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TO MOVE DIRECTLY TO AN ARTICLE CLICK ON THE TITLE

TABLE OF CONTENTS

From Our Leader:

Articles:

Practitioner's Corner:

The name and cover design of the Texas Tax Lawyer
Are the property of the State Bar of Texas, Section of Taxation

CHAIR'S MESSAGE

Greetings Tax Section Members,

It has been a busy year for the Tax Section so far, with several big accomplishments that deserve a mention. Before that, however, please take a moment to mark your calendars for several upcoming events:

- April 21, 2010 – Property Tax Conference, Austin Texas
- June 10-11, 2010 – Texas Federal Tax Institute, San Antonio, Texas
- June 25, 2010 – Tax Section Annual Meeting, Dallas, Texas
- August 25-27, 2010 – Advanced Tax Law Course, Dallas, Texas

Details regarding these upcoming events can be found on the Section's website at www.texastaxsection.org.

The Section's 12th Annual International Tax Symposium was held in November in Plano and was a great success, thanks in large part to the leadership and hard work of our International Tax Committee chair Andrius Kontrimas. Andrius is doing double duty this year and is also the Editor of the Texas Tax Lawyer and as such is largely responsible for improvements that began in the Fall 2009 issue and continue in this Winter 2010 issue. Those improvements include the links in the table of contents that make it easier to open and print specific articles, as well as links within articles to statutes or websites cited therein.

Kudos are also due to Elizabeth Copeland, chair of our Section's Pro Bono Committee. Elizabeth has presided over a significant expansion of that committee's United States Tax Court calendar call program, in which Tax Section members advise pro se taxpayers appearing before the Tax Court. The Tax Court judges and IRS counsel have all expressed great appreciation to the Section for this service, which both aids taxpayers and also greatly improves the functioning of the courts themselves.

Congratulations are also in order for our State and Local Tax Committee and their highly successful margin tax comments submitted in late 2009. The committee drafted comments regarding the Comptroller's proposed margin tax rule 3.582(e). Our comments urged the Comptroller to delete certain language in the proposed rule that would have called into question the continuing practical viability of the passive entity exemption to the margin tax. On December 25, 2009, final rules issued by the Comptroller were published in the Texas Register, deleting the language as urged by the Section's comments and citing the Section's comments in the rule preamble explaining the decision to strike the language. Special thanks go to Matthew Larsen, Alyson Outenreath, Ira

Lipstet, David Colmenero, Cindy Ohlenforst, Geoff Polma, and Dan Baucum for this outstanding result.

I am also pleased to announce that the Tax Section Council has selected Charles O. Galvin as the 2010 recipient of the Outstanding Texas Tax Lawyer award. This is the highest award that our Section gives, and it recognizes and honors recipients for their outstanding reputation, expertise, and professionalism in the practice of tax law in Texas. Professor Galvin taught countless students at SMU Law School over the years, and was also instrumental in many tax reform efforts. Professor Galvin joins our short and distinguished list of recipients of this award, and his addition will serve only to further increase the esteem of that group. Details regarding the presentation of the award to Professor Galvin are still in process and will be posted on our website when they are completed.

Finally, if you are not already involved in the Section's activities, I encourage you to get involved. Take a quick look at the Section's leadership roster on our website, identify a committee where you think you can help, and call or email the chair of that committee. If you are not sure who to contact, then call (214-969-1409) or email (tyree.collier@tklaw.com) me. You will not only help to build and maintain a stronger Section, but I think you will find that it is fun.

Thanks, and I look forward to finishing out this year on a high note.

Tyree Collier, Chair

All That Glitters Is Not Gold …
Entering Into And Enforcing Charitable Pledges In Texas

Lisa M. Rossmiller and Brent C. Gardner, Jr.
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ALL THAT GLITTERS IS NOT GOLD…

ENTERING INTO AND ENFORCING CHARITABLE PLEDGES IN TEXAS

By: *Lisa M. Rossmiller and Brent C. Gardner*[1]

Over his life, infamous oil executive J. Howard Marshall, pledged millions of dollars to his alma matter, Haverford College. In response to Marshall's generous pledges, Haverford College named a scholarship, a professorship, and its Fine Arts Center after Mr. Marshall. But when Mr. Marshall died in 1995, he had donated only a fraction of what Haverford claimed he had pledged. Haverford sued Marshall's estate in a Houston probate court to recover more than $4 million in unpaid pledges. A jury found that Haverford was not entitled to the uncollected pledges because the college had not "substantially [relied] to its detriment"[2] on Mr. Marshall's pledges.

Haverford College's experience is not entirely unique. It is not uncommon for charitable organizations to find that a prospective donor (or his or her estate) is unwilling or unable to honor prior charitable pledges. In such a situation, a charitable organization must consider (1) whether the pledge is enforceable, and (2) if it is, whether the organization should or must seek to enforce the pledge in court. A charitable organization should also establish and implement "best practices" for documenting its charitable pledges to ensure that to the extent legally possible, its charitable pledges are collected.

I. IS A CHARITABLE PLEDGE ENFORCEABLE?

Contract law, which varies from state to state, dictates whether a charitable pledge is enforceable.[3] In Texas, the elements of an enforceable contract are: (1) an offer, (2) acceptance of the offer, and (3) consideration, which is the bargained for exchange of something of legal value.[4] A charitable pledge usually lacks consideration because the charitable organization generally does not give anything in exchange for the pledge and the promisor does not seek any benefit in return for the pledged property.

Where consideration is absent, courts will often find a surrogate for traditional consideration in the doctrine of promissory estoppel. Under the doctrine of promissory estoppel, or detrimental reliance, a contract will be deemed where there is (1) a promise, (2) foreseeability of reliance thereon by the promisor, and (3) substantial reliance by the promisee to his detriment.[5] Additionally, Texas courts have emphasized that promissory estoppel requires a *reasonable* or *justified* reliance on the conduct or statement of the person sought to be estopped by the person seeking the benefits of the doctrine.[6] The underlying function of the theory is to promote equity.[7]

In Texas, the issue of whether a charitable pledge is enforceable based on theory of promissory estoppel was first heard by the Texas Supreme Court in 1857 in *Hopkins v. Upshur*.[8] In that case, Upshur pledged $50 to help a local church pay for the construction of a chapel in

Austin. After the church had already begun construction of the chapel, Upshur refused to provide the money he had pledged. The Texas Supreme Court ruled that the pledge was a voluntary agreement that matured into an enforceable contract by Upshur having permitted the church to incur legal liabilities and encounter expenses upon the faith of the pledge. The pledge became an enforceable contract under the doctrine of promissory estoppel when the church relied on Upshur's promise to its detriment.

Although the charitable organization in *Hopkins v. Upshur* had taken substantial steps in reliance on Upshur's promised contribution, Texas courts have not always required such substantial reliance when enforcing charitable pledges under the detrimental reliance standard. For example, in *Rouff v. Wash. & Lee Univ.*,[9] Rouff made a charitable pledge to assist Washington & Lee University found a school of civil engineering. Even though the university had not begun constructing the new building and had not procured all of the required one hundred founders, it had taken some steps in reliance on Rouff's charitable pledge prior to his death, including acquiring equipment and machinery and hiring two full-time professors. The court concluded that the pledge became a valid and irrevocable obligation, since "under all the given circumstances … there being especially no time limit attached, [the] subscription did not fail because the objective for it had not been fully attained."[10]

Although the typical charitable pledge lacks consideration, this is not always the case. For example, where a promisor pledges funds on a return promise (i.e., a bilateral contract), such as a scholarship or memorial being named after the promisor, a Texas court might find that an enforceable contract was formed at the time of the pledge.[11] Likewise, a Texas court might enforce a charitable pledge upon which other donors rely in making their pledges or a pledge that is given in consideration of similar pledges by other donors.[12]

Under a more modern legal theory, a Texas court might also enforce a charitable pledge based on public policy even without consideration or reliance. This modern approach is adopted in the Restatement (Second) of Contracts § 90 which provides that:

> (1) A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forebearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.
>
> (2) A charitable subscription or a marriage settlement is binding under Subsection (1) *without proof that the promise induced action or forebearance*.[13]

This legal theory is based on the principle that a charitable pledge should be enforced even if there has been no detrimental reliance by the charitable organization on the promised contribution, so long as it was reasonable to expect that the charitable organization would rely on the pledge and that injustice would result if the pledge is not enforced. Although Texas courts have not specifically applied the legal theory of Section 90 of the Restatement (Second) of Contracts to enforce a charitable pledge, they have acknowledged that pledges "for public, or quasi public enterprises, are favored in law, and as a matter of public policy are construed, if they reasonably may be, to support a recovery. Doubtful questions are to be resolved against subscribers who seek to evade promised contributions."[14]

