer may defer only $300 of the $1,000. Any cancellation of debt income that the taxpayer does not elect to defer may be excluded from income under section 108(a)(1)(A), (B), (C), or (D), if applicable.

[254] I.R.C. § 108(d)(7)(A).
[255] For election procedures, see Rev. Proc. 2009-37, 2009-36 I.R.B. 309.
[256] Rev. Proc. 2009-37, 2009-36 I.R.B. 309, § 2.03.
[257] Rev. Proc. 2009-37, 2009-36 I.R.B. 309, § 2.04.
[258] *Id.*

For partnerships and S corporations, the election is made by the partnership or S corporation, not by the individual partners or shareholders.[259] If a partnership elects to defer less than all of the cancellation of debt income realized from the reacquisition of an applicable debt instrument, the partnership may allocate among the partners, in any manner, (1) the deferred cancellation of debt income and the cancellation of debt income that is not deferred, (2) the portion, if any, of each partner's cancellation of debt income amount that is deferred, and (3) the portion, if any, of each partner's cancellation of debt income amount that is not deferred.[260] Thus, for example, all of one partner's share of cancellation of debt income can be deferred while none (or only part) of another partner's share of cancellation of debt is deferred. Any portion of a partner's share of cancellation of debt income that is not deferred may be excluded under section 108(a)(1)(A), (B), (C), or (D), if applicable.[261]

Under the section 108(i) election, income from a debt cancellation in 2009 is recognized beginning in the fifth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018. Income from a debt cancellation in 2010 is recognized beginning in the fourth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018.[262] If a taxpayer elects to defer cancellation of debt income under section 108(i), the section 108(a) exclusions for bankruptcy, insolvency, qualified farm indebtedness, and qualified real property business indebtedness do not apply to the year of the election or any subsequent year.[263] Thus, the election cannot be used to move the year of inclusion to a year in which it is expected that one of those exceptions might apply. Once the election is made, inclusion is inevitable. Deferred recognition is accelerated into the year of death of an individual taxpayer, the liquidation or termination of a business of an entity, the year of sale of substantially all of the assets of the taxpayer, or the cessation of the taxpayer's business.[264] The acceleration rule also applies in the event of the sale, exchange, or redemption of an interest in a partnership or S corporation by a partner or shareholder.

If a taxpayer makes a section 108(i) election and reacquires (or is treated as reacquiring) the debt instrument generating the cancellation of debt income for a new debt instrument with original issue discount, the interest deductions for the resulting original issue discount also are deferred.[265] However,

[259] I.R.C. § 108(i)(5)(B)(iii). Sections 2.08 and 2.09 of Revenue Procedure 2009-37, 2009-36 I.R.B. 309, provide special rules for allocations under section 704 of partnership cancellation of debt income deferred under section 108(i). *See* Blake D. Rubin, Andrea Macintosh Whiteway & Jon G. Finkelstein, *Stimulus COD Income Deferral Raises Issues for Partnerships*, 124 Tax Notes (TA) 677 (Aug. 17, 2009).

[260] Rev. Proc. 2009-37, 2009-36 I.R.B. 309, § 4.04(3).

[261] *Id.*

[262] I.R.C. § 108(i)(1).

[263] I.R.C. § 108(i)(5)(C).

[264] I.R.C. § 108(i)(5)(D).

[265] I.R.C. § 108(i)(2).

the original issue discount deferral rule does not apply if the amount of original issue discount is less than a *de minimis* amount, as determined under section 1273(a)(3).[266]

5. *Cancellation of Home Mortgage Debt*

Section 108(a)(1)(E), which was added by the Mortgage Forgiveness Debt Relief Act of 2007 and amended by the Emergency Economic Stabilization Act of 2008, excludes from gross income the cancellation of "qualified principal residence indebtedness" if the cancellation occurs on or after January 1, 2007 and before January 1, 2013. Congress enacted this provision in response to the subprime mortgage loan crisis because it was moved by the specter of thousands of homeowners restructuring their mortgage debts or losing their homes in foreclosures and having to recognize cancellation of debt income cancellation of indebtedness income as a result.[267] "Qualified principal residence indebtedness" is limited to acquisition indebtedness, as defined in section 163(h)(3)(B),[268] with respect to a taxpayer's principal residence (as defined for purposes of section 121)[269] that does not exceed $2,000,000 for married couples filing joint returns and $1,000,000 for other taxpayers.[270] Section 108(a)(1)(E) does not apply to (1) indebtedness on a home that is not the taxpayer's principal residence, or (2) home equity indebtedness. Furthermore, the provision applies only if the debt cancellation was on account of either (1) a decline in the value of the home, or (2) the taxpayer's financial condition.[271] The taxpayer's basis in the residence must be reduced by the excluded amount.[272] This basis reduction will not result in any subsequent income rec-

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[266] A *de minimis* amount of OID is OID of not more than one-quarter of one percent per year. I.R.C. § 1273(a)(3).

[267] *See* H.R. Rep. No. 110-356, at 4–5 (2007), *as reprinted in* 2008 U.S.C.C.A.N. 572, at 572.

[268] Whether interest is paid with respect to indebtedness that was incurred to acquire, construct, or substantially improve a residence generally is determined under the tracing rules of Temporary Regulation section 1.163-8T, except that special "90-day rules" permit the allocation of certain debt to the acquisition (or construction or improvement) of a residence notwithstanding the tracing rules. Notice 1988-74, 1988-2 C.B. 385.

[269] There is no statutory definition of a taxpayer's principal residence. Under the regulations, a taxpayer's principal residence depends upon all the facts and circumstances, but the residence used for a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. Reg. § 1.121–1(b)(1), (b)(2). The regulations provide a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence. Among the factors considered when the taxpayer has two or more residences are the location of the taxpayer's business or employment, the address on the taxpayer's tax returns, the address for voter registration and driver's licensure, and the location of the taxpayer's place of worship. No particular factor is conclusive, because that can produce inconsistent evidence. Reg. § 1.121–1(b)(2). A taxpayer cannot have more than one principal residence at a time. Temp. Reg. § 1.163–10T(p)(2). A taxpayer's principal residence may be a boat or recreational vehicle with appropriate accommodations and facilities. Reg. § 1.121–1(b)(1).

[270] I.R.C. § 108(h)(2).

[271] I.R.C. § 108(h)(3).

[272] I.R.C. § 108(a)(1)(E).

ognition as long as the taxpayer does not dispose of the residence; and even if the taxpayer does sell the residence, the taxpayer could exclude all or part of the realized gain under section 121.

If only a portion of a cancelled debt is qualified principal residence indebtedness, the exclusion applies only to the extent the cancelled debt exceeds the portion of the debt that is not qualified principal residence indebtedness.[273] Assume, for example, a principal residence secures an indebtedness of $400,000, of which only $300,000 is qualified principal residence interest. If the residence is sold for $260,000, and $140,000 of debt is cancelled, then only $40,000 qualifies for the exclusion.

If a taxpayer qualifies for both the qualified principal residence indebtedness exclusion and the insolvency exclusion in section 108(a)(1)(B), the qualified principal residence indebtedness exclusion applies, unless the taxpayer elects to apply the insolvency exclusion.[274]

6. *Cancellation of Student Loans*

Section 108(f)(1) and (2) exclude from gross income forgiveness of student loans (and certain refinancings of student loans) incurred to attend a qualified institution of higher learning if the discharge of the indebtedness is pursuant to a provision in the loan under which all or part of the debt would be discharged if the student works for a period of time in certain professions or for any broad class of employers. The exclusion applies only to loans made by governmental entities, tax-exempt public benefit corporations, and qualified educational organizations, under an agreement or program designed to encourage students to serve in occupations with unmet needs or in areas with unmet needs, and the services provided by the student must be provided under the supervision of a governmental unit or tax-exempt charitable organization.[275] If the conditions of section 108(f)(2) are not met, the discharge of student loan debt for less than full payment gives rise to cancellation of debt income.[276]

Section 108(f)(4) excludes from gross income amounts received under the National Health Service Corps loan repayment program and under state loan repayment programs that receive federal grants.[277] Such programs require the

[273] I.R.C. § 108(h)(4).

[274] I.R.C. § 108(a)(2)(C).

[275] I.R.C. § 108(f)(2); *see* Porten v. Commissioner, 65 T.C.M. (CCH) 1994, 1993 T.C.M. (RIA) ¶ 93,073 (forgiveness of a student loan from the State of Alaska conditioned upon working in any capacity as a resident of Alaska (and not in designated professions or for a designated class of employers) was not excludable).

[276] Plotinsky v. Commissioner, 96 T.C.M. (CCH) 292, 2008 T.C.M. (RIA) ¶ 2008-244 (discharge of a portion of consolidated student loans pursuant to an incentive provision providing for such discharge if the debtor made 36 timely payments, which was provided as an incentive to consolidate loans with the refinancing creditor, gave rise to cancellation of debt income).

[277] I.R.C. § 108(f)(4).

recipient of the repayment to provide services in a geographic area identified as having a shortage of healthcare professionals.

VI. Conclusion

In light of the volume of currently outstanding debt owed and the historically high rates of default and foreclosure, as explained in the Introduction, in the immediate future the rules with respect to cancellation of debt income will be applied to a greater number of transactions annually than ever before. In some of these transactions, the existence of cancellation of debt income will be clear; in others, particularly those involving contested liabilities, it might not be so clear. In most instances, where cancellation of debt income is realized, determining the amount is not exceedingly difficult, but in those cases in which the amount of cancellation of debt income depends in whole or in part on the value of property transferred to the creditor in connection with the discharge of the debt, including cases in which a creditor accepts an equity interest in the debtor in connection with the discharge of the debt, important factual valuation questions arise and must be answered before the amount of cancellation of debt income can be ascertained.

Whenever cancellation of debt income is realized, the critical question is whether and to what extent the debtor can take advantage of one of the exclusions in section 108. If more than one such exclusion might apply, the taxpayer must choose which one to apply, either through an express election, where allowed, or by structuring the transaction effecting the discharge of the debt to fit within the most advantageous exception. In most instances, that choice will be dictated by the ancillary consequences facing the taxpayer, usually the loss of favorable tax attributes. No exposition of a catalogue of rules of thumb is possible. Both the course of action in planning a transaction to effect a discharge of indebtedness for less than full payment, thereby giving rise to cancellation of debt income, and *ex post* arguments for a result more favorable to the taxpayer than that proposed by the Internal Revenue Service, depend on each taxpayer's particular situation. For example, an insolvent taxpayer might prefer to recognize cancellation of debt income, which would otherwise be taxed as ordinary, while a solvent taxpayer might prefer to structure or characterize a transaction as a transfer of property in payment of a debt to recognize capital or section 1231 gain taxed at a preferential rate.

Finally, care must be taken not to let the tax tail wag the economic dog. A solvent taxpayer that otherwise might recognize cancellation of debt income might be tempted to seek nonrecognition by filing a bankruptcy petition for Chapter 13 individual debt adjustment or Chapter 11 reorganization of a business. There are, however, significant nontax consequences to such an action that must be thoroughly considered before engaging in such an action as a tax planning technique.

In the end, this Article is designed merely to provide a taxonomy of the various rules that must be considered by the careful tax professional in advising debtor taxpayers with respect to the structuring and reporting of transactions that can or do give rise to realization and recognition of cancellation of debt income. It is a roadmap to be consulted in devising plans and arguments, but it does not in and of itself provide those plans and arguments. Each transaction warrants careful consideration of its specific facts and the taxpayer's overall set of tax attributes before the various rules are applied to produce a customized transaction or argument.