As with any contract, however, a charitable pledge will not be enforced if certain defenses to recovery exist such as where the donor was a victim of undue influence, fraud, or where a constructive trust is deemed.[15] Given the advanced age of many who provide charitable pledges, courts seem especially sensitive to allegations of undue influence or fraud.[16]

In one such case, the estate of Francis K. Snyder sued to set aside a two million dollar gift to the Texas A&M-Corpus Christi Foundation (the "Foundation").[17] The estate administrator argued that the pledge should be set aside because the deceased donor was incompetent at the time the gift was made. At the time of the gift, Snyder was 99 years old. The president of the Foundation had the opportunity to exert undue influence, as he admitted to private meetings with the decedent prior to the gift instrument's execution. The decedent's friend, accountant, attorney, nurse, and doctors all stated she was mentally incapacitated during the time period in which the instrument was signed. Furthermore, the original gift, which was drafted by Snyder's attorney, was for only one million dollars. The final version of the instrument was prepared by the Foundation's president and was presented to Snyder for her signature without any of her familial, legal, or financial representatives present. In addition to several other factors, the size of the gift left Snyder with little funds in comparison. These facts, combined with others, led the court to agree with the estate administrator that the circumstances of the case produced a reasonable belief of undue influence, although none of the circumstances standing alone would have been sufficient to show its elements.

In addition to undue influence and fraud, other defenses recognized by Texas courts with respect to the enforceability of charitable pledges include that the charitable organization waived its claim against the donor, that the charitable organization is estopped from asserting the claim, and that in making its claim, the charitable organization acted with "unclean hands."[18] The applicability of each of these defenses is, notably, fact specific.

Although some contracts are only enforceable if they are in writing,[19] as a general rule, courts do not require that a charitable pledge be in writing. The Texas Statute of Frauds does not expressly apply to charitable pledges and Texas courts have held that charitable pledges are not generally contracts of the type that must be in writing.[20] Regardless, best practice dictates that from an evidentiary perspective, a charitable organization should request that all charitable pledges be in writing.[21]

II. SHOULD A CHARITY SEEK TO ENFORCE A CHARITABLE PLEDGE?

When a promisor or his estate refuses to honor a charitable pledge, charitable organizations are often reluctant to enforce the pledge through a court action. There are many practical reasons that a charitable organization would simply accept that it will not receive payment on a reneged pledge. The potentially high costs of litigation coupled with the uncertainty of success in court is one factor that should be considered. But perhaps more importantly, enforcing pledges against donors might be perceived to be bad from a public relations perspective. A prospective donor might think twice about pledging funds to a charitable organization that has a history of suing donors or their heirs to collect on pledges.

Regardless of these negative implications, the fiduciaries of a charitable organization may have a legal obligation in certain situations to attempt to collect an unfulfilled charitable pledge.

A. Is There a Fiduciary Duty to Enforce a Charitable Pledge?

1. Financial Accounting Standards Treat Some Pledges as Assets

Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, P. 24 (2008) ("FAS 116"), adopted in June of 1993, establishes uniform financial accounting and reporting standards for charitable contributions.[22] Under FAS 116, an "unconditional" pledge of cash or other assets must be reported by the charitable organization as revenue and an asset (i.e., a receivable) at the time the pledge is made. Reserves may be established, however, to recognize losses due to uncollected pledges.[23] An "unconditional" transfer of cash or other assets is a "written or oral agreement to contribute cash or other assets, so long as there is evidence in the form of verifiable documentation that a promise was made and received."[24] Furthermore, "a communication that does not indicate clearly whether it is a promise is considered an unconditional promise to give if it indicates an unconditional intention to give that is legally enforceable."[25]

Unconditional pledges without donor-imposed restrictions must be classified on the charitable organization's balance sheet as "unrestricted net assets." An unconditional pledge with donor-imposed restrictions or payments due in future periods will generally be reported under the classification of "restricted support"[26] and will increase the charitable organization's "temporarily restricted" net assets.[27] Unconditional pledges payable over a period of more than one year are valued at present value using a discount rate commensurate with the risks involved (often risk-free).[28]

A "conditional" promise to give, in contrast, is a promise that depends on the "occurrence of a specified future and uncertain event to bind the promisor."[29] A conditional pledge must be recognized in the charitable organization's financial statements when the conditions on which they depend are "substantially met" and it becomes an unconditional pledge.[30] Typical conditional pledges include matching pledges and unprobated wills containing future bequests. Until the pledge qualifies as an unconditional pledge, the charitable organization must report the pledge as a refundable advance.

2. Director and Trustee Fiduciary Duty to Enforce Charitable Pledges

The fiduciary duties of directors and trustees of Texas nonprofit corporations and trusts are set forth in the Texas Business Organizations Code ("TBOC") and the Texas Trust Code ("TTC"), respectively.

A director of a Texas nonprofit corporation must discharge his or her duties (1) in good faith, (2) with ordinary care, and (3) in a manner that the director reasonably believes to be in the best interest of the nonprofit corporation.[31] The duty of "good faith" requires directors to honestly and faithfully fulfill their duties and obligations.[32] Under this standard, a director may not consciously disregard the nonprofit corporation's best interests or abdicate the duty of care. The duty of "ordinary care" requires a director to act as an ordinarily prudent person would act in a similar position under similar circumstances.[33] This duty includes the requirement that a director protect the nonprofit corporation's assets in a prudent manner. A director must also act in a manner that he or she reasonably believes to be in the nonprofit corporation's best interest, meaning the director owes the corporation a duty of loyalty. This duty prevents a director from elevating his own interests above those of the nonprofit corporation.

Similarly, a trustee of a Texas charitable trust must administer the trust in good faith and according to its terms.[34] Among other duties, the trustee of a charitable trust owes the trust's beneficiaries the duty to take reasonable steps to realize claims and enforce debts owned to the trust.[35] Other fiduciary duties owed by a trustee include the duty (i) to administer the trust with ordinary prudence, (ii) to take reasonable steps to maintain control of the trust property, (iii) to reasonably preserve the trust property, and (iv) to reasonably defend against actions that may result in a loss to the trust estate.[36]

Although it is clear that directors and trustees have certain fiduciary duties with respect to their respective nonprofit corporations and charitable trusts, it is unsettled as to whether these duties extend to encompass the enforcement of all charitable pledges. Because unconditional pledges must be reported by nonprofit organizations as assets on their financial statements in accordance with FAS 116, an argument can be made that such pledges must be protected by directors and trustees who have fiduciary duties to protect the assets of their respective charitable organizations.[37] As such, directors and trustees are placed in the unenviable position of deciding whether to accept a significant write-off of the charitable organization's assets or putting pressure on donors to honor their pledges which, in turn, may jeopardize future donations.[38] Until the duties of directors and trustees are clearly established, directors and trustees must thoughtfully and thoroughly consider the implications of their action or inaction on behalf of their respective charitable organizations in light of their known fiduciary duties.

B. Oversight by the Texas Attorney General in an Enforcement Action

Although the fiduciary duties of a director, trustee, fiduciary or managerial agent of a charitable organization are established by applicable state law, the public at large generally cannot enforce such fiduciary duties.[39] Rather, the enforcement power to bring a proceeding against a director, trustee, fiduciary or managerial agent for breach of a fiduciary duty is vested in the Attorney General of the State of Texas.[40] As the ability to act is discretionary, the Attorney General may or may not act in a particular situation. Since under Texas law there are not any statutory provisions as to how the Attorney General should perform its enforcement duties or when the Attorney General should act, the Attorney General cannot be forced to take action on behalf of the public at large in any particular situation. If the Attorney General brings a proceeding, however, and is successful, it is entitled to recover the actual costs it incurred in bringing the suit, including reasonable attorney's fees from the fiduciary or managerial agent.[41]

In order to protect charitable assets, the Attorney General of the State of Texas also has standing to intervene in any proceeding involving a charitable organization on behalf of the general interest of the public of the State of Texas.[42] The party initiating a proceeding involving the charitable organization is required to notify the Attorney General of the proceeding within 30 days of the filing of a petition or other instrument, but not less than 25 days prior to a hearing in a proceeding.[43] A judgment in a proceeding or a compromise, settlement agreement, contract or judgment relating to a proceeding involving a charitable organization is voidable on motion of the Attorney General if the Attorney General has not been properly notified.[44]

Once notice to the Attorney General is provided, the Attorney General may request additional information in order to make a determination as to whether intervention is warranted. Similar to the enforcement provisions, the Attorney General cannot be compelled to act on any particular matter. Rather, the ability to act is within the Attorney General's discretionary power. If the Attorney General elects to participate in a proceeding and a resolution is reached, the Attorney General may join as a party and enter into a compromise, settlement agreement, contract, or judgment relating to the proceeding involving the charitable organization.[45]

III. BEST PRACTICES

To the extent possible, charitable organizations should seek to ensure that pledge agreements: (1) are in writing (noting the donor's name, the intended amount of the donation and the intended purpose for the donation), (2) specify a specific payment schedule, (3) state that the agreement is binding and that the charitable organization will rely, potentially to its detriment, on the donor's promise to pay, and (4) specify the actions the charitable organization will take in reliance on the pledge.[46] Charitable organizations should also carefully document any steps actually taken in reliance on a pledge and send correspondence to the donor, notifying them that such steps that were taken. If appropriate, charitable organizations that are requested to be involved in a donor's estate planning might additionally request that the donor include appropriate language in their estate planning documentation indicating that the executor or trustee of their assets should specifically honor the charitable pledge.