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SECTION 108(i) ADDENDUM*

Section § 1231(a) of the 2009 ARRA added Code § 108(i), which defers and then ratably includes income arising from business indebtedness discharged by the reacquisition of a debt instrument. This new provision allows a taxpayer to irrevocably elect to include cancellation of debt income realized in 2009 and 2010 ratably over five tax years, rather than in the year the discharge occurs, if the debt was issued in connection with the conduct of a trade or business or by a corporation. Under the § 108(i) election, income from a debt cancellation in 2009 is recognized beginning in the fifth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018. Income from a debt cancellation in 2010 is recognized beginning in the fourth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018. If a taxpayer elects to defer debt cancellation income under § 108(i), the § 108(a) exclusions for bankruptcy, insolvency, qualified farm indebtedness, and qualified real property business indebtedness do not apply to the year of the election or any subsequent year. § 108(i)(5)(C). Thus, the election cannot be used to move the year of inclusion to a year in which it is expected that one of the exceptions will apply.

For partnerships and S corporations, the election is made by the partnership or corporation, not by the individual partners or shareholders. I.R.C. § 108(i)(5)(B)(iii). Section 108(i)(6) requires a partnership to allocate the COD income to partners according to partnership share on the day immediately preceding reacquisition and provides that the discharge will not trigger § 752(b) recognition under § 731 because of a reduction in a partner's share of partnership liabilities.

Once the election is made, inclusion is inevitable; the statute requires acceleration of inclusion to the taxpayer's final return in the event of the intervening death of an individual or liquidation or termination of the business of an entity. § 108(i)(5)(D). The acceleration rule also applies in the event of the sale or exchange or redemption of an interest in a partnership or S corporation by a partner or shareholder.

Although the statute speaks in terms of cancellation of debt income arising from "reacquisition" of a "debt instrument," the statutory definitions of "reacquisition" and "an applicable debt instrument," respectively, are broad enough the provision applies to most situations in which the debt is cancelled. Section 108(i)(3)(B) broadly defines "debt instrument" to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement : meaning of 08(i)(4)(B) defines "acquisition" to include (1) an acquisition of the debt instrument for cash, (2) the exchange of the

* This description of § 108(i) and the guidance thereunder is adapted from Martin J. McMahon,Jr., Ira B. Shepard & Daniel L. Simmons, RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION, Southern Federal Tax Institute (Sept. 27, 2010).

debt instrument for another debt instrument, including an exchange resulting from a modification of the debt instrument (which includes a reduction of the principal amount of the debt), (3) the exchange of the debt instrument for corporate stock or a partnership interest, (4) the contribution of the debt instrument to capital, and (5) the complete forgiveness of the indebtedness by the holder of the debt instrument.

In the statutory language, the statutory definition of "acquisition" appears to omit the cancellation of a debt in connection with a property transfer, for example, a deed in lieu of foreclosure, although the legislative history contains some indication that this type of debt cancellation is included. However, Rev. Proc. 2009-37, 2009-36 I.R.B. 309 (8/17/09) ruled that § 1089i) applied to the cancellation of a debt in connection with a property transfer.

Rev. Proc. 2009-37, 2009-36 I.R.B. 309 (8/17/09) provides the procedures for taxpayers to make § 108(i) elections. Debt cancellation in connection with a property transfer is included in § 108(i). Section 4.04(3) permits partial elections, with the partnership permitted to determine "in any manner" the portion of the COD income that is the "deferred amount" and the portion of the COD income that is the "included amount" with respect to each partner. Section 4.11 permits protective elections where the taxpayer concludes that a particular transaction does not generate COD income but fears that the IRS may determine otherwise. A partner's deferred § 752(b) amount, arising from a decrease in his share of partnership liabilities, will be treated as a current distribution of money in the year that the COD income is included. Taxpayers are allowed an automatic one-year extension from the due date to make the election, and taxpayers who made elections before the issuance of the revenue procedure will be given until 11/16/09 to modify (but not revoke) their existing elections. Corporate taxpayers making a § 108(i) election are required to increase earnings and profits for the year of the election.

In T.D. 9497, Guidance Regarding Deferred Discharge of Indebtedness Income of Corporations and Deferred Original issue Discount Deductions, 75 F.R. 49394 (8/13/10), and T.D. 9498, Application of Section 108(i) to Partnerships and S Corporations, 75 F.R. 49380 (8/13/10), the IRS and Treasury promulgated Temp. Reg. §§ 1.108(i)-0T through 1.108(i)-3T, dealing with § 1089i).

Temp. Reg. § 1.108(i)-2T(d)(1) provides five safe harbors where debt instruments issued by a partnership or S corporation will be treated as issued in a trade or business: (1) The gross fair market value of the trade or business assets of the partnership or S corporation represent at least 80 percent of [illegible]'s on the date of issuance, (2) trade or business expenses of the partnership or S corporation represent at least 80 percent of all expenditures, (3) at least 95 percent of the interest paid on the debt instrument is allocable to trade or business expenditures under the interest allocation rules of Reg. § 1.163-8T, (4) at least 95 percent of the proceeds from the debt instrument were used to acquire trade or business assets within six months of the issue of the debt, or (5) the partnership or S corporation issued the debt instrument to the seller of a trade or business to acquire the trade or business. Absent anchoring in one of the safe harbors, qualification of a trade or business debt is a matter of facts and circumstances

While § 108(i)(5)(B)(iii) requires the election to be made at the partnership level, Temp. Reg. § 1.108(i)-2T(b)(1), allows the partnership to allocate both deferred and included portions of COD income to the partners. The temporary regulations first require that COD income be allocated to the partners in the partnership immediately before the reacquisition in the manner the income would be included in distributive shares under § 704, then the partnership must determine the amount of COD income from the applicable instrument that is the deferred amount includible in the partner's share and the amount that is immediately includible. With respect to deferred COD income of an S corporation, the Temp. Reg. § 1.108(i)-2T(c)(1) requires that on an election by the S corporation, deferred income must be shared pro rata on the basis of stock ownership immediately prior to the reacquisition.

Temp. Reg. § 1.108(i)-2T(b)(2) provides that a partner's basis is not adjusted under § 705(a) to account for the partner's share of partnership deferred COD income until the deferred item is recognized by the partner. Likewise, § 1.108(i)-2T(c)(2) provides that neither an S corporation shareholder's basis under § 1367 nor the shareholder's accumulated adjustment account is adjusted for deferred COD income until the shareholder recognizes the deferred COD income.

Following the rules of Rev. Proc. 2009-37, and applying the rules of § 108(i)(6), Temp. Reg. § 1.108(i)-2T(b)(3) provides that reduction in a partner's share of partnership liabilities is determined under § 752(b) when a debt instrument is reacquired, but that the reduction in liabilities is not treated as a distribution of money until deferred COD income is recognized by the partner. The temporary regulations provide additional rules for determining a partner's deferred amounts where the partner would recognize § 731 gain in the year of the reacquisition.

1. Partners' capital accounts are adjusted as if no § 108(i) election were made.

2. Temp. Reg. § 1.108(i)-2T(d)(3) provides that gain attributable to a reduction in a partner's or S corporation shareholder's amount at-risk under § 465(e) will not be taken into account in the year of reacquisition and will be deferred to the date the COD income in recognized.

3. In the case of an acceleration event under § 108(i)(5)(D) that requires a partnership or S corporation to recognized deferred items, under Temp. Reg. § 1.108(i)-2T(c)(3) the partners or S corporation shareholders must account for deferred COD in the year that the accelerating event takes place. In addition, the temporary regulations described various circumstances in which a partner or S corporation shareholder terminates the interest in the entity that will require acceleration of deferred COD income, including death, liquidation, sale or exchange, redemption, or abandonment.

The temporary regulations provide that the deferred items allocated to the direct and indirect partners of the electing partnership, which includes a shareholder of an S corporation that is a direct/indirect partner of an electing partnership (S corporation partner), and to the shareholder of an electing S corporation are accelerated if the electing partnership or the electing S corporation (i) liquidates, (ii) sells, exchanges, transfers (including contributions and distributions), or gifts substantially all of its assets, (iii) ceases doing business, or (iv) files a petition in a Title 11 or similar case. In addition, the deferred items of the shareholders of an electing S corporation or an S corporation partner are accelerated in the taxable year in which the S corporation's or S corporation partner's election under § 1362(a) is terminated. The acceleration rules and exceptions that apply to an electing corporation under Temp. Reg. § 1.108(i)-1T(b) also apply to a C corporation partner in the same manner as if the C corporation partner were an electing corporation.

Temp. Reg. § 1.108(i)-1T(b)(6)(i)(B) and (c)(3)(i)(B) provides that substantially all of the partnership's or S corporation's assets means assets representing at least 90 percent of the fair market value of the partnership's or S corporation's net assets and at least 70 percent of the fair market value of the partnership's or S corporation's gross assets, as measured immediately prior to the sale, exchange, transfer, or gift in question.

In addition to the electing partnership-level or electing S corporation-level events that trigger acceleration under § 108(i), Temp. Reg. § 1.108(i)-1T(b)(6)(ii) and (c)(3)(ii) provide that certain events that occur at the partner or shareholder level also trigger acceleration of that partner's or shareholder's share of the electing partnership's or electing S corporation's deferred items. For instance, the deferred items allocated to a direct or indirect partner of an electing partnership are accelerated if: (1) The partner dies or liquidates, (2) the partner sells, exchanges (including redemptions treated as exchanges under § 302), transfers (including contributions and distributions), or gifts (including transfers treated as gifts under § 1041) all or a portion of a separate interest, (3) the partner's separate interest is redeemed, or (4) the partner abandons its separate interest. A partner's interest is redeemed only where a partner's interest in the partnership is completely liquidated. A distribution by a partnership to a partner of property in a transaction that does not constitute a complete redemption of the partner's interest, does not constitute an acceleration event, even if, for example, the distribution causes gain to be recognized to the partner under § 731(a).

A shareholder's share of an electing S corporation's deferred items is accelerated if the shareholder: (1) Dies, (2) sells, exchanges (including redemptions treated as exchanges under § 302), transfers (including contributions and distributions), or gifts (including transfers treated as gifts under § 1041) all or a portion of its interest in the electing S corporation, or (3) abandons its interest in the electing S corporation. For purposes of the temporary regulations, a "separate interest" is defined as any direct interest in an electing partnership or in a partnership or S corporation that is a direct or indirect partner of an electing partnership.

If a partner or shareholder sells, exchanges, transfers, or gifts only a portion of its interest in a partnership or an S corporation, only a proportionate amount of the partner's or shareholder's share of the partnership's or S corporation's deferred items is accelerated. For example, if a

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partner of an electing partnership with a $100 deferred amount from the electing partnership sells half of its interest in the electing partnership, $50 of the partner's $100 share of the partnership's deferred amount is accelerated.

For a C corporation, in addition to the statutory acceleration events, under Temp. Reg. § 1.108(i)-1T (b)(2)(ii), a corporation generally is required to accelerate all of its remaining deferred COD income if it engages in an "impairment transaction," if immediately after the transaction the value of its assets does not satisfy a minimum threshold. Generally speaking, impairment transactions are transactions that impair a corporation's ability to pay the amount of Federal income tax liability on its deferred COD income and include, for example, distributions (including § 381(a) transactions), redemptions, below market sales, and charitable donations, and the incurrence of additional indebtedness without a corresponding increase in asset value. However, value-for-value sales or exchanges (including, for example, an exchange to which § 351 or § 721 applies) are not impairment transactions.

The regulations also provide rules applicable to all taxpayers regarding deferred OID deductions under § 108(i) as a result of a reacquisition of an applicable debt instrument by an issuer or related party

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SECTION OF TAXATION
State Bar of Texas

March 30, 2011

The Honorable Harvey Hilderbran
Chair, Ways and Means Committee
Texas House of Representatives
P.O. Box 2910
Austin, Texas 78768-2910

Re: Franchise Tax Comments

Dear Mr. Chairman:

By letter of October 12, 2010, your predecessor as Chair of the House Ways and Means Committee, Representative Rene Oliveira, requested that the Section of Taxation of the State Bar of Texas provide the Committee with comments, guidance and background information in connection with the Committee's consideration of the Texas franchise tax in the 2011 Texas Regular Legislative Session. The Section of Taxation is pleased to provide the following comments.

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

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.

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We commend the Texas Legislature and the Office of the Comptroller for their leadership in drafting and passing House Bill 3 and House Bill 3928, and appreciate the opportunity to participate further in proposing legislation that promotes equity and fairness in the franchise tax.

Respectfully submitted,

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

cc:

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Texas Comptroller of Public Accounts

COMMENTS CONCERNING TEXAS FRANCHISE TAX

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

These comments were prepared by individual members of the Committee on State and Local Taxation (the "Committee"). Principal responsibility was exercised by Matthew Larsen, the Chair of the Committee, and by two of the Committee's Vice-Chairs, Alyson Outenreath and Charolette Noel. The Comments were reviewed by and substantive contributions were made by Cynthia Ohlenforst. They were also reviewed by and substantive contributions were made by Daniel Micciche as reviewer for the Section's Committee on Governmental Submissions. The comments were also reviewed by Stephanie Schroepfer as Chair of the Section's Committee on Governmental Submissions.

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

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Date: March 30, 2011

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TAX SECTION OF THE STATE BAR OF TEXAS
STATE AND LOCAL TAX COMMITTEE
COMMENTS CONCERNING TEXAS FRANCHISE TAX[1]

I. EXECUTIVE SUMMARY

The following comments are submitted in response to an October 12, 2010 request from then-Chair of the House Ways and Means Committee Rene Oliveira for comments concerning the Texas franchise tax in connection with the 2011 Texas Regular Legislative Session.

Following is a summary of our comments:

A. Definition of Taxable Entity (Section 171.0002)

1. Series Limited Liability Companies: We suggest that the Legislature consider clarifying for franchise tax purposes whether (i) each series of a series limited liability company is a separate taxable entity or, alternatively, (ii) the series limited liability company is a single taxable entity. We believe that the disadvantages of treating a series LLC as a single taxpayer for franchise tax purposes outweigh the advantages of such treatment.

2. Death of Natural Person-General Partnerships/Grantor Trusts: We suggest that the Legislature consider amending Section 171.0002 to clarify that the death of a natural person will not by itself cause an otherwise non-taxable general partnership or grantor trust to become taxable.

3. Beneficiaries of a Grantor Trust: We suggest that the Legislature consider clarifying that only the current beneficiaries of a grantor trust are considered when determining whether a grantor trust is nontaxable under Section 171.0002(c)(1).

B. Passive Entities (Section 171.0003)

1. Distributive Shares of Partnership Income: We suggest that the Legislature consider amending Section 171.0003(a)(2)(B) to clarify that income will be considered a "distributive share of partnership income" for purposes of the passive entity rules if such income is treated as a distributive share of partnership income for federal income tax purposes.

2. Joint Operating Agreements/Contract Operators: We suggest that the Legislature consider amending Section 171.0003 to clarify that the operator of a mineral property for purposes of Section 171.0003 is the operator named in the joint operating agreement, unless such operator duties have been assigned to a contract operator, in which case there would be a rebuttable presumption that the contract operator would be considered the operator of the subject mineral property for purposes of Section 171.0003.

C. Total Revenue (Section 171.1011)

1. Exclusion by a Taxable Entity of Income From a Passive Entity: To prevent possible double taxation, we suggest that the Legislature consider amending Section 171.1011(e) to expressly recognize that a taxable entity may exclude from total revenue its distributive share of a passive entity's revenue

[1] Citations to "Sections" in these Comments refer to Chapter 171 of the Texas Tax Code Ann., as amended by H.B. 3, 79th Leg., 3rd C.S. (2006) ("HB3"), effective for franchise tax reports due on or after January 1, 2008.

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that was generated by a lower tier taxable entity, regardless of whether the passive entity's ownership of the lower tier taxable entity is direct or indirect.

2. Exclusion of Flow-Through Funds - Mandated by Contract: We suggest that the Legislature consider amending Section 171.1011(g) to permit an exclusion of all flow-through funds that are mandated by contract to be distributed to non-affiliated entities on a dollar-for-dollar basis. This amendment would protect many service providers from being subject to a disproportionately high tax burden.

3. Exclusions of Flow-Through Funds - Entities and Individuals: We suggest that the legislature consider amending Section 171.1011(g) to clarify that flow-through funds paid or distributed to an unaffiliated individual, as well as an unaffiliated entity, are excluded from total revenue.

4. Exclusions of Flow-Through Funds - Employees/Non-Employees: We suggest that the Legislature consider clarifying whether excludable sales commissions paid to a person who receives the commission as an independent contractor but who may be an employee in some other capacity are excluded from total revenue.

5. Health Care Institutions and Heath Care Providers: We suggest that the Legislature consider clarifying that the exclusion for qualifying payments received by health care providers and health care institutions will apply in full where - as is common - an affiliate of the provider or institution receives the qualifying payments on behalf of the provider or institution.

D. Compensation Deduction (Section 171.1013)

1. Employer Share of Employment Taxes: We suggest that the Legislature consider amending Section 171.1013(b)(2) to address whether an employer's Social Security and Medicare payments are deductible as compensation.

E. Combined Reporting (Section 171.1014)

1. Controlling Interest of Nonprofit Corporations: We suggest that the Legislature consider amending the definition of a controlling interest for combined reporting purposes to address nonprofit corporations that are taxable entities but that do not have any stock or membership interests.

2. Controlling Interest When Voting and Beneficial Interest Held by Different Persons/Entities: We suggest that the Legislature consider amending Section 171.0001 to clarify that an owner's beneficial ownership interest in an entity will not be taken into account for purposes of the controlling interest test to the extent that the beneficially-owned interest is also treated as a stock, capital, profits, or membership interest of the owner.

F. Exemption for Certain Nonprofit Entities (Section 171.063)

1. LLCs Wholly-Owned by I.R.C. Section 501(c)(3) Charitable Entities: We suggest the Legislature consider clarifying that if an entity qualifies as an exempt charitable organization for franchise tax purposes due to its exemption from federal income tax under I.R.C. Section 501(c)(3), a wholly-owned subsidiary of the charitable organization that is disregarded as separate from the charitable organization for federal income tax purposes is also exempt from franchise tax.

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G. Successor Tax Liability on Sale of Business or Stock of Goods (Section 111.020)

1. Tax Clearance or Statement of Amount Due: We suggest the Legislature consider amending Section 111.020(c) to provide that a certificate of no tax due or statement of amount of tax due in connection with the sale of a business may be based on Comptroller estimations as to franchise tax so as to avoid increased delays in issuing certificates due to the complexities of combined reporting. To safeguard the Comptroller, we recommend clarifying that such certificates or statements are issued solely for the protection of the purchaser and do not release the selling taxpayer from any liability.

II. COMMENTS

A. Definition of Taxable Entity (Section 171.0002)

1. Series LLCs

a. Language at Issue

Section 171.0002(a) provides:

> (a) Except as otherwise provided by this section, "taxable entity" means a partnership, limited liability partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity. The term includes a combined group. A joint venture does not include joint operating or co-ownership arrangements meeting the requirements of Treasury Regulation Section 1.761-2(a)(3) that elect out of federal partnership treatment as provided by Section 761(a), Internal Revenue Code.

Subsections (b) and (c) of Section 171.0002 describe various entities and arrangements that are not considered "taxable entities" for franchise tax purposes. Subsection (d) provides that "[a]n entity that can file as a sole proprietorship for federal income tax purposes is not a sole proprietorship for purposes of Subsection (b)(1) and is not exempt under that subsection if the entity is formed in a manner under the statutes of this state, another state, or a foreign country that limit the liability of the entity."

b. Suggestion

We suggest that the Legislature consider amending Section 171.0002 to address how series limited liability companies (commonly referred to as series LLCs) are to be treated for franchise tax purposes.

c. Explanation

The Texas Business Organizations Code allows for the organization and operation of series LLCs in Texas.[2] A series LLC is an LLC that provides in its governing documents for the establishment of a series of members, managers, membership interests, and assets that have separate business purposes, economics, rights, obligations and liabilities from the general LLC and each other series. Each series has the ability to independently sue and be sued, enter into contracts, hold title to assets, and grant liens or security interests in its assets. Furthermore, the profits, losses and liabilities of each series are legally separate from that of each other series. Series LLCs are commonly used in the real estate industry where real estate developers will create separate series within an LLC for each parcel of property being developed. Series LLCs are also commonly used by business owners who offer multiple (and sometimes wholly unrelated) services or who sell multiple (and sometimes wholly unrelated) products. We anticipate that series LLCs will become even more popular in future years as more and more states enact series LLC statutes. To our knowledge, eight states (including Texas) have enacted series LLC statutes to date: Delaware,[3] Illinois,[4] Iowa,[5] Nevada,[6] Oklahoma,[7] Tennessee,[8] Texas[9] and Utah.[10] Additionally,

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[2] *See* Texas Business Organizations Code, Chapter 101, Subchapter M, §§ 101.601 - 101.621.
[3] *See* Del. Code Ann. tit. 6, §18-215.
[4] *See* 805 ILCS §180/37-40.

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Puerto Rico[11] also has enacted a series LLC statute, and several other states (*e.g.*, Wisconsin, Minnesota and North Dakota) have language in their LLC statutes discussing "classes" or "series" of LLC membership interests although such statutes do not contain the level of detail as the previously-referenced state statutes.

For franchise tax purposes, the threshold question is whether (i) each series of a series LLC should be treated as a separate entity for franchise tax purposes, or (ii) all of the series should be aggregated and treated as one single entity for franchise tax purposes. For reference, the U.S. Department of Treasury recently issued proposed regulations in September 2010 regarding the federal treatment of series LLCs.[12] For federal income tax purposes (except for purposes of employment and withholding taxes), the proposed regulations treat each series of a series LLC as a separate entity and apply the federal entity classification rules to each separate series (*e.g.*, classifying each separate series of the LLC as either a disregarded entity, partnership, corporation, etc.). The Internal Revenue Service similarly advised this result in Priv. Ltr. Rul. 200803004 (Jan. 18, 2008).

Chapter 171 of the Texas Tax Code does not currently address how series LLCs are to be treated for franchise tax purposes. Due to the increased use of series LLCs, we suggest that the Legislature consider specifying how such LLCs are to be treated. Under the existing Texas Tax Code, in conjunction with the Texas Business Organizations Code, arguments can be made for treating series LLCs as either one single taxable entity or multiple taxable entities for franchise tax purposes. Thus, taxpayers would benefit from a statutory clarification.

Some pros and cons of treating a series LLC as either a single taxable entity or multiple taxable entities are as follows:

- ***Pros/Cons of Treating Series LLC as Single Taxable Entity:***

Treating a series LLC as a single taxable entity could be viewed as administratively convenient for both the Comptroller and taxpayers because a single Texas Franchise Tax Report (or, if the series LLC were a member of a combined group, a collective entry on the affiliate schedule) would be required rather than the filing of multiple reports/schedules. On the other hand, this seeming "pro" is countered, or at least minimized, by the fact that taxpayers are already required to separately compute the tax liability for each separate series for purposes of their federal income tax returns since federal tax law already treats each series of a series LLC as separate entities.