If a charitable pledge is not honored, directors of Texas nonprofit corporations and trustees of Texas charitable trusts should make reasonable inquiries and analyze the specific documentation relating to the pledge and the actions taken by the charitable organization in reliance on the pledge. In their analysis, they should consider the materiality of the pledge and the negative financial impact on the charitable organization of not receiving the pledge with the damaging publicity that could be associated with enforcing a charitable pledge in a legal proceeding. They should also consider the collectibility of the pledge and any defenses on collection available to the donor or the donor's estate. Finally, directors and trustees should consider their own fiduciary duties to their respective organizations as well as the impact of the required involvement of the Texas Attorney General in the case of a settlement or proceeding relating to the pledge. Notably, with the specified defined and uniform procedures in place for handling charitable pledges, a charitable organization will be in much better position to enforce and collect its charitable pledges and achieve its charitable purposes.

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[1] Lisa M. Rossmiller and Brent C. Gardner practice law with Fulbright & Jaworski, LLP in Houston, Texas. This discussion is not intended as legal advice, and cannot be relied upon for any purpose.

[2] Charge of the Court, *The Corporation of Haverford College v. Robert S. Macintyre, Jr., Temporary Administrator of the Estate of J. Marshall Howard II, Deceased, et. al.*, No. 276,815-407 (Probate Court No. 2, Harris County, Texas Apr. 8, 2003) (Jury Question No. 1). The jury charge defined "substantial

detrimental reliance" to mean that a "party incurred legal liabilities or expense as a result of the promise, if any."

[3] This article focuses on the relevant laws of the State of Texas.

[4] *See., e.g., Sikander Ghia v. Am. Express Travel Related Servs.*, 2007 Tex. App. LEXIS 8194 (Tex. App.--Houston [14th Dist.] 2007).

[5] *English v. Fischer*, 660 S.W. 2d 521 (Tex. 1983).

[6] *Simpson v. MBank Dallas, N.S.*, 724 S.W.2d 102 (Tex. App.—Dallas 1987, writ ref'd n.r.e.).

[7] *Wheeler v. White*, 398 S.W. 2d 93 (Tex. 1965) ("This remedy is always so applied as to promote the ends of justice.").

[8] 20 Tex. 89 (1857).

[9] 48 S.W.2d 483 (Tex. Civ. App.--Galveston 1932).

[10] Id. at 488.

[11] *See, e.g., Allegheny College v. National Chautauqua County Bank of Jamestown*, 159 N.E. 173 (N.Y. 1927) and *Vanegas v. Am. Energy Servs.*, 53 Tex. Sup. J. 204 (Tex. 2009).

[12] No known Texas cases involving charitable pledges have dealt with this issue. But *see, e.g.*, *Congregation B'nai Sholom v. Martin*, 160 N.W.2d 784 (Mich. Ct. App. 1968), rev'd, 173 N.W.2d 504 (Mich. 1969).

[13] Emphasis added.

[14] *Rouff v. Wash. & Lee Univ.*, 48 S.W.2d at 488 (citing *Merchants' Bldg. Improv. Co. v. Chicago Exch. Bldg. Co.*, 210 Ill. 26 (Ill. 1904).).

[15] *See, e.g., Holmes v. Furgason*, 2003 Tex. App. LEXIS 7588 (Tex. App.--Corpus Christi 2003); *see also*, *Stephens County Museum, Inc. v. Swenson*, 499 S.W.2d 676, 678 (Tex. Civ. App.--Eastland 1973).

[16] *Id*.

[17] *Holmes v. Furgason*, 2003 Tex. App. LEXIS 7588 (Tex. App.--Corpus Christi 2003).

[18] Charge of the Court, *The Corporation of Haverford College v. Robert S. Macintyre, Jr., Temporary Administrator of the Estate of J. Marshall Howard II, Deceased, et. al.*, No. 276,815-407 (Probate Court No. 2, Harris County, Texas Apr. 8, 2003) (Jury Question Nos. 6, 7 and 8).

[19] Texas Business & Commerce Code § 26.01.

[20] *Thompson v. McAllen Federated Woman's Bldg. Corp.*, 273 S.W.2d 105 (Tex. Civ. App. 1954).

[21] *See, e.g., Wasson v. Clarendon College & University Training School*, 131 S.W. 852 (1910) (Although the *Wasson* court concludes that an unwritten and unsigned promise is not a "subscription," the court does not address the issue of whether an oral charitable pledge is enforceable against the promisor. Nonetheless, the *Wasson* case does indicate that, although not technically required, courts might look more favorably upon a written, rather than an oral, promise.).

[22] FAS 116, Summary.

[23] See generally Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* (1975).

[24] FAS 116, Paragraph 6.

[25] *Id*.; In addition to promises that are legally enforceable, the Financial Accounting Standards Board also states that unconditional promises can constitute assets even if the promises are supported only by social and moral sanctions (as opposed by legal enforceability). FAS 116, Paragraph 97.

[26] FAS 116, Paragraphs 14-15.

[27] *Id*.

[28] FAS 116, Paragraph 111.

[29] FAS 116, Paragraph 22.

[30] FAS 116, Page 22.

[31] TBOC § 22.221. Directors of Texas nonprofit corporations do not have the same duties as the trustee of a charitable trust (see discussion below). TBOC § 22.203.

[32] Revised Model Nonprofit Corporation Act, § 8.30.

[33] TBOC 22.001(6).

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[34] TTC § 113.051.

[35] *See*, *e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 117 (1959).

[36] RESTATEMENT (SECOND) OF TRUSTS § 117 cmt. A.

[37] Blackwell, *Legal Issues in Museum Administration*, SP035 ALI-ABA 83 (04/2009); Budig, Butler, and Murphy, *Pledges to Nonprofit Organizations: Are They Enforceable and Must They Be Enforced?*, 27 U.S.F. L. Rev. 47 (1992-1993).

[38] *Id*.

[39] With vehicles such as charitable lead trusts, there may be, however, fiduciary duties owed to remainder beneficiaries.

[40] Tex. Prop. Code § 123.005.

[41] *Id*.

[42] Tex. Prop. Code § 123.002. Proceedings involving a charitable organization include suits or judicial proceedings, the object of which is to (i) terminate a charitable organization (including a trust that stated purpose of which is to benefit a charitable organization, or an inter vivos or testamentary gift to a charitable organization) or distribute its assets to other than charitable donees; (ii) depart from the objects of the charitable organization stated in the instrument creating the organization, including a proceeding in which the doctrine of cy-pres is invoked; (iii) construe, nullify, or impair the provisions of a testamentary or other instrument creating or affecting a charitable organization (iv) contest or set aside the probate of an alleged will under which money, property, or another thing of value is given for charitable purposes; (v) allow a charitable organization or trust to contest or set aside the probate of an alleged will; (vi) determine matters relating to the probate and administration of an estate involving a charitable organization or trust; or (v) obtain a declaratory judgment involving a charitable organization or trust.

[43] Tex. Prop. Code § 123.003.

[44] Tex. Prop. Code § 123.004.

[45] Tex. Prop. Code § 123.002.

[46] Blackwell, *Legal Issues in Museum Administration*, SP035 ALI-ABA 83 (04/2009).

Taxation of State Tax Renewable Energy Incentives and Grants

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TAXATION OF STATE TAX RENEWABLE ENERGY INCENTIVES AND GRANTS

By: *Roger D. Aksamit and Cheri Whiteside*[1]

An increasing number of states have gone green, establishing a variety of state incentives aimed at encouraging businesses to invest in renewable energy. State incentives may include, among others, cash or in-kind grant programs, individual and corporate tax incentives (usually a tax credit), property tax incentives, cash rebates, and buydowns. For example, Texas has established a Renewable Energy Systems Property Tax Exemption. This property tax incentive exempts an eligible recipient from a certain amount of property tax equal to the amount of the appraised property value that arises from the installation or construction of a solar or wind-powered energy device. The device must be primarily used for the production and distribution of thermal, mechanical, or electrical energy for on site-use, or used to store that energy. Texas also offers a Solar and Wind Energy Business Franchise Tax Exemption, which exempts Texas companies engaged solely in the business of manufacturing, selling, or installing solar energy devices from the franchise tax. These Texas state incentives, along with other examples of state renewable energy incentives, can be found on the Database for State Incentives for Renewables & Efficiency at http://www.dsireusa.org.

Despite the rise in popularity and increasing use of these state incentives, many businesses are unaware of the federal tax consequences of receiving a state or local renewable energy incentive or grant. As a general rule, most of these state incentives and grants received by businesses are taxable.[2] For purposes of federal taxation, income is broadly defined to include all income, regardless of the source or form of the income, unless the income is specifically excluded.[3] Specific income exclusions that are most frequently discussed in the context of state incentives include exclusions for gift payments, welfare payments, capital contributions to a corporation, and qualified disaster relief payments. These income exclusions generally would not apply to state tax renewable energy incentives. In addition, no specific income exclusion exists in the code regarding state renewable energy incentives to businesses.

Further, the Internal Revenue Service ("IRS") has historically held that state incentives, such as grants, are included within the broad definition of income and are taxable to the recipient. For example, a grant received under the Solar Hot Water Initiative Program, which authorized states to disburse allocated grant funds, was held to be taxable.[4] The IRS reasoned that income was defined broadly enough to encompass the grant and the grant did not otherwise state it was excludable from income. Other examples of state grants held to be taxable by the IRS include monthly benefits payments received under the Alaska Longevity Bonus Act, state incentives encouraging stable population through payments based on continuous residence, and state disaster relief payment to businesses.[5] In all of these rulings, the IRS began with the premise that state grants are taxable, unless a specific income exclusion applied.

One position that the authors have seen taken with respect to certain types of incentives or grants provided by a state or local governmental authority for projects has been that the assistance was a "contribution in aid of construction" that was a nontaxable capital contribution under Section 118(a) of the Code ("Section 118(a)"). Typically, Section 118(a) excludes from taxation contributions of income, debt, or property made to a corporation by a shareholder of the corporation without the receipt of additional stock. Section 118(a) also excludes certain nonshareholder contributions. For a contribution in aid of construction to qualify as a nontaxable Section 118(a) capital contribution, the contribution must meet certain requirements, otherwise the contribution is taxable under Section 118(b) of the Code ("Section 118(b)").[6] In order for a contribution in aid of construction not to be taxable under Section 118(b), it must be shown that (1) the contribution was received by a regulated public utility that provides water or sewerage disposal services, (2) the contribution was made in aid of construction, (3) where the contribution consists of property other than water or sewerage disposal facilities, the amount of such contribution meets the requirements of an expenditure rule under Section 118(c) of the Code, and (4) the amount of the contribution, or property acquired with the contribution, is not included in the taxpayer's rate base for rate-making purposes.[7] Generally, a contribution is considered made in aid of construction when the purpose of the contribution is to provide for the expansion, improvement, or replacement of the utility's water or sewerage disposal facilities. Finally, the exclusion under Section 118(a) by its literal terms applies only to corporations although the authors have seen instances where it was relied upon by non-corporate entities.

In some respects, however, a business may financially benefit more from characterizing a state incentive as income versus non-income for purposes of determining the amount it may depreciate or take as a federal tax credit. The amount a business can claim under Federal Investment Tax Credit ("federal ITC") and the Modified Accelerated Cost-Recovery System ("MACRS") program depends on the business' basis of qualifying renewable energy property. If a business receives non-taxable amounts from the state, the business is required to decrease its basis of this property for which these federal incentives are calculated. However, if a business receives taxable amounts, no decrease in its basis is required and the business will qualify for a greater federal tax credit and depreciation deduction benefits under the federal ITC and MACRS. The potential benefits of the effect of not reducing taxable basis has been illustrated in a similar paper on this topic. See, Grouchoe, Gillette and Herig, "Are Solar Rebates and Grants for Homeowners and Businesses Taxable?"[8]

The state and local taxation of benefits and items that are otherwise taxable for federal tax purposes is a matter of state law. In those states that apply some form of income or gross-receipts tax, the same analysis that applies for federal tax purposes, may apply for state and local tax purposes unless a specific exemption applies.

Accordingly, when any type of business is looking at the siting of a renewable energy project, the availability of state and local incentives and grants is always a factor that will affect the economics and returns to investors in the project. However, an often overlooked issue is the fact that the incentives or grants may be taxable for federal tax purposes, as well as state and local purposes, thereby reducing their present value and increasing the upfront cost of the project.

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[1] Roger D. Aksamit and Cheri Whiteside are with the law firm of Thompson & Knight, LLP.
[2] Note that isolated exceptions exist where these tax incentives are not taxable. Additionally, although the IRS has not taken an official position regarding state tax incentives that provide a state tax reduction, in Coordinated Issue Paper 04-0408-023, the Large and Mid-Size Business Division concluded that a state location tax incentive providing a tax reduction for relocating businesses was not gross income. However, the paper did not address or imply that tax benefits provided in return for specific consideration such as services, property, or use of property would be treated in the same way. Also, the federal taxation of state and local incentives provided to individuals that are purchasing or installing a renewable energy or energy efficient device for personal use (usually in connection with a principal residence) is another issue because of the argument that such use may be for the "public welfare" and, hence, non-taxable to individual.
[3] I.R.C. § 61
[4] Rev. Rul. 79-356, 1979-2 C.B. 28.
[5] See Rev. Rul. 76-131, 1976-1 C.B. 16; I.R.S. Priv. Ltr. Rul. 81-21-122 (Feb. 27, 1981); Rev. Rul. 2005-46, 2005-2 C.B. 120.
[6] I.R.C. § 118(b).
[7] I.R.C. § 118(c)(1).
[8] Susan Gouchoe, et al, American Solar Energy Society, Proceedings of the Solar Conference: *Are Solar Rebates and Grants for Homeowners and Businesses Taxable?* (2004) (available at http://www.dsireusa.org/documents/PolicyPublications/Taxability_ASES_2004.pdf).

Time to Turn Yourself In:
Self-Reporting Requirements
for Group Health Plans in 2010

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TIME TO TURN YOURSELF IN: SELF-REPORTING REQUIREMENTS FOR GROUP HEALTH PLANS IN 2010

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The Internal Revenue Code of 1986, as amended,[2] imposes excise taxes on plan sponsors for failing to comply with various health plan mandates. However, the Internal Revenue Service (IRS) has generally not (i) assessed these taxes as part of an audit, or (ii) required plan sponsors to report noncompliance. As a means to enforce payment of these excise taxes, the IRS issued final regulations (referred to herein as the "Final Regulations") on September 8, 2009 requiring plan sponsors of group health plans to report and pay the applicable excise taxes for any noncompliance occurring on or after January 1, 2010.[3] This article summarizes the Final Regulations and their impact on plan sponsors of group health plans.

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Overview of Code Section 4980

Under Code sections 4980B, 4980D, 4980E, and 4980G, an excise tax is imposed on group health plans for the failure to comply with the following requirements:

- the Consolidated Omnibus Budget Reconciliation Act of 1986, as amended (COBRA) (Code section 4980B(f));
- the portability and nondiscrimination requirements of the Health Insurance Portability and Accountability Act of 1996, as amended (HIPAA) (Code sections 9801-9802);
- the Genetic Information Nondiscrimination Act (GINA) (Code section 9802);
- the Newborns' and Mothers' Health Protection Act (Code section 9811);
- the Mental Health Parity and Addiction Equity Act (Code section 9812);
- Michelle's Law (Code section 9813); and
- the comparable employer contribution rules applicable to health savings accounts (HSAs) and Archer medical savings accounts (MSAs) (Code sections 4980E(d) and 4980G(b)).

The amount of the excise tax is generally $100 per individual for each day of noncompliance. However, for noncompliance with the HSA and MSA comparable employer contribution requirements, the excise tax is equal to 35% of all employer contributions made to all HSAs and MSAs during the applicable calendar year.

Overview of the Final Regulations

Although the excise taxes in Code sections 4980B, 4980D, 4980E, and 4980G have existed since the adoption of the relevant group health plan mandates, the IRS has generally has not sought the recovery these excise taxes. For instance, the IRS has not historically imposed these excise taxes as part of an audit or required plan sponsors to report noncompliance. As a result, the excise taxes generally have not been paid. In an effort to recover these excise taxes, the IRS adopted the Final Regulations.