For state law purposes, the Texas Business Organizations Code treats a series LLC as a single entity. Only one certificate of formation is issued when organizing a series LLC.[13] Furthermore, a series LLC organized under the laws of another jurisdiction is treated by the Texas Secretary of State as a single

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5 *See* Iowa Code §489.1201 *et seq.*
6 *See* Nev. Rev. Stat. §86.161.
7 *See* Okla. Stat. tit. 18, §2005.
8 *See* Tenn. Code Ann. §48-249-309.
9 *See* Tex. Bus. Org. Code §101.601 *et seq.*
10 *See* Utah Code Ann. §48-2c-606.
11 *See* P.R. Laws Ann. tit. 14, §3426p.
12 See REG-119921-09 (F.R. Doc. 2010-22793; 75 Fed. Reg. 55699 et seq.), adding Prop. Treas. Regs. §§301.6011-6, 301.6071-2, and 301.7701-1(a)(5), and amending §§301.7701-1(e) and (f).
13 *See* Texas Business Organizations Code §§ 3.001, 101.601. *See also* Texas Secretary of State FAQs, Formation of Texas Entities, (Nov. 23, 2010).

entity for foreign qualification purposes - meaning the entire LLC must qualify to do business in Texas rather than each respective series.[14]

Certain provisions of Chapter 171 of the Texas Tax Code that determine taxability based on Texas state law principles rather than federal income tax principles could also be viewed as support for treating all series of a series LLC collectively as one single taxable entity for franchise tax purposes. For example, Section 171.0002(d) provides that an entity treated as disregarded for federal income tax purpose is not similarly disregarded for franchise tax purposes. Thus, it could be viewed as inconsistent to deem each series as a separate taxable entity for franchise tax purposes.[15]

The most significant con to treating a series LLC as a single entity is that it would result in the inconsistent treatment of series LLCs and combined groups. These two business structures are very similar but treating a series LLC as a single entity for franchise tax purposes would result in significantly different tax consequences.,. The reasons for this and the associated impact are discussed in more detail below.

- ***Pros/Cons of Treating Series LLC as Multiple Taxable Entities:***

Section 171.0002(a), which includes a "catch-all" proviso mandating that "other legal entities" constitute "taxable entities" for franchise tax purposes, could be viewed as support for treating each series as a separate taxable entity (*e.g.*, following the federal treatment of series LLCs). Arguably, within a series LLC, each series constitutes a separate "legal entity" because each series has its own independent business purpose, assets, economics, rights, obligations, liabilities, and ability to sue and be sued. Furthermore, the profits, losses, and liabilities of each series are legally separate from those of each other series. California is an example of a state that follows this reasoning and has issued guidance confirming that it imposes its LLC fee on each series of a series LLC.[16]

Treating a series LLC as multiple taxable entities would be consistent with the way such entities are treated for federal income tax purposes. Accordingly, as discussed above, there should be little or no administrative burden on taxpayers if they were required to file separate Franchise Tax Reports and/or affiliate schedules for each series because such calculations would have already been formulated by each series in preparing their federal income tax returns.

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[14] *See* Texas Secretary of State FAQs, Formation of Texas Entities, (Nov. 23, 2010).

[15] Inconsistent treatment among the Comptroller's office and the Secretary of State could also create confusion if the holding of *Rylander v. Bandag Licensing Corporation, Texas Court of Appeals., 18 S.W.3d 296 (Tex. App.--Austin [3rd Dist.] 2000, pet. denied),* were ever reversed. *Bandag* holds that the mere passive holding of a Texas Certificate of Authority by a foreign entity does not, by itself, cause such foreign entity to have nexus for franchise tax purposes. Under *Bandag*, it would not be problematic if the Texas Tax Code were to treat a series LLC as multiple taxable entities (meaning that an independent nexus determination for franchise tax purposes would be made for each separate series), because even if the Secretary of State issues a Texas Certificate of Authority to a series LLC as a whole rather than on a series-by-series basis, the fact that a singular series within the LLC without any connection to Texas might be viewed as "holding" that Certificate of Authority should not adversely affect the franchise tax nexus determination of that singular series. However, if *Bandag* were ever reversed and the mere passive holding of a Texas Certificate of Authority were enough to create nexus for franchise tax purposes, it might be unclear whether such non-Texas singular series would have nexus solely based on the single Texas Certificate of Authority held by the series LLC as a whole. This potential confusion could be remedied if it ever arises, however, by the Secretary of State issuing separate Texas Certificates of Authority on a series-by-series basis.

[16] *See* 2009 Limited Liability Company Booklet (Instructions to California Form 568, Limited Liability Company Return of Income); California FTB Informational Pub. No. 3556, Limited Liability Company Filing Information Sept. 2009).

Treating a series LLC as multiple taxable entities would also be consistent with the combined group reporting rules of the franchise tax. For example, the combined group rules require that the numerator of the apportionment formula for the combined group include only the Texas gross receipts of taxable entities independently having nexus with Texas for franchise tax purposes (commonly known as the "Joyce rule"). Application of the Joyce rule can be beneficial to combined groups because it can have the effect of lowering the amount of apportioned income ultimately subject to franchise tax. If a series LLC were treated as a single taxable entity, the Joyce rule would be inapplicable to any group of series within the series LLC that are affiliated and unitary with one another, leading to a result where combined groups and series LLCs are treated differently for franchise tax purposes. There is no apparent policy reason for allowing the Joyce rule to apply to combined groups but not a series LLC where certain series engage in affiliated and unitary operations.

Another example of how treating a series LLC as multiple taxable entities would be consistent with the combined group reporting requirements is when otherwise affiliated entities are not engaged in unitary operations. If otherwise affiliated entities are not considered engaged in unitary operations, then such non-unitary entities cannot be included within a combined group. This results in such non-unitary entities filing as separate taxable entities, thereby being able to determine their own deduction methodology and independently apply the exemption threshold for small businesses (*e.g.*, the $1M threshold applicable to the 2011 Franchise Tax Report based on 2010 revenues). Treating a series LLC as a single taxable entity would have the effect of mandating that all series are unitary with each other. Moreover, this treatment could be inconsistent with the real-world operations of a series LLC. For example, a common reason for forming a series LLC is to segregate unitary and non-unitary operations.

As illustrated in the two paragraphs above, treating a series LLC as a single taxable entity would result in a situation where the favorable taxpayer provisions of combined group reporting (the Joyce rule) would not apply to a series LLC, but the unfavorable taxpayer provisions of combined group reporting (discussed in the paragraph immediately above) would apply to a series LLC. Applying significantly different tax treatment to series LLCs and combined groups could be viewed as arbitrary and illogical.

Based on the foregoing, we believe the there are significant cons to adopting a position that a series LLC be treated as a single taxable entity for franchise tax purposes

2. General Partnerships and Grantor Trusts / Death of Natural Person

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

Section 171.0002(b)(2) provides that a taxable entity does not include a general partnership "(A) the direct ownership of which is entirely composed of natural persons; and (B) the liability of which is not limited under a statute of this state or another state, including by registration as a limited liability partnership." Similarly, Section 171.0002(c)(1) provides that a taxable entity does not include an entity that is "a grantor trust as defined by Sections 671 and 7701(a)(30)(E), Internal Revenue Code, all of the grantors and beneficiaries of which are natural persons or charitable entities as described in Section 501(c)(3), Internal Revenue Code, excluding a trust taxable as a business entity pursuant to Treasury Regulation 301.7701-4(b)."

b. <u>Suggestion</u>

We suggest that the Legislature consider amending Section 171.0002 by adding a new Subsection (f) that provides: "A general partnership or grantor trust not otherwise considered a taxable entity pursuant to Subsection (b)(2) or (c)(1) shall not be considered a taxable entity solely due to the designation of a deceased natural person's estate as a partner of such general partnership or a grantor or beneficiary of such grantor trust."

c. Explanation

Chapter 171 of the Texas Tax Code does not address the effect on a nontaxable general partnership or grantor trust when a natural person dies and the person's estate becomes a partner, grantor or beneficiary. Under a literal reading of Section 171.0002, the death of a natural person might convert an otherwise non-taxable general partnership or grantor trust into a taxable entity. Such a result seems contrary to the Legislature's intent when enacting Section 171.0002, and it would be inconsistent with Comptroller Policy. *See* FAQ No. 6 relating to taxable entities and Rule 3.581; Comp. Ltr. Rul. 201007710L (July 21, 2010) (stating that "a general partnership composed entirely of natural persons will not become a taxable entity because of the estate of a deceased partner"). Our suggested approach would clarify that the death of a natural person partner/beneficiary/grantor would not cause an otherwise non-taxable general partnership or grantor trust to become taxable.

3. Permitted Beneficiaries of a Nontaxable Grantor Trust

a. Language at Issue

Section 171.0002(c)(1) provides that a taxable entity does not include "a grantor trust as defined by Sections 671 and 7701(a)(30)(E), Internal Revenue Code, all of the grantors and beneficiaries of which are natural persons or charitable entities as described in Section 501(c)(3), Internal Revenue Code, excluding a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b)[.]"

b. Suggestion

We suggest that the Legislature consider amending Section 171.0002(c)(1) to provide that a taxable entity does not include "a grantor trust as defined by Sections 671 and 7701(a)(30)(E), Internal Revenue Code if, during the period on which margin is based, all of the grantors and beneficiaries of ~~which~~ the trust are natural persons or charitable entities as described in Section 501(c)(3), Internal Revenue Code, excluding a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b)[.]":

c. Explanation

It is common for a revocable grantor trust established during an individual grantor's lifetime for estate planning purposes to provide for distribution of trust assets to the grantor during the grantor's lifetime, with the remainder distributed to trusts for descendants on the death of the grantor. If these trusts for descendants were considered beneficiaries of the grantor trust during the grantor's lifetime for purposes of applying Section 171.0002(c)(1), then the revocable trust may be subject to franchise tax during the grantor's lifetime, a result which the Legislature did not likely intend. Most individuals that establish revocable trusts would likely be unaware that they were creating taxable entities. Those individuals that are aware of the potential franchise tax consequences might be discouraged from using these trusts for estate planning purposes, which could in turn increase the burden on Texas probate courts. Interpreting 171.0002(c)(1) to apply to non-current, "contingent" beneficiaries would also be inconsistent with the way in which the franchise tax is applied to general partnerships. General partnerships whose current partners are all natural persons are not taxable, even though the future death of a partner may transfer a partnership interest to a non-natural person.

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The Comptroller has issued a non-published letter ruling to at least one taxpayer that interprets Section 171.0002(c)(1) in the manner we suggest - it provides that in applying Section 171.0002(c)(1) to determine whether a grantor trust is subject to franchise tax with respect to a given franchise tax report, only the beneficiaries during the period on which the franchise tax report is based will be considered.[17] We therefore suggest that the Legislature consider amending Section 171.0002(c)(1) to clarify that only the beneficiaries of a grantor trust "during the period on which margin is based" will be considered during the period at issue when applying this section. Similar language is used in Section 171.0003 to specify that the test for determining whether an entity is an exempt passive entity is applied on a year-by-year basis.