Under the Final Regulations, for any failure to comply with Code sections 4980B(f), 9801, 9802, 9811, 9812, 9813, 4980E(d), and 4980G(b) on or after January 1, 2010, plan sponsors must report the applicable excise tax on IRS Form 8928, and pay the excise tax when reported. In essence, plan sponsors are now responsible for reporting to the IRS when they fail to comply with the applicable group health plan mandates. This section explains when and how to comply with this new self-reporting requirement, the consequences for failing to comply with this requirement, and the exceptions to this requirement.

When to Report

The deadline for filing the Form 8928 and paying the requisite excise tax depends on the violation. For noncompliance with COBRA, the HIPAA portability and nondiscrimination rules, GINA, the Mental Health Parity and Addiction Equity Act, the Newborns' and Mothers' Health Protection Act, and Michelle's Law, the excise tax and Form 8928 are due on or before the due date (without extension) of the plan sponsor's federal income tax return. For calendar year taxpayers, this means that the excise tax and Form 8928 are due by March 15. With respect to noncompliance with COBRA, an insurer or third party administrator may be responsible for paying and reporting the excise tax, for instance, if the insurer or administrator is the party responsible for such noncompliance. In such case, the excise tax and Form 8928 are due on or before the due date (without extension) of the responsible party's federal income tax return. For noncompliance with the HSA and MSA comparable employer contribution requirements, the excise tax and Form 8928 are due on or before the April 15 of the year following the year in which the noncomparable contributions were made.

How to Report

Plan sponsors must use Form 8928 to report and pay the applicable excise tax. Form 8928 and its instructions are available on the IRS website. [4] The form should be sent to: Department of the Treasury, Internal Revenue Service, Cincinnati, OH 45999-000.

Consequences of Failure to Report

As with most tax reporting obligations under the Code, there are consequences for failing to timely file the Form 8928 and pay the requisite excise tax. Under Code section 6651, the penalty for a late return is generally 5% of the amount due for each month or part of a month the return is late, up to a maximum of 25%, and the penalty for failure to timely pay an excise tax is ½% of the unpaid tax for each month or part of a month the tax remains unpaid, up to a maximum of 25%. Plan sponsors also may be subject to interest on the unpaid taxes and penalties at the rate provided under Code section 6621 (generally, the federal short-term rate plus three percentage points).

Exceptions to the Reporting Requirement

Because a failure to timely file the Form 8928 and pay the requisite excise tax may result in serious penalties and interest, the Final Regulations provide several exceptions to these requirements. To the extent the excise tax is excessive and the failure is due to "reasonable cause" and not "willful neglect," the Secretary of the Department of Treasury has the authority to waive the excise tax. Whether the failure resulted from "reasonable cause" and not "willful neglect" is a facts and circumstances determination made by the IRS, based on a reasonable cause statement that is submitted by the taxpayer. Pursuant to the regulations issued under Code section 6651, reasonable cause exists to the extent the taxpayer can show that he exercised ordinary business care and prudence in providing for the payment of his tax liability, but was nevertheless either unable to pay the tax, or would have suffered undue hardship if he paid on the due date. For instance, a taxpayer who invests in speculative or illiquid assets has not exercised ordinary business care and prudence. On the other hand, a taxpayer who makes reasonable efforts to conserve sufficient assets in marketable form to satisfy his tax liability has exercised ordinary business care.[5]

In addition, plan sponsors are not subject to the excise tax and reporting requirements if: (i) the failure is due to reasonable cause and is promptly corrected (generally within 30 days), or (ii) the responsible party did not know of the failure despite the exercise of reasonable diligence. These two exceptions are not available for failures involving noncompliance with the HSA and MSA comparable employer contribution requirements.

Compliance with the Final Regulations

While the excise taxes in Code sections 4980B, 4980D, 4980E, and 4980G have been applicable to group health plans since the adoption of such mandates, the group health plan mandates that are subject to such excise taxes continue to evolve, making compliance difficult and excise taxes more likely. For instance, the following new group health plan mandates are now subject to the excise tax and new self-reporting requirement:

COBRA Subsidy

Effective December 19, 2009, group health plans must comply with the Department of Defense Appropriations Act of 2010,[6] which extends the COBRA subsidy period from nine months to 15 months and expands the definition of "assistance eligible individual" so that an individual may qualify for the subsidy if he or she is involuntarily terminated through February 28, 2010.

GINA [7]

Effective for plan years beginning on or after December 7, 2009, GINA prohibits a group health plan from: (i) increasing group premiums or contributions based on an individual's genetic information, (ii) mandating the completion of a health risk assessment that requires an individual to provide genetic information to qualify for a reward, or (iii) requesting genetic information prior to or in connection with an individual's initial enrollment in a group health plan.

Mental Health Parity and Addiction Equity Act of 2008[8]

Effective for plan years beginning on or after October 3, 2009, group health plans must ensure that financial requirements (i.e., deductibles, copayments) and treatment limitations (i.e., limits on the frequency of treatment, number of visits) on any mental health and substance abuse benefits offered under the plan are no more restrictive than those applicable to medical and surgical benefits offered under the plan.

Michelle's Law[9]

For plan years beginning on or after October 9, 2009, group health plans may not terminate a college student's health coverage on the basis of the student taking a medically necessary leave of absence from school or changing to a part-time status.

Under the Final Regulations, if a group health plan, for example, improperly terminated a college student's health coverage, the group health plan would be subject to the excise tax under Code section 4980D and would be required to report such tax on the new Form 8928. As a result, it is important for plan sponsors of group health plans to stay abreast of changes to the group health mandates subject to the excise taxes in Code sections 4980B, 4980D, 4980E, and 4980G.

Action Steps

To minimize excise tax liability, and to avoid penalties and interest on any such liability, plan sponsors of group health plans should:

- Maintain proper procedures to identify compliance problems;
- Implement procedures to ensure the timely submission of the IRS Form 8928 and the timely payment of all applicable excise taxes;
- Familiarize human resources personnel and other affected employees with the federal group health mandates listed above and the Final Regulations, and provide training as needed;
- If compliance with any federal group health mandate is outsourced, develop a protocol to regularly obtain information from vendors to ensure that they are complying with such mandate and the Federal Regulations; and

- Conduct compliance audits at least annually prior to the due date of the plan sponsor's federal income tax return (without extension).

Conclusion

With the passage of the Final Regulations, plan sponsors of group health plans not only have the task of determining how to comply with various group health plan mandates, but must also self-report and pay excise taxes if they fail to comply. However, by implementing proper procedures, training, and audits, plan sponsors of group health plans may minimize liability.

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[2] All references to the "Code" shall be references to the Internal Revenue Code of 1986, as amended, unless the context clearly indicates otherwise.
[3] 74 Fed. Reg. 45994 (Sept. 8, 2009).
[4] http:/www.irs.gov/pub/irs-pdf/f8928.pdf; http://www.irs.gov/pub/irs-pdf/i8928.pdf.
[5] Treas. Reg. § 301.6651-1(c).
[6] P.L. 111-118.
[7] P.L. 110-233.
[8] P.L. 110-343.
[9] P.L. 110-381.

Don't Creep into Ordinary Income Treatment with Your Real Estate: Factors to Consider in Real Estate Sales

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DON'T CREEP INTO ORDINARY INCOME TREATMENT WITH YOUR REAL ESTATE: FACTORS TO CONSIDER IN REAL ESTATE SALES

by Ryan T. Gardner[1]

Introduction:

For years, many Americans have purchased real estate for recreational use, the ability to earn income and as a means to accumulate wealth. In general, real estate values have constantly grown at rates greater than inflation resulting in a large accumulation of wealth for many Americans. With the constant growth of urban development, real estate that was purchased primarily for farming or oil and gas exploration ten, twenty or fifty or more years ago may be much more valuable as developed real estate, such as a residential subdivision or commercial building. The ability to cash in on the "farm" has caused many people to look into ways to further develop real estate to attract real estate development and to squeeze more money into capital gain treatment. Unfortunately for these landowners (hereafter "taxpayers"), while their actions may seem to only increase the value of their investment, such actions may result in an unintentionally lowering of their wealth by at least twenty percent, when a small amount of planning could prevent this loss of wealth.

This article summarizes the relevant law that applies when a taxpayer decides to start developing his real estate, and concludes with a recommendation on how to potentially prevent the loss of twenty percent of the increase in value of such real estate prior to engaging in development activities. In summary, this article provides the law on whether a taxpayer is holding property as inventory or for investment, and how to trigger the capital gain prior to engaging in real estate development.