B. Passive Entities (Section 171.0003)

1. Distributive Shares of Partnership Income

a. Language at Issue

Section 171.0003(a)(2)(B) provides that passive income for purposes of the passive entity exception from franchise tax under Section 171.0003 includes "distributive shares of partnership income to the extent that those distributive shares of income are greater than zero."

b. Suggestion

We suggest that the Legislature consider amending Section 171.0003(a)(2)(B) to read that passive income for purposes of the passive entity exception from franchise tax includes "distributive shares of income from entities taxed as partnerships for federal income tax purposes to the extent that those distributive shares of income are greater than zero."

c. Explanation

Under federal income tax law, certain entities that are not partnerships under state law may elect to be taxed as partnerships. The following considerations would support treating distributive shares of income from all entities taxed as partnerships under federal tax law as passive income for purposes of the passive entity exemption to the franchise tax.

Section 171.0003(a)(2) provides that an entity is an exempt passive entity if at least 90% of its federal gross income consists of one or more of the categories of income enumerated in Section 171.0003(a)(2)(B). This language would seem to require the calculation of an entity's gross income for federal income tax purposes, and the subsequent determination of the portion *of that gross income* which falls within one of the categories of income enumerated in Section 171.0003(a)(2)(B). To administer the test in this manner, the categories of income enumerated in Section 171.0003(a)(2)(B) must be viewed as subsets of total gross income for federal income tax purposes, and the same federal income tax law that is used to calculate federal gross income must be used to calculate the categories of income enumerated in Section 171.0003(a)(2)(B).

The Comptroller took this approach in defining certain passive income categories for purposes of its rule regarding passive entities (Rule 3.582). In the preamble to Rule 3.582, the Comptroller noted that because an entity's passive income is determined using values from its federal tax return, federal tax law regarding the inputs underlying those values should apply to ensure that the numerator and the

[17] *See* Exhibit A.

denominator of the passive income ratio are consistent. For example, the preamble makes clear that the Comptroller interpreted Section 171.0003(a)(2)(B)'s reference to "gain" as "net gain" in Rule 3.582(c)(2)(C) because federal gross income calculations include net gains, not gains. The Comptroller reasoned that "net gains" had to be used to make the numerator and denominator of the federal gross income ratio consistent. Furthermore, the Comptroller stated in the preamble that explicit references to federal tax statutes to quantify the items of income enumerated in Section 171.0003(a)(2)(B) should be unnecessary because the determination of passive income for franchise tax purposes "is derived from lines on the federal income tax return," making it "implicit that the Comptroller follow the federal law for those underlying items."

The Comptroller has declined taxpayers' requests for similar assurances, however, that "distributive income from a partnership" and "income from a limited liability company" (the subject of the next comment) would be similarly defined using federal income tax principles. Accordingly, it might be viewed as unclear whether income is passive if it is a distributive share of income from either (i) an entity which is not a state law partnership but which is taxed as a partnership for federal income tax purposes or (ii) an entity which is a state law partnership but which is not taxed as a partnership for federal income tax purposes. If federal tax principles were not used, an entity's state law classification would control whether a distributive share of income from it is included in the numerator of its owner's passive income ratio and its federal tax law classification would control whether a distributive share of income from it is included in the denominator of its owner's passive income ratio. Entities could potentially exploit this inconsistency to be considered passive for franchise tax purposes when they would otherwise not be considered passive.

For example, consider a state law partnership ("Partnership 1") which owns a 99.9% limited partnership interest in another state law partnership ("Partnership 2"). Partnership 1 also generates $1000 of active income from other sources. Partnership 2 has $1000 of active income and elects to be taxed as a corporation for federal income tax purposes. Partnership 2 does not make any cash distributions to Partnership 1. If the state law definition of "distributive shares of partnership income" were applied for purposes of the passive entity test's numerator, Partnership 2 would be considered a partnership and Partnership 1's $999 share of Partnership 2's income would be passive income. For purposes of the passive entity test's denominator, Partnership 1 will have no federal gross income from Partnership 2 because Partnership 1 receives no "dividends" from Partnership 2 (there will be federal gross income from an entity taxed as a corporation only to the extent that the entity taxed as a corporation pays dividends). Therefore, using state law definitions for the numerator and federal tax definitions for the denominator, Partnership 1 would be a passive entity ($999 passive income from distributive shares of Partnership 2's income divided by $1000 federal gross income) even though its federal gross income includes no passive income. If federal tax definitions were used consistently for both the numerator and denominator, Partnership 1 would not be a passive entity ($0 passive income divided by $1000 federal gross income).

Our suggested amendment would eliminate this potential loophole, while also ensuring that distributive income from LLCs and business trusts that are taxed as partnerships for federal income tax purposes is included in the numerator of the passive income ratio.

2. Joint Operating Agreements and Contract Operators

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

Section 171.0003(a)(2)(D) provides that "royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests" are considered passive income for purposes of the passive entity exception from franchise tax under Sections 171.0002 and 171.0003. Section 171.0003(b)(2) provides that the following income does not qualify as passive income for purposes of Section 171.0003(a)(2)(D): "income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement."

b. Suggestion

We suggest that the Legislature consider amending Section 171.0003 by adding a new Subsection (c) that provides: "For purposes of determining the operator of a mineral property under Section 171.0003, the operator shall be the operator named in the joint operating agreement, unless such operating duties have been otherwise assigned in writing, in which case there shall be a rebuttable presumption that the operator shall be such assigned operator. Any party may rebut such presumption by proving that the assigned operator is not performing operating duties. In the event operating duties have been so assigned for part of the period on which franchise tax is based, then the taxpayer shall allocate such income by the number of days pre-assignment and post-assignment (with the date of assignment counting within the post-assignment period) in determining whether such income (or a portion thereof) is passive for purposes of Section 171.0003."

c. Explanation

Under the provisions of Sections 171.0003(a)(2)(D) and (b)(2), mineral interest income cannot be considered passive income for purposes of Section 171.0003 if a partnership is the operator of the subject mineral property or is in an affiliated group for franchise tax purposes with the operator. It is common practice in the oil and gas industry for operators of mineral properties to be "contract" operators, meaning that such operators received their operator rights via an assignment of such duties rather than being the named operator in the subject joint operating agreement. In alignment with this common practice, the Texas Railroad Commission respects the "contract" operator as the operator of the subject mineral property rather than the named operator in the joint operating agreement. To be consistent with industry practice and other Texas agencies, we recommend that Section 171.0003 be amended to clarify that the operator of a mineral property for purposes of Section 171.0003 is the operator named in the joint operating agreement, unless such operator duties have been assigned to a "contract" operator, in which case the "contract" operator would be considered the operator of the subject mineral property for purposes of Section 171.0003. To address the potential use of a contract operator "in name only" in order to obtain passive entity treatment, our suggested approach includes "rebuttable presumption" language.

To properly address the situation where operator rights have been contractually assigned mid-year, a procedure for determining the passive or non-passive status of such income should be statutorily outlined. There appear to be two main alternatives:

- Alternative (1): Allocate such income by the number of days pre-assignment and post-assignment in determining whether such income (or a portion thereof) is passive for purposes of Section 171.0003.

- Alternative (2): Set a date to serve as a benchmark to determine whether such income is passive for the entire year upon which franchise tax is based. The benchmark date logically could be (i) operator on first day of the year; (ii) operator on last day of year; or (iii) operator for majority of the days of the year, and have that control for the entire year upon which franchise tax is based.

Alternative (2) would likely be easier to administer from both the Comptroller's and taxpayer's perspectives; however, Alternative (2) by determining whether income is passive for the entire year based on a benchmark date might also allow taxpayers to minimize their franchise tax by assigning the contract shortly before or after the benchmark date. For this reason, Alternative (1) appears more equitable and is the reason for our suggested statutory language above. Moreover, Alternative (1) appears more in line with the overall "pro rata" methodology used to compute passive income under other provisions of Section 171.0003. For example, Section 171.0003(a)(2)(C) provides that "capital gains from the sale of real property" constitute passive income. Section 171.0003(b)(1) provides that rent does not constitute passive income. With respect to investment rental property that generates rental income for part of the year upon which franchise tax is based and which is subsequently sold during the same year, Section 171.0003 would treat the rental payments as non-passive and the capital gain as passive, as opposed to finding the entire income attributable to the property as either passive or non-passive based upon a determinative factor existing on a specified date.

C. Total Revenue (Section 171.1011)

1. Exclusion by a Taxable Entity of Income From a Passive Entity

a. Language at Issue

Section 171.1011(e) provides: "A taxable entity that owns an interest in a passive entity shall exclude from the taxable entity's total revenue the taxable entity's share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity."

b. Suggestion

We suggest that the Legislature consider amending Section 171.1011(e) as follows: "[a] taxable entity that owns an interest in a passive entity shall exclude from the taxable entity's total revenue the taxable entity's share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity <u>owned directly or indirectly by the passive entity</u>."

c. Explanation

Our suggestion would clarify that the net income generated by the margin of a taxable entity with a passive entity owner would not be subject to multiple layers of franchise tax in the hands of an indirect owner merely because multiple passive entities exist between the indirect owner and the taxable entity generating the margin. For example, Taxable LLC is owned by Passive Partnership 1, which is in turn owned by Passive Partnership 2, which is in turn owned by Taxable Corporation. It might be viewed as unclear whether Taxable Corporation's distributive share of income from Passive Partnership 2, which was originally earned by Taxable LLC, will be considered to be "generated by the margin of" Taxable LLC for purposes of Section 171.1011(e) because Passive Partnership 2 does not own Taxable LLC directly. Our suggestion makes clear that the net income of Passive Partnership 2 was generated by Taxable LLC, and should thus avoid the taxation of the same revenue again at the Taxable Corporation level.

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2. Exclusion of Flow-Through Funds - Mandated by Contract

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

Section 171.1011(g) provides:

"(g) A taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), only the following flow-through funds that are mandated by contract to be distributed to other entities:

(1) sales commissions to non-employees, including split-fee real estate commissions,

(2) the tax basis as determined under the Internal Revenue Code of securities underwritten; and

(3) subcontracting payments handled by the taxable entity to provide services, labor or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property."

b. <u>Suggestion</u>

We suggest that the Legislature consider amending Section 171.1011(g) to add a new Subsection (4) that reads: "(4) other flow-through funds that are mandated by contract to be distributed to other entities on a dollar-for-dollar basis."

c. <u>Explanation</u>

Many service providers make remittances for services, taxes, or other items for their customers under an agreement that the customer will provide the funds for these items, either upfront or as a reimbursement for the remittance. Including such remittances in a taxable entity's taxable margin can produce significant distortions. For example, if a travel agent purchases a $1,000 airline ticket for a customer and charges a $50 commission, the travel agent's true taxable margin on the transaction - receipts prior to the deduction of any expenses relating to that transaction or the expenses of operating the agency generally - is the $50 commission. Intuitively, the franchise tax on this transaction should be no more than 0.7% (70% of total revenue multiplied by the 1% franchise tax rate) of $50, or $0.35. However, if the travel agent cannot exclude the $1,000 customer payment for the airline ticket from gross revenue, the franchise tax on the transaction will be 0.7% of $1,050, or $7.35, for an effective tax of almost 15% of true *gross* income. Certain taxable entities, such as advertising agencies, ticket brokers, event planners, credit card processors, auctioneers, homeowners' associations, and many other agents, brokers, and service providers, are subject to this potential result. Our proposed solution would allow an exclusion for receipts earmarked by contract for payment to a third party. The requirement that such receipts be paid to a third party on a dollar-for-dollar basis is intended to prevent service charges from being treated by contract as reimbursements of general operating expenses. The Legislature might consider directing the Comptroller to promulgate rules regarding whether a distribution or reimbursement for a distribution is made on a dollar-for-dollar basis to address potentially abusive transactions. A similar dollar-for-dollar reimbursement requirement is currently used in the property management company carve-out to the sales tax on real property services. 34 Tex. Admin. Code § 3.356(n). The former franchise tax's rules and interpretive authorities regarding the exclusion of agency reimbursements from receipts might also serve as a guide. See Comptroller's Hearing No. 12,318 (8312H0554A01) (1983) (agency relationship deemed to exist "whenever goods or services pass from the supplier through one corporation to another corporation on a 'dollar-for-dollar' flow-through basis whereby the corporation that ultimately consumes the goods or services pays the middleman corporation the exact same amount it would have paid the supplier for the goods or services consumed by it"); Comptroller's Hearing No. 28,484 (9308H1256B07) (1993).