This article does not address the gray area of the law which is where taxpayers have already started to transform their land from held for investment to held as inventory, or vice versa. It is possible to reform held as inventory status, but such reformation requires time and planning. The gray area can be illustrated with the following example. Assume a taxpayer and his parents have farmed, ranched and engaged in oil and gas development for over seventy-five years purchasing during that time period over 10,000 acres of real estate. Assume further that the average cost per acre of this real estate is $500. Due to the location of this real estate and urban development, this "farmland" is currently worth approximately $3,500 per acre, but could be worth as much as $10,500 per acre with a small amount of clearing and subdividing. Question: Should the taxpayer capture the $30,000,000 (($3,500 - $500) x 10,000 acres) in appreciation of value in capital gains prior to engaging in real estate development or should the taxpayer attempt to squeeze more of the potential appreciation in value of $70,000,000 (($10,500 - $3,500) x 10,000 acres) into capital gain treatment. If you find yourself or your client in this position of desiring to squeeze some of the $70,000,000 into capital gain treatment, you have fallen into the gray area of the law and should be ready to hire a tax attorney to, at a minimum, provide further advice and potentially fight with the IRS. The problem with the taxpayer's position in this gray area is that there are an *enormous volume* of cases that can be argued in favor of both the IRS and for the taxpayer on the exact same facts. If you or your client falls into this gray area, the recommendation at the end of this article may apply to you in part, but will require further analysis and the creation of several taxpayers to minimize "tainted" property on the sale from other "nontainted" properties. In order to prevent this very expensive endeavor, if at all possible, a taxpayer should consider implementing the recommendation provided in this article prior to engaging in real estate development activities.

Held for Investment or Inventory:

As alluded to above, if land is considered a taxpayer's inventory, gains on the sale of the land will receive ordinary income treatment when it is sold. If land is considered to be held for investment and thus a capital asset, and it is held by the taxpayer for longer than one year, then the land will receive long-term capital gain treatment when it is sold. Currently, the difference in the rates between the two types of tax treatment is approximately 20% (i.e., maximum 15% long-term capital gain rate as compared to a maximum 35% ordinary income tax rate). In addition, if land is considered to be the taxpayer's inventory, non-taxable like kind exchanges and installment sale rules are not available when such land is disposed of by the taxpayer. [2]

Any taxpayer may be considered a real estate developer holding inventory as to certain tracts of their land and holding other tracts of such land as investments, and thus capital assets.[3] Furthermore, within any given tract of property, part of such tract may be held for investment and part may be held as inventory.[4]

The Fifth Circuit has stated "the real estate capital gains – ordinary income issue [is] old, familiar, recurring, vexing and oft-times elusive."[5] The issue a court would analyze in determining whether a taxpayer holds their land as inventory or for investment consists of:

> Is the land to the taxpayer a capital asset as defined in Section 1221 of the Internal Revenue Code of 1986, as amended (the "Code") or is it considered his, her or its inventory?

Held for Investment, Capital Asset:

Code Section 1221 defines the term "capital asset" as property held by the taxpayer (whether or not connected with his trade or business), but does not include property held by the taxpayer *primarily* for sale to customers in the ordinary course of his trade or business.[6] The IRS has argued before the United States Supreme Court that the term "primarily" as used in Code Section 1221 means a "substantial" purpose.[7] However, the Supreme Court held that "primarily" means "of first importance" or "principally."[8] Therefore, for the typical property held for investment (e.g., farmland) to have transformed into the taxpayer's inventory, the Supreme Court requires that the principal purpose for such land must be for sale to customers and it is not sufficient for the land to be held for two or more alternative purposes (e.g., held for sale to customers if someone provides the right price, but also held for oil and gas production or exploration, or for ranching).[9]

In analyzing whether the land is held primarily (i.e., of first importance or principally) for sale to customers in the ordinary course of the taxpayer's trade or business, the Fifth Circuit has stated repeatedly that the principle statutory questions that must be considered are:

(i) Was the taxpayer engaged in a trade or business, and if so, what business?
(ii) Was the taxpayer holding the property primarily for sale in that business?
(iii) Were the sales contemplated by the taxpayer "ordinary" in the course of that business?[10]

The first two questions reiterate the fact that a taxpayer may be engaged in the real estate development business for certain tracts of the land but hold other tracts for investment.[11] In performing the facts and circumstances analysis on the above three questions, the courts look at many factors, but predominately look at the following factors:

(i) The nature and purpose of the acquisition of the property and the duration of the ownership;
(ii) The extent and nature of the taxpayer's efforts to sell the property;
(iii) The number, extent, continuity and substantiality of the sales;
(iv) The extent of subdividing and developing the property; and
(v) Other sales factors such as: (a) the use of a business office for the sale of the property; (b) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (c) the time and effort the taxpayer habitually devoted to the sales.[12]

Original Purpose and Holding Period:

In general, the original purpose for acquiring the property is afforded some weight in determining the purpose for which a taxpayer currently holds property, unless there have been significant improvements or sales of lots comprising such property.[13] Generally, an original investment purpose has no built-in perpetuity nor a guarantee of capital gains treatment forever more.[14] A voluntary change in the taxpayer's purpose for holding such property invalidates most if not all the weight afforded the original purpose for acquiring such property.[15] Furthermore, a short holding period tends to resemble the activity of a real estate developer buying and selling property.[16]

Sales Efforts:

Sale solicitation and advertising efforts are quite relevant both to the existence of a trade or business and to taxpayer's holding purpose.[17] The presence of solicitation and advertising efforts to sell the property can strengthen the case for ordinary income treatment.[18] However, the absence of solicitation and advertising efforts to sell the property is not conclusive as to either of these statutory questions for, "even one in the real estate business need not engage in promotional exertions in the face of a favorable market."[19]

Sales of Real Estate:

Several Fifth Circuit cases have stated that the frequency and substantiality of sales are the most important factors.[20] The Fifth Circuit noted the rationale for this as:

> The presence of frequent and substantial sales is highly relevant to each of the principal statutory inquiries listed above. A taxpayer who engages in frequent

> and substantial sales is almost inevitably engaged in the real estate business. The frequency and substantiality of sales are highly probative on the issue of holding purposes because the presence of frequent sales ordinarily belies the contention that property is being held "for investment" rather than "for sale." And the frequency of sales may often be a key factor in determining the "ordinariness" question.[21]

This is a very fact intensive issue, but sales of more than two tracts per year for a few years or the sale of four lots in a single year could result in portions of the land becoming the taxpayer's inventory.[22]

Extent of Development:

The extent of development activity and improvement is highly relevant to the question of whether taxpayer is a real estate developer.[23] Development activity and improvements may also be relevant to the taxpayer's holding purpose, but standing alone, some degree of development activity is not inconsistent with holding property as a capital asset.[24] For example, a taxpayer might clear trees and conduct some grading and filing activities for the preparation for farming the land.[25] However, the extent of development activity and improvements, although an important factor, is less conclusive than the substantiality and frequency of sales.[26] In general, the Fifth Circuit looks to whether the improvements or activities are consistent with those associated with normal real estate development, such as platting, or adding streets, drainage, or sewage or other utilities.[27]

Platting the land for subdivision purposes will be considered to be a very *substantial* factor in reflecting a changed holding purpose for land. Gains from the sale of any property that has been subdivided will probably be characterized as ordinary income, unless a taxpayer can satisfy the requirements of Code Section 1237 on such land. Section 1237 allows taxpayers, other than C corporations, to receive capital gain treatment even though the taxpayer has subdivided the land if such taxpayer has:

(i) held property for at least five years, or acquired such property through inheritance;

(ii) not previously held any part of such land or any other land primarily for sale to customers; and

(iii) not made substantial improvements to the land which substantially increased the value of the land sold.[28]

If a taxpayer is treated as a real estate developer based upon activity in any year, then Code Section 1237 will not apply.[29]

Other Factors:

Other factors that can result in a taxpayer being treated as a developer consist of: (a) the use of a business office for the sale of the property; (b) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (c) the time and effort the taxpayer habitually devoted to the sales.[30] Extensive advertising, active solicitation and promotional activities, whether by the taxpayer or by brokers on his, her or its behalf are inconsistent with investor status and are evidence that the property is held for sale to customers.

Potential Planning:

In order to facilitate capital gain treatment, and to separate ordinary income development from long-term investments eligible for capital gain treatment, prior to engaging in activities which could be considered to be development activities, a taxpayer should consider creating entities that are recognized as separate taxpayers for federal income tax purposes to handle any and all development of the land.[31] Prior to platting, road construction, or utility development within any land or any other material development activities, a taxpayer should consider selling such property, on an installment basis, from the then owner to another entity that is recognized as such for federal income tax purposes (e.g., a C or S corporation). The use of an entity taxed as a partnership will not be effective for this planning. [32] This sale should trigger all the capital gain in such property with the value addition arising from the future real estate development being captured as ordinary income in the new taxable entity. The activities between the then owner of the real estate and the new taxable entity *must be kept completely separate* and such entities must stand alone in order for this tax planning technique *to be potentially effective*.[33] If the IRS can successfully argue that the corporation is simply the taxpayer's agent, this planning technique will not be effective.[34] One form of this argument would arise if the corporation is unprofitable, the IRS could argue that the corporation lacks economic substance, which would result in this technique being unsuccessful. Furthermore, if the corporation is thinly capitalized and does not have adequate capital to service the installment obligation, then sale treatment may be denied.[35] In addition, if the land being sold to the related party includes depreciable property in which a step-up in basis is allowed on the sale, Code Section 1239 will impose ordinary income treatment.[36] Moreover, the value in which the land is sold from one taxpayer to another related taxpayer should be at a true fair market value supported by a qualified appraiser's appraisal. Finally, as alluded to above, if the taxpayer has fallen into the gray area with certain tracts of his, her or its property, such taxpayer may need to create several entities to prevent the "taint" of one property that has already incurred real estate development activities from being inferred onto other related properties. Although there can be no *assurance* that this tax planning structure will be respected, it may provide the taxpayer with a better position that the taxpayer has separated its holdings in land held for investment, subject to capital gain treatment, from those being held for sale to customers, and thus subject to ordinary income treatment.

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2 *See* F.T.C.2d at ¶ I-3091 for cases illustrating the disallowance of like-kind exchanges when real estate is deemed to be held as inventory; *see also* I.R.C. § 1031(a)(2)(A) for exception to like kind exchange treatment for inventory items and I.R.C. §§ 453(b)(2)(A) and 453(l)(1)(B) for exception to installment rules for real property that is inventory.

3 *See* Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980) (*providing* the principal issue in the case is whether a real estate developer was holding certain tracts of real estate as inventory or as long-term investments; the court analyzed the factors noted in this memorandum to each tract or property separately.);

see also Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1976). Contrasting the above cases, in Graves v. Commissioner, 867 F.2d 199 (4th Cir. 1989) the taxpayer argued for separate tax treatment for different lots, but due to his plans to develop the tracts that were claimed to be held for investment by the taxpayer, the gains on all of the taxpayer's lots received ordinary income treatment.

4 *See* Wood v. Commissioner, 276 F.2d 586, 590-1 (5th Cir. 1960) (*providing*:

> The residential tract, or that portion of it retained or reacquired by the taxpayer, was purchased for the purpose of ultimate resale after an enhancement in value. . . . It will not be questioned that a property owner may hold some of it [sic, his property] for sale to customers in the ordinary course of business and hold the remainder as capital assets.).

See also cases cited in FTC.2d ¶ I-6320 for proposition "[a] taxpayer may hold part of a tract of property for one purpose and part for another purpose."

5 *See* Thompson v. Commissioner, 322 F.2d 122, 123 (5th Cir. 1963); *see also* Biedenharn Realty Co. v. United States at 414-5, (*providing*:

> Over the past 40 years, this case by case approach with its concentration on the facts of each suit has resulted in a collection of decisions not always reconcilable. Recognizing the situation, we have warned that efforts to distinguish and thereby make consistent the Court's previous holdings must necessarily be "foreboding and unrewarding" . . . . Litigants are cautioned that "each case must be decided on its own particular facts. . . .).

6 *See* I.R.C. § 1221(a)(1); *see also* Wood v. Commissioner, 16 T.C. 213 (1951) (*providing* real estate is not stock in trade or inventory unless held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business).

7 Malat v. Riddell, 383 U.S. 569, 572 (1966) (*citing* Corn Products Co. v. Commissioner, 350 U.S. 46, 52 (1955) and Commissioner v. Gillette Motor Co., 364 U.S. 130, 134 (1960)). The Supreme Court in Malat at page 572 provides:

> The purpose of the statutory provisions with which we deal is to differentiate between the profits and losses arising from the everyday operation of a business on the one hand . . . and the realization of appreciation in value accrued over a substantial period of time on the other.

8 *See* Malat at 572.

9 *See id.* Assume a landowner has cattle still on his land or oil and gas exploration or production taking place on such land. A facial argument could be made that the principal purpose for the land is cattle operations or oil and gas exploration or production. However, the IRS will not stop at the facial argument and will look at the several factors to see if the taxpayer's purpose in holding the land has changed from held for investment to held as inventory. *See* cases defining "primarily" at F.T.C.2d ¶¶ I-6104 and 6303.

10 *See* Bramblett v. Commissioner, 960 F.2d 526, 530 (5th Cir. 1992) for all three factors; *see also* Suburban Realty Co. v. United States, 615 F.2d 171, 178 (5th Cir. 1980) (*stating* at page 182:

> At the very moment of sale, the property is certainly held "for sale." The appropriate question certainly must be the taxpayer's primary holding purpose at some point before he decided to make the sale in dispute. . . . The "holding purpose" inquiry may appropriately be conducted by attempting to trace the taxpayer's primary holding purpose over the entire course of his ownership of the property.).

11 *See* Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980) where the primary issue in the case is whether the real estate developer was holding some tracts of land for investment and thus subject to long-term capital gain treatment.

12 *See* Bramblett v. Commissioner, 960 F.2d 526, 530-1 (5th Cir. 1992) (*noting* the frequency and substantiality of sales is the most important factor); *see also* Graves v. Commissioner, 867 F.2d 199, 202 (4th Cir. 1989) (*citing* Matthews v. Commissioner, 315 F.2d 101 (6th Cir. 1963) and Thompson v. Commissioner, 422 F.2d 122 (5th Cir. 1963)); Suburban Realty Co. v. United States, 615 F.2d. 171, 178 (5th Cir. 1980) (*noting* the frequency and substantiality of sales will be the most important factor); and Biedenharn Realty Co. v. United States, 526 F.2d 409, 416 (5th Cir. 1976) (*noting*:

> Although frequency and substantiality of sales are not usually conclusive, they occupy the preeminent ground in our analysis. The recent trend of Fifth Circuit decisions indicates that when dispositions of subdivided property extend over a long period of time and are especially numerous, the likelihood of capital gains is very slight indeed. . . .

> Conversely, when sales are few and isolated, the taxpayer's claim to capital gain is accorded greater deference.).

For factors used to distinguish between dealers and nondealers see F.T.C.2d ¶ I-6312.

13 *See* Biedenharn Realty Co. v. United States, 526 F.2d 409, 421 (5th Cir. 1976) (*providing*:

> Undoubtedly, in most subdivided-improvement situations, an investment purpose of antecedent origin will not survive into a present era of intense retail selling. The antiquated purpose, when overborne by later, but substantial and frequent selling activity, will not prevent ordinary income from being visited upon the taxpayer.).

For cases discussing the purpose of real estate acquisition see I.R.C. § 1221 Annotated ¶ 12,215.37(5).

14 *See* Biedenharn at 421.

15 *See id*.; *see also* F.T.C.2d ¶ I-6324 for cases where there was a change from holding property for investment to holding such property for sale to third parties. For cases that provide a change of holding purpose see I.R.C. § 1221 Annotated ¶ 12,215.37(10).

16 *See* Hertzog v. Commissioner, 44 T.C. 694 (1965) (*providing* the short period of time between acquisition of the property and the sales was a factor in preventing capital gain treatment).

17 *See* Suburban Realty Co. at 179. For cases addressing solicitation and advertising and the effect on character of income see I.R.C. § 1221 Annotated ¶ 12,215.35(20).

18 *See* Suburban at 179.

19 *Id.*

20 *See* Bramblett; Suburban Realty Co.; Biedenham Realty Co. and supra fn. 11.

21 *See* Suburban Realty Co. at 178.

22 *See* Estate of Clinton Millett v. Commissioner, 23 T.C.M. (CCH) 945 (1964) (*providing* first year two lots sold and capital gain received, however sales in second and third year of two lots each year triggers ordinary income for such later year sales); *see also* Los Angeles Extension Co. v United States, 315 F.2d 1 (9th Cir. 1963) (*providing* four sales in one year resulted in ordinary income treatment); Trimpe v. United States, 12 A.F.T.R.2d 6014 (S.D. In. 1963) (*providing* four sales per year over a two year period resulted in ordinary income treatment); J. Gordon Harris v. Commissioner, 47 T.C.M. (CCH) 760 (1983) (*providing* about four sales per year over six years resulted in ordinary income treatment); Major Realty Corp. v. Commissioner, 749 F.2d 1483 (11th Cir. 1985) (*providing* six sales in a year resulted in ordinary income treatment); Houston Endowment Inc. v. United States, 606 F.2d 77 (5th Cir. 1979) (*providing* sales of eight and half lots on average over twenty-seven years resulted in ordinary income treatment). For further analysis see cases cited at F.T.C.2d ¶¶ I-6330 through I-6332. For frequency and continuity of sales see I.R.C. § 1221 Annotations at ¶ 12,215.35(5).