This expansion of the flow-through-funds exclusion is necessary because it will often be unclear whether dollar-for-dollar flow-through funds that are appropriately excluded from a taxpayer's margin for the reasons described in the previous paragraph may be excluded from total revenue under Tax Code §§ 171.1011(c)(1)(A), (c)(2)(A), or (c)(3). As a matter of practice, some service providers exclude customer payments for such items from gross income on federal income tax reports (as opposed to including the customer payment in gross income and then deducting it). In many such cases, however, it could be difficult for a taxpayer to provide federal income tax authority supporting an exclusion of the payment from federal gross income and thus from total revenue - the IRS has had little incentive to contest these cases or otherwise generate authority on the issue because the federal income tax result is generally the same whether the customer payment is excluded or deducted from gross income. The Comptroller, however, has suggested that she may contest whether a flow-through item has been properly excluded from a taxpayer's federal gross income, even where the IRS has not challenged the exclusion. The Comptroller has specifically identified a landlord's contractual reimbursements from tenants of property taxes and insurance as examples of flow-through funds that should not be excluded from the landlord's federal gross income and should therefore be included in the landlord's total revenue under Subsections (c)(1)(A), (c)(2)(A), or (c)(3), regardless of how the landlord actually reports the reimbursements for federal income tax purposes. If the flow-through funds exclusion is not expanded to explicitly cover these types of dollar-for-dollar flow-through funds, it could be difficult to protect a large class of low profit margin service providers from being subject to a disproportionately high tax burden.

Furthermore, the 81st Texas legislative session saw the expansion of the contractual flow-through fund exclusion to apply to seemingly all flow-through funds received by destination management companies. Section 171.1011(g-6), effective January 1, 2010, provides: "A taxable entity that is a qualified destination management company as defined by Section 151.0565 shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), payments made to other persons to provide services, labor, or materials in connection with the provision of destination management services as defined by Section 151.0565." This expansion of the contractual flow-through provision in Section 171.1011(g) to cover some but not all affected industries results in similarly-situated taxpayers being treated differently.

3. Exclusion of Flow-Through Funds - Entities and Individuals

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

Section 171.1011(g) provides:

"(g) A taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), only the following flow-through funds that are mandated by contract to be distributed to other entities:

(1) sales commissions to nonemployees, including split-fee real estate commissions,

(2) the tax basis as determined under the Internal Revenue Code of securities underwritten; and

(3) subcontracting payments handled by the taxable entity to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property."

b. Suggestion

We suggest that the Legislature consider amending the lead-in sentence to Section 171.1011(g) to read: "A taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), only the following flow-through funds that are mandated by contract to be paid or distributed to ~~other entities:~~ an entity or person not affiliated with the taxable entity . . . ."

c. Explanation

Comptroller Rule 3.587(e)(2) corresponds to Section 171.1011(g). The lead-in sentence to Comptroller Rule 3.587(e)(2) provides: "Flow-through funds that are mandated by contract to be distributed to other entities or persons . . . ." Comptroller Rule 3.587(e)(2) indicates that the contractual flow-through fund provision of Section 171.1011(g) applies with respect to covered contractual flow-through fund payments made to both entities and individuals. Our suggested language would clarify the purpose and meaning of Section 171.1011(g) and would prevent unnecessary confusion. Our suggested language also clarifies that covered payments include amounts either "paid" or "distributed," which appears to be the intent of Section 171.1011(g).

4. Exclusion of Flow-Through Funds - Employees/Non-Employees

a. Language at Issue

Section 171.1011(g) states that a taxable entity shall exclude from its total revenue, to the extent included therein, certain flow-through funds that are mandated by contract to be distributed to other entities, including (i) sales commissions to non-employees, including split-fee real estate commissions; (ii) the tax basis under the Internal Revenue Code of securities underwritten; and (iii) certain subcontracting payments handled by a taxable entity to provide services, labor or materials in connection with the design, construction, remodeling or repair of improvements or the location of the boundaries of real property.

b. Suggestion

We suggest the Legislature consider amending the exclusion for sales commissions to clarify whether excludable sales commissions can be paid to a person who receives the commission as an independent contractor but who may be an employee in some other capacity. The following language may be appropriate if in fact an exclusion is available under those circumstances: "sales commissions that are not paid as employee compensation, including split-fee real estate commissions . . ."

c. Explanation

The phrase "sales commissions to nonemployees" may create unnecessary confusion and arguably leaves open the question of whether excludable sales commissions can ever be paid to a person who receives the commission as an independent contractor, but who may hold an employee position in some other capacity. For example, corporate officers are deemed to be employees by statute for federal income tax purposes. 26 U.S.C. § 3121(d). If that same person engages in activities described by Section 171.1011(*l*)(1) and receives a sales commission separate and apart from wages the person receives as an officer, is the sales commission paid to that person excludable from the taxable entity's total revenue?

5. Health Care Institutions and Health Care Providers

a. Language at Issue

Section 171.1011(n) allows a health care provider to exclude certain items from its revenue, and Section 171.1011(o) reduces this exclusion to 50% of those revenues for certain health care providers that qualify as health care institutions. Section 171.1011(p)(3) defines a 'Health care provider' as "a taxable entity that participates in the Medicaid program, Medicare program, Children's Health Insurance Program (CHIP), state workers' compensation program, or TRICARE military health system as a provider of health care services." Section 171.1011(p)(2) provides that a health care institution includes specific types of facilities, including a hospice, a hospital, a birthing center, etc.

b. Suggestion

We suggest the Legislature consider amending Section 171.1011(n) as follows:

(n) Except as provided by Subsection *(o)*, a taxable entity that is a health care provider shall exclude from its total revenue:

(1) to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), ~~the total amount of payments the health care provider received~~ any item of total revenue arising out of professional services provided:

(A) under the Medicaid program, Medicare program, Indigent Health Care and Treatment Act (Chapter 61, Health and Safety Code), and Children's Health Insurance Program (CHIP);

(B) ~~for professional services provided~~ in relation to a workers' compensation claim under Title 5, Labor Code; and

(C) ~~for professional services provided~~ to a beneficiary rendered under the TRICARE military health system; and"

In connection with the above suggestion, we suggest the Legislature consider amending the lead-in sentence to Section 171.1011(p)(2) as follows: "'Health care institution' means the following institutions, and any entity included in a combined group with such institution that receives payments arising out of services provided by such institution:"

We also suggest the Legislature consider adding the following language to the end of Section 171.1011(p)(3): "A health care provider includes a member of a combined group that receives payments arising out of services provided by a health care provider that is a member of the combined group."

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c. Explanation

Due to the nature of the insurance industry, in many situations, the entity that actually provides health care services will not directly receive the associated payment. Often, entities that provide these services use affiliates to receive payments, and it is arguably unclear whether these payments to affiliates are excluded from total revenue under 171.1011(n). The intent of the statute is to exclude from total revenue payments for health care services rendered under an enumerated list of government programs - rigid requirements regarding the mechanisms by which such payments are received would not appear to further this intent. Our recommendation furthers the statutory intent by clearly extending the exclusion to qualifying affiliates that receive payments arising out of qualifying services. Because it is possible that the use of a payment entity might result in the provider and/or payment entity recognizing items of total revenue in ways that might arguably not be covered by the current statutory exclusion for "payments" from qualifying sources, we suggest using the phrase "total revenue arising out of professional services provided." This should ensure that revenue recognized by either the provider or the payment entity on account of the services will be excluded.

D. Compensation Deduction (Section 171.1013)

1. Treatment of Social Security and Medicare Contributions

a. Language at Issue

Section 171.1013(b)(2) allows a compensation deduction for the cost of benefits provided to officers, directors, owners, partners, and employees, "to the extent deductible for federal income tax purposes." Comptroller Rule 3.589(d), however, excludes certain items from the term "compensation." Specifically, Comptroller Rule 3.589(d)(3) excludes from the term "compensation" an employer's share of payroll taxes.

b. Suggestion

We suggest the Legislature consider clarifying Section 171.1013(b)(2) to address whether employer contributions for social security and Medicare are deductible benefits.

c. Explanation

Employer contributions for social security and Medicare are deductible for federal income tax purposes. These contributions are used by the federal government to provide retirement and health benefits to the employees. Since this is a mandatory cost imposed on employers relating to their employees, and such costs are deductible by the employer for federal income tax purposes, one could reasonably interpret the Texas Tax Code as permitting a franchise tax deduction under Section 171.1013 for such amounts when a taxpayer elects to deduct compensation. However, the statute does not directly address this issue. Given that the Comptroller has not advanced a compelling reason for her interpretation of the statute as not permitting a deduction for these items, we suggest the Legislature consider clarifying the statute to specifically address the issue.

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E. Combined Reporting (Section 171.1014)

1. Controlling Interests in Nonprofit Corporations

a. Language at Issue

Section 171.0001(8) defines "controlling interest" as "(A) for a corporation, either more than 50 percent, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50 percent, owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation[.]"

b. Suggestion

We suggest the Legislature consider amending Section 171.0001(8) to address nonprofit corporations that are taxable entities but that do not have any stock or membership interest. We recommend that Section 171.0001(8) be amended as follows: "(A) <u>(I)</u> for a corporation, either more than 50 percent, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50 percent, owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation<u>; or (II) for a nonprofit corporation that does not have stock or membership interests, direct or indirect control over the appointment of more than 50 percent of the board of directors or persons responsible for the day-to-day management of the corporation;</u>"

c. Explanation

Under some circumstances, a nonprofit corporation might be considered a taxable entity subject to franchise tax. Applying Section 171.0001(8) to a taxable nonprofit corporation may give rise to confusion, because a Texas nonprofit corporation is not required to have any shareholders or members (see Section 22.151 of the Texas Business Organizations Code and Section 2.08 of the Texas Non-Profit Corporations Act). Our suggested amendment to Section 171.0001(8) would clarify that a taxable, nonprofit corporation that has no stock or membership interests will be required to file as part of a combined group with a taxable entity that controls the board of directors or persons responsible for the day-to-day management of the nonprofit corporation.

2. Controlling Interest Treatment of Beneficial Interests

a. Language at Issue

With respect to combined group reporting, Section 171.0001(8) defines "controlling interest" as follows:

(A) for a corporation, either more than 50 percent, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50 percent, owned directly or indirectly, of the beneficial ownership in the voting stock of the corporation;

(B) for a partnership, association, trust or other entity other than a limited liability company, more than 50 percent, owned directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity; and

(C) for a limited liability company, either more than 50 percent, owned directly or indirectly, of the total membership interest of the limited liability company or more than

50 percent, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company.

b. Suggestion

We suggest the Legislature consider amending Section 171.0001 to address how a "controlling interest" is calculated when some portion of an interest is held by beneficial ownership. To prevent a potential double counting of the same ownership interest, we suggest that the Legislature consider amending Section 171.0001(8) as follows by adding the following new subsection 171.0001(8)(D):

> (D) In determining whether a controlling interest exists, an owner's beneficial ownership interest in an entity shall not be taken into account to the extent that the beneficially-owned interest is also treated as a stock, capital, profits, or membership interest of the owner within the meaning of subsections (A) - (C).

c. Explanation

Section 171.1014(a) provides that "[t]axable entities that are part of an affiliated group engaged in a unitary business shall file a combined group report in lieu of individual reports based on the combined group's business." To be considered part of an affiliated group, there must be a "controlling interest" as between a common owner or owners, either corporate or noncorporate, or by one or more of the member entities. In defining the term "controlling interest," Section 171.0001(8) makes clear that such determination is made by reference to actual ownership or beneficial ownership. However, the same ownership interest might be treated as both actually and beneficially owned under Section 171.0001(8).

For example, assume Corporation A has a right to vote 10% of the voting stock of Corporation C pursuant to an agreement executed by and between Corporation A and Corporation B. Further assume that Corporation A owns 60% of Corporation B, which owns 41% of Corporation C (although Corporation B only has voting rights to 31% of Corporation C's voting stock due to the aforementioned voting agreement). Under such circumstance, Corporation A would have a beneficial ownership interest in 10% of the voting stock of Corporation C. This could mean that Corporation B's ownership interest in Corporation C, when determining whether a controlling interest exists, should be 31%. But a literal reading of Section 171.0001(8) might reach a different result whereby Corporation B's interest in applying the controlling interest test is 41% - a result that leads to the same 10% stock ownership being counted twice. The outcome can be critical because if Corporation B has a 41% stock ownership interest in Corporation C, this leads to the affiliated group comprising Corporation A, Corporation B and Corporation C. In contrast, if Corporation B has a 31 % stock ownership interest in Corporation C, this leads to the affiliated group comprising only Corporation A and Corporation B. Our suggested language clarifies whether, in determining whether a controlling interest exists, any stock, capital interest, profits interest, membership interest or beneficial interest should only be counted once (whether because of actual or beneficial ownership).

F. Exemption for Certain Nonprofit Entities (Section 171.063)

1. Wholly-Owned Subsidiaries of I.R.C. § 501(c)(3) Charitable Entities

a. Language at Issue

To establish an exemption for franchise tax purposes, Section 171.063(b) provides that "a corporation is entitled to an exemption under this section based on the corporation's exemption from the federal income tax if the corporation files with the comptroller evidence establishing the corporation's exemption." Section 171.063(c) then states "[a] corporation's exemption under Subsection (b) of this section is established by furnishing the comptroller with a copy of the Internal Revenue Service's letter of exemption issued to the corporation."

b. Suggestion

We suggest the Legislature consider adding language to Section 171.063 to confirm whether an LLC that is wholly-owned by an I.R.C. Section 501(c)(3) charitable organization and disregarded as an entity separate from such charitable organization for federal income tax purposes is covered by the charitable organization's franchise tax exemption. We suggest the following additional language:

> Section 171.063(a)(1) (subsection 171.063(a) lists categories of exempt non-profit corporations) - A nonprofit corporation exempted from the federal income tax under Section 501(c)(3), (4), (5), (6), (7), (8), (10), or (19), Internal Revenue Code which in the case of a nonprofit hospital means a hospital providing community benefits that include charity care and government-sponsored indigent health care as set forth in Subchapter D, Chapter 311, Health and Safety Code, <u>and which includes an entity wholly-owned by, and disregarded for federal income tax purposes as separate from, a nonprofit corporation exempted from the federal income tax under Sections 501(c)(3), (4), (5), (6), (7), (8), (10), or (19) of the Internal Revenue Code;</u>
>
> Section 171.063(b) - A corporation is entitled to an exemption under this section based on the corporation's exemption from the federal income tax if the corporation files with the comptroller evidence establishing the corporation's exemption. <u>An entity exempt under Section 171.063(a)(1) as a wholly-owned subsidiary of a corporation exempt from federal income tax under Internal Revenue Code Section 501(c) must provide to the comptroller (i) the corporation's tax-exempt determination letter issued by the Internal Revenue Service and (ii) the entity's governing documents evidencing that such entity is organized solely to carry out the exempt purposes of the corporation.</u>

c. Explanation

The IRS issued Priv. Ltr. Rul. 200134025 (Aug. 27, 2001) in 2001, where it ruled that an LLC whose sole member is a tax-exempt I.R.C. Section 501(c)(3) organization will be treated as a disregarded entity for federal income tax purposes. Because the tax-exempt I.R.C. Section 501(c)(3) organization must treat the operations and finances of the LLC as its own for franchise tax purposes, the IRS will not require the LLC to file a separate application for tax-exempt status to obtain its own tax-exempt determination letter. The rationale for this ruling by the IRS is that because (i) the LLC is formed solely to carry out the charitable activities of the parent 501(c)(3) organization, and (ii) the LLC is ignored as a separate entity and simply treated as part of the parent 501(c)(3) organization, then the LLC comes under the umbrella of the parent 501(c)(3) organization's tax exemption. The Comptroller has historically taken a different approach, however, regarding LLCs wholly-owned by I.R.C. Section 501(c)(3) organizations. For example, in Tex. Comp. Rul. 200106899L (June 21, 2001), the Comptroller required a subsidiary LLC to obtain its own tax-exempt determination letter from the IRS in order to obtain a franchise tax exemption. This could be viewed as creating an unnecessary trap for unwary Texas charities, because, as discussed above, LLCs wholly-owned by I.R.C. Section 501(c)(3) charities and classified as disregarded entities for federal income tax purposes are not required (and may not even be able) to obtain such a tax-exempt determination letter from the IRS.

It is our understanding that the Comptroller may have changed her position with respect to certain facts and taxpayers. In any case, our suggestion would eliminate confusion and implement the Legislature's intent that an organization operating (per the IRS) within the statutorily enumerated subsections of I.R.C. Section 501(c) be allowed to operate in that same manner free of franchise tax.

G. Successor Tax Liability on Sale of Business or Stock of Goods (Section 111.020)

1. Request for Tax Clearance or Statement of Amount Due

a. Language at Issue

Section 111.020(a) states that "[i]f a person who is liable for the payment of an amount under [Title 2 of the Texas Tax Code] sells the business or the stock of goods of the business or quits the business, the successor to the seller or the seller's assignee shall withhold an amount of the purchase price sufficient to pay the amount due . . . ." Section 111.020(b) provides that the "purchaser of a business or stock of goods who fails to withhold [the required amount] is liable . . . for the amount required to be withheld to the extent of the value of the purchase price. Section 111.020(c) allows the purchaser to "request that the comptroller issue a statement stating that no tax is due or issue a statement of the amount required to be paid before a certificate may be issued" and requires the comptroller to "issue the certificate or statement . . . within 90 days after the date of receiving the request." According to Section 111.020(d), "[i]f the comptroller fails to mail the certificate or statement within the applicable period provided by Subsection (c) of this section, the purchaser is released from the obligation to withhold the purchase price or pay the amount due."

b. Suggestion

We suggest the Legislature consider amending Section 111.020(c) as follows:

"The purchaser of a business or stock of goods may request that the comptroller issue a certificate stating that no tax is due or issue a statement of the amount required to be paid before a certificate may be issued <u>to the purchaser</u>. The comptroller shall issue the certificate or statement within 60 days after receiving the request or within 60 days after the day on which the records of the former owner of the business are made available for audit, whichever period expires later, but in either event the comptroller shall issue the certificate or statement <u>to the purchaser</u> within 90 days after the date of receiving the request <u>if the comptroller has also received a copy of a letter of intent, purchase agreement, or confirmation of the request by the former owner or seller of the business. The statement of amount required to be paid may be based on the comptroller's estimate of franchise tax liability and shall be limited by the amount of the purchase price. Such statement of amount required to be paid shall be issued solely for the benefit of the purchaser or purchasers of the business or stock of goods to establish the amount of required withholding. Until the purchaser receives a certificate of no tax due, the purchaser must withhold the amount stated to be due for the benefit of the purchaser and the State of Texas for any unpaid tax liabilities of the seller. Neither a certificate of no tax due issued to a purchaser nor a statement of the amount required to be paid before such a certificate may be issued shall release the seller from any taxes, interest, or penalties otherwise owing under this title.</u>"

We also suggest adding the following language to Section 111.020(d):

"Correspondence from the comptroller that fails to either state that no tax is due or provide a specific amount of tax required to be paid to obtain a certificate of no tax due is not a certificate or statement that satisfies the comptroller's obligation within the meaning of Subsection (c) of this section."

c. Explanation

The combined reporting requirement of the franchise tax has made the process of determining a seller's tax liability more difficult. Accordingly, the comptroller has recently been unable, at times, to issue a statement of tax liability within the 90 day period required by the statute. Our suggested solution permits estimating franchise tax liabilities for withholding purposes and is modeled after similar withholding provisions in other states. It also clarifies that the comptroller's certificate or statement is issued solely for the protection of the purchaser and does not release the selling taxpayer from any liability. Our suggestion adds protections for both the comptroller and companies seeking to purchase a business or stocks of goods in Texas, reduces uncertainty in the tax clearance process, and helps reduce unnecessary transactional costs while aiding in tax compliance and collection. The suggestion also protects the selling business from unexpected or unnecessary audits or reviews unless the parties have entered into sale negotiations.

EXHIBIT A

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Grantor Trust Letter Ruling

From: Teresa Bostick [mailto:Teresa.Bostick@cpa.state.tx.us]
Sent: Wednesday, October 28, 2009 4:45 PM
To: Larsen, Matthew
Subject: 08322257 - Request for ruling

08322257

October 28, 2009

To: Matt Larsen [matthew.larsen@bakerbotts.com]

Dear Mr. Larsen:

Thank you for your November 17, 2008 email regarding the revised Texas franchise tax with the margin calculation. I apologize for the lengthy delay in response.

You state that your client, Individual A, will transfer assets to a revocable trust (the "Trust") of which he is the sole current beneficiary. The Trust will be a grantor trust with Individual A being treated as the owner of the Trust for federal income tax purposes and the Trust will be described by Internal Revenue Code Section Sections 671 and 7701(a)(30)(E). The Trust will not be taxable as a business entity pursuant to Treasury regulation Section 301.8801-4(b). The Trust instrument will provide that Individual A will be the sole beneficiary of the Trust during his lifetime but the instrument will name other individuals, trusts for individuals, or charitable organizations that may receive Trust assets upon Individual A's death. You request verification that the Trust will not be subject to the franchise tax during Individual A's lifetime.

Texas Tax Code Section 171.0002(c)(1) provides that a taxable entity does not include "a grantor trust as defined by Sections 671 and 7701(a)(30)(E), Internal Revenue Code, all of the grantors and beneficiaries of which are natural persons or charitable entities as described in Section 501(c)(3), Internal Revenue Code, excluding a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b)".

In applying the above provision, we will look to the beneficiaries during the period on which the report is based. Therefore, for the period in which Individual A is the sole beneficiary, the Trust qualifies as a non-taxable entity.

You will find links to the franchise tax statute, adopted rules, frequently asked questions (FAQs), tax forms and publication 98-806, Revised Franchise Tax Overview, on our web site at http://window.state.tx.us/taxinfo/franchise/.

This response is based on current law and the facts and information presented. If there are different or additional facts, the response may change.

Sign up for e-mail updates on the Comptroller topics of your choice at http://www.window.state.tx.us/subscribe

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If you have any questions, my e-mail address is teresa.bostick@cpa.state.tx.us or you may call me toll-free at (800) 531-5441, ext. 5-9952.

Sincerely,

Teresa Bostick
Tax Policy Division

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SECTION OF TAXATION
State Bar of Texas

February 22, 2011

Ms. Robin Robinson
Deputy General Counsel
General Counsel Division
Texas Comptroller of Public Accounts
P.O. Box 13528
Austin, Texas 78711-3528

RE: Proposed Changes to Texas Comptroller Practice and Procedure Rule § 1.9 Concerning Position Letters

Dear Ms. Robinson:

The Section of Taxation of the State Bar of Texas is providing comments pertaining to proposed changes to Comptroller Rule of Practice and Procedure § 1.9. The proposed rule changes were published in the January 28, 2011 edition of the Texas Register.

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 THIS LETTER, 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 GOVERNMENTAL SUBMISSIONS OF THE STATE BAR OF TEXAS 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 SECTION OF TAXATION MEMBERS WHO PREPARED THEM.

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We greatly appreciate the opportunity to work with your office on these significant tax issues and hope to provide relevant analysis for your review. Thank you for your consideration.

Respectfully submitted,

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

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COMMENTS CONCERNING THE TEXAS COMPTROLLER'S DRAFT RULE 1.9 AS PUBLISHED IN THE TEXAS REGISTER ON JANUARY 28, 2011

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

These comments were prepared by individual members of the Section's Committee on State and Local Taxation (the "Committee"). Principal responsibility was exercised by one of the Committee's Vice Chairs, Ira Lipstet. The comments were reviewed and substantive contributions were made by Matthew Larsen, Chair of the Committee, and by two of the Committee's Vice Chairs, Alyson Outenreath and Charolette Noel. The comments were also reviewed by Daniel Micciche of the Committee on Government Submissions of the State Bar of Texas.

Although many of the persons who participated in preparing this letter have clients who would be affected by the state tax principles addressed by this letter or have advised clients on the application of such principles, no such person (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 this letter.

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I. INTRODUCTION

We recognize and appreciate the challenges facing the Comptroller when balancing the task of providing a fair and transparent administrative process for resolving taxpayer disputes against the Comptroller's need for an efficient administrative process to resolve such controversies. It is our intent to present items for consideration that may help and support you and your staff.

Our comments are in response to certain proposed additions to 34 Tex. Admin. Code § 1.9[1] as published in the Texas Register on January 28, 2011 ("Proposed Rule 1.9(d)"). As discussed below, we believe that certain elements of the addition of new subsection (d) to Rule § 1.9 as set out in the Proposed Rule are inconsistent with providing full opportunities for taxpayers to resolve controversies with the Comptroller in a transparent and consistent matter.

II. PROPOSED RULE § 1.9(d)

In the January 28, 2011 issue of the Texas Register, the Comptroller's Office published proposed changes to Rule § 1.9 concerning the issuance of Position Letters in redetermination and refund hearings. Rule § 1.9 would be modified by adding the following language as new Rule subsection 1.9(d):

> (d) This section is optional for the Tax Division in cases for which:
>
> a) The statement of grounds does not contain the information required by § 1.7 of this title (relating to the Content of Statement of Grounds; Preliminary Conference);
>
> b) The dispute is the denial of a settlement pursuant to Tax Code §§111.101-111.103; or
>
> c) State Office of Administrative Hearings (SOAH) can readily decide the matter without the position letter.

III. COMMENTS TO PROPOSED CHANGES

A. Current Process

The focus in these comments is on the addition of a Rule provision that will make the issuance of a Position Letter by the Comptroller Tax Division an optional step in the administrative process currently in place to resolve controversies between taxpayers and the Comptroller. As discussed in greater detail below, we believe the elimination of the requirement (in some cases) for the Comptroller Tax Division to issue a Position Letter to taxpayers would reduce the ability of those taxpayers to pursue their claims in an effective manner, would likely

[1] Hereinafter, all references to "Rule" or "Rules" (as appropriate) are to Chapter 34 of the Texas Administrative Code.

result in inconsistent determinations as to when a Position Letter will or will not be issued in similar cases, and would introduce uncertainty as to what procedure is to be followed by taxpayers in those situations when there has not been (as a result of the adoption of the Proposed Rule) the issuance of a Position Letter.

The statutory regime and administrative process currently in place provide authority for taxpayers to contest the issuance of a deficiency determination by submitting a timely filed petition for redetermination and Statement of Grounds with the Comptroller. Texas Tax Code ("TTC")[2] § 111.009; Rule § 1.5(a). Similarly, taxpayers may contest the Comptroller denial of a refund claim by timely submitting to the Comptroller a request for a hearing with respect to the refund claim denial. TTC § 111.105(a); Rule § 1.5(c). Longstanding Rules §§ 1.1-1.42 provide guidance and authority as to how the administrative process is to be conducted (other than when the controversy has been sent to the State Office of Administrative Hearings ("SOAH") for the actual oral or written proceeding).

The Rules provide that the Statement of Grounds must contain the reasons the taxpayer disagrees with action of the Comptroller in issuing the deficiency determination or denying the refund claim. Rule § 1.7(a). If a taxpayer's Statement of Grounds fails to state the factual basis and legal grounds on which relief is sought, the case may be dismissed. Rule § 1.7(c).

Absent a resolution of the controversy between taxpayer and the Comptroller, long standing Comptroller procedure requires the Tax Division Assistant General Counsel ("AGC") to review all relevant information and then draft and send a Position Letter to the taxpayer. The Position Letter drafted by the AGC and sent to the taxpayer will accept or reject, in whole or in part, each contention of the taxpayer, and set forth what the AGC finds is properly subject to or exempt from taxation. Rule § 1.9(a).

A taxpayer must accept or reject the Tax Division's Position Letter, in whole or in part, within 45 days after the date of the Position Letter. Rule § 1.10(a). The taxpayer may agree with the Position Letter in whole or in part, or reject some or all of the conclusions of the Position Letter. Rule § 1.9(b)(1), (2). Communication of taxpayer acceptance or rejection of the Position Letter is accomplished by the taxpayer filling out a selection form and returning the same to the AGC within 45 days (or longer if agreement is reached between taxpayer and the AGC for an extension of time to submit the selection form and accompanying documentary information and/or evidence). Rule § 1.10(b). If the taxpayer timely fails to respond to the Tax Division's Position Letter, the Comptroller may dismiss the contested case. Rule § 1.10(c).

If there is ultimately no agreement at the Comptroller level, the case will be transferred to the SOAH for hearing on oral or written submissions. Rule §1.22. The assigned SOAH administrative law judge will issue a Proposal for Decision, which will (after exceptions, if any, are addressed) then be sent back to the Comptroller for purposes of making and issuing a final Comptroller decision. Rule §§ 1.27, 1.28.

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[2] Hereinafter all section reference are the TTC unless otherwise noted.

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B. Impact of Elimination of Position Letter requirement

Pursuant to the standing Rules, issuance of a Position Letter is a pivotal component in the administrative process of attempting to determine a resolution of the controversy between the taxpayer and the Comptroller. The Position Letter provides taxpayers with the first (and sometimes only) summary of the Comptroller's position, as well as the bases for those positions. The selection form provided with the Position Letter is the mechanism by which the taxpayer informs the AGC of the taxpayer's decision to go forward (or not) with the contested administrative process. In addition, the Position Letter establishes the means by which the taxpayer both explains and argues for taxpayer's disputed items, and provides documentation in support of the matter. Making the issuance of a Position Letter by the Tax Division optional would be problematic for a number of reasons, as discussed below.

1. If the Statement of Grounds does not (presumably in the opinion of the AGC) contain sufficient factual and/or legal information as required by Rule 1.7, no Position Letter has to be issued. Absent the issuance of a Position Letter (as could result with adoption of Proposed Rule 1.9(d)(1)), it is not clear how, when or if the taxpayer will be apprised of the asserted deficient nature of the Statement of Grounds or refund claim. Absent this information, the taxpayer would be hard pressed to fix the asserted deficient Statement of Grounds or refund claim, and, indeed may not be aware of the problem until receiving a statement of tax due. This might be especially problematic for the many *pro se* taxpayers who are trying to navigate the administrative process as best they can. Properly or not, the perception among taxpayers and/or claimants who have not received any specific response to their redetermination or refund claim may be that they have not had a fair opportunity to explain their side of the controversy or, in essence, have been denied due process.

2. Taxpayers would be in the same situation as having submitted an insufficient Statement of Grounds or refund claim if no position letter is issued in response to a request for settlement of tax, penalty and/or interest per the authority of TTC §§111.101-111.103) (per Proposed Rule § 1.9(d)(2)). In addition to not knowing what the response and position of the Comptroller is, taxpayers might have difficulty in determining the basis for denial of the settlement offer. This could be particularly significant for those taxpayers (again, including many who are proceeding *pro se*) that are having financial difficulty and are trying to reach an accommodation with the Comptroller that will allow them to remain in business.

3. Per Proposed Rule 1.9(d), the Tax Division may decide not to issue a Position Letter if "SOAH can readily decide the matter without the Position Letter." This addition is vague, and provides no basis for evaluating when a matter may or may not be "readily decided by SOAH." The very purpose of having an administrative process is to resolve disputes between the taxing authority and the taxpayer. Central to that process is putting the taxpayer on notice as to what the specific bases are for disagreement by the Comptroller. If there is no Position Letter required providing that information, taxpayers would be at a substantial disadvantage in preparing for and pressing their claims before a SOAH administrative law judge. In addition, the administrative process would be

impeded if the first time taxpayers find out the specifics of the Comptroller's position is late in the hearing process, or even at the hearing itself.

4. There are a number of practical procedural issues that would arise if there is no requirement to issue a Position Letter in certain situations, including:

a) Many of the administrative hearing process procedures key off the issuance of the Position Letter, such as:

(1) alerting the Comptroller of taxpayers' intentions on a go-forward basis as the selection form is provided as part of the Position Letter. Rule 1.10 provides that the taxpayer must accept or reject the Position Letter within 45 days after the day the Position Letter is dated by submitting the selection form to the Tax Division. There might be confusion about how this would be done if no Position Letter is ever provided to the taxpayer or no other clarifying rule is adopted.

(2) determining a taxpayer's course of action. It may be difficult for taxpayers and their representatives to determine how and when the administrative process will unfold and how they should most appropriately respond without information contained in the Position Letter.

(3) allowing a taxpayer to reply to the state's position. The current process allows for taxpayers to file a Reply to the Position Letter ("Reply"). Rule § 1.15. The Reply is to "address all unresolved contentions and provide legal and factual support for the taxpayer's position." Per Rule 1.15(b), the taxpayer is to provide sworn affidavits, certified business records or otherwise admissible evidence with the Reply to Position Letter. It seems unclear how, when, or if a taxpayer would be able to provide this information if there is no Position Letter, and, consequently, no Reply.

(4) allowing an AGC response. If taxpayer files a Reply that contains new or different contentions, the AGC is authorized to file, within 45 days, a response to the Reply that addresses these contentions. Rule § 1.15(b). It seems unclear how the AGC could comply with (and the taxpayer rely on) the 45 day response period if there is no Reply to Position Letter, and, therefore, potentially no possibility of a response to the Reply.

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C. Determination as to whether a Position Letter will be issued would be entirely up to the discretion of the Tax Division and AGC. Such subjective discretionary authority could lead to a significant disparity between issuance and non-issuance of Position Letters in otherwise similar situations, due simply to differing approaches taken by AGCs. Such occurrences could give rise to due process considerations.

For the reasons discussed above, we suggest that you consider not adopting Proposed Rule 1.9(d).

IV. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.