23 *See* Suburban Realty Co. at 178.

24 *See id.* at 178-9.

25 *See* Suburban Realty Co. at fn. 22.

26 *See* Suburban Realty Co. at 179.

27 *See* Biedenharn Realty Co. at 417-8; *see also* United States v. Winthrop, 417 F.2d 905, 906 (5th Cir. 1969). *See* I.R.C. § 1221 Annotations at ¶ 12,215.35(15) for cases where subdivision and improvements resulted in ordinary income treatment.

28 *See* I.R.C. § 1237(a) and Treas. Reg. § 1.1237-1(a)(2).

29 *See* Treas. Reg. § 1. 1237-1(b).

30 *See* Biedenharn Realty Co. (*providing* the taxpayer hired brokers who, used media and on site advertising, worked vigorously on taxpayer's behalf); *see also* Suburban Realty Co. v. United States, 615, F.2d 171 (5th Cir. 1980).

31 *See* Suburban Realty Co. v United States, 615 F.2d 171, 185 (5th Cir. 1980) (*providing* "the burden is on the taxpayer to establish that the parcels held primarily for investment were segregated from other properties held primarily for sale.").

32 *See* I.R.C. § 707(b)(2) for sale to partnership and treatment as ordinary income.

33 *See* Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992) (*providing* a case where separate entities owned by the same parties were respected for federal income tax purposes with one entity holding property for investment, and when and if such property was to be developed it was transferred to other entity for development. For cases discussing when the development and sales activities of agents will be imputed to the principal, *see* I.R.C. § 1221 Annotated ¶ 12,215.36(5). For cases dealing with subdivision and resale by

a controlled corporation that are imputed to another related taxpayer *see* I.R.C. § 1221 Annotated ¶ 12,215.36(29).

[34] *See* cases dealing with whether gain or loss from the disposition of real estate to a controlled corporation is capital or ordinary, *see* F.T.C.2d ¶ I-6327. For when a sale of taxpayer's property by related entity will be respected, *see* F.T.C.2d ¶ I-6337.

[35] For cases dealing with thinly capitalized corporations and sale of assets to such corporation which results in capital contribution instead of sale treatment, *see* F.T.C.2d ¶ F-1604.

[36] *See* I.R.C. § 1239. *See also* F.T.C.2d ¶¶ 8701 and 8702 for cases interpreting this statute.

Determining Whether Substantial Authority Exists in Facts and Circumstances Cases

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DETERMINING WHETHER SUBSTANTIAL AUTHORITY EXISTS IN FACTS AND CIRCUMSTANCES CASES

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The Section 6662 and Section 6694 penalties have now been harmonized and neither the taxpayer nor the tax return preparer will be penalized for an understatement of tax that is the result of a tax position supported by substantial authority.[2] Thus, both signing and non-signing tax return preparers will be sharpening their focus on the analysis of substantial authority, especially as it applies to issues that are determined on the basis of the facts presented as opposed to classic legal interpretation. The controlling regulatory definition of substantial authority emphasizes the weight of law, generally that which is to be considered or not considered, and the weight of various types of legal authority.[3] But the Regulations provide very little guidance when it comes to how to determine whether there is substantial authority for tax issues where facts and circumstances are determinative of the legal issues.[4]

The Regulations' only instruction on how to deal with facts in connection with a substantial authority inquiry is simply to say that a particular item of authority having some facts in common with the tax treatment at issue is not relevant if the authority is materially distinguishable or its facts are otherwise inapplicable to the tax treatment at issue, a fairly obvious observation basic to all legal research. The problem with analyzing certain facts and circumstance issues, however, is that with respect to certain issues there is a considerable body of case law that simply cannot be reconciled; the cases deal with identical or nearly identical fact patterns and come to opposite conclusions, many times without the benefit of any analysis.

The return preparer's challenge is to be knowledgeable regarding (1) the exceptions to the Section 6662 and Section 6694 penalties when the tax position giving rise to such penalties has substantial authority, (2) the analysis set forth in the Regulations addressing whether a tax position has substantial authority, and (3) the body of case law addressing whether a tax position has substantial authority in cases where facts and circumstances are determinative of the legal issue. These challenges are considered below, along with an analysis of the issue of substantial authority in facts and circumstances cases that commonly occur and are frequently litigated. While closely comparing the facts at hand with the facts of the various items of authority is obviously a routine, almost instinctive, function of legal research, that skill is now one practitioners will need to hone because there is a serious monetary risk for both the practitioner and the taxpayer if the practitioner errs, regardless of whether such error is made in good faith.

THE PENALTY EXCEPTION FOR SUBSTANTIAL AUTHORITY

Section 6662(a) imposes an accuracy-related penalty on taxpayers who understate their income tax liability. The penalty is 20% of any underpayment that is attributable to, among other things, a substantial understatement.[5] A substantial understatement exists for any tax year if (1) the tax required to be shown on the return for a tax year exceeds the amount shown on the return, reduced by any rebate (an "understatement") and (2) the understatement exceeds the greater of 10% of the tax required to be shown on the return or $5,000.[6]

The accuracy-related penalty will not be imposed, however, on a taxpayer who can demonstrate that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such understatement.[7] In addition, there will be no accuracy-related penalty imposed for a substantial understatement of income tax if there is or was substantial authority for the position that gives rise to the substantial understatement or if there is a reasonable basis for such position and the position is adequately disclosed.[8]

Section 6694 imposes a penalty on a tax return preparer who prepares a return or claim for refund that contains an understatement of liability due to an "unreasonable position" that the tax return preparer knows about or reasonably should have known about.[9] The penalty is equal to the greater of $1,000 or 50% of the income derived (or to be derived) by the tax return preparer from the return preparation.[10] The imposition of a Section 6694 penalty can also lead to the referral of the tax return preparer to the Service's Office of Professional Responsibility.[11]

A tax return preparer includes any person who prepared for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund under the Code.[12] Included in the definition of tax return preparer are those professionals responsible for manually preparing the return and related disclosures, as well as non-accountant tax advisors who give advice on return positions with respect to those transactions in which all events have occurred.[13] Except in the case of a tax shelter (as defined in Section 6662(d)(2)(C)(ii)) or a reportable transaction to which Section 6662A applies, the preparer penalty will not apply when there is substantial authority for the position giving rise to the understatement or when there is a reasonable basis for such position and the position is disclosed on the return.[14]

DETERMINING WHETHER SUBSTANTIAL AUTHORITY EXISTS

In considering whether there is substantial authority for a position in a facts and circumstances context, practitioners must take into account both the standards set forth in the Regulations and judicial determinations.

The Regulations' Substantial Authority Standard

The substantial authority standard—as applied in both the Section 6662 penalty rules and the Section 6694 return preparer penalty rules—is an objective standard involving an analysis of the law and the application of that law to the relevant facts.[15] As such, the substantial authority standard does not consider the taxpayer's subjective belief as to whether or not there is substantial authority for a tax position.[16]

There is substantial authority for a tax position only if the weight of the authorities supporting the position, in light of all pertinent facts and circumstances, is substantial in relation to the weight of the authorities supporting the contrary position.[17] But there may be substantial authority for more than one tax position with respect to a given event.[18] Substantial authority is determined for a tax position at the time the return containing the position is filed or on the last day of the tax year to which the return relates.[19]

The Regulations provide a list of authorities that may be considered for purposes of determining whether there is substantial authority for a tax position.[20] Reg. 1.6662-4(d)(3)(ii) requires that, in weighing these authorities, the relevance, persuasiveness, and type of document providing authority must be taken into account. For example, a case or a Revenue Ruling having some facts in common with the tax treatment of the position being examined is not relevant if the facts are materially distinguishable. In addition, those authorities that present reasoning and cogent application of law to the facts have much heavier weight than a regurgitation of a string of authorities and then a conclusion. The type of document being used as authority, the relevance, and the age of the authority must also be considered. For example, a Revenue Ruling is given greater weight than a private letter ruling addressing the same issue and private letter rulings, technical advice memoranda, or actions on decisions that are over ten years old are accorded very little weight.

If any authority is overruled or modified, implicitly or explicitly, by a body with the power to modify or overrule, then such authority ceases to be authority.[21] Secondary sources are not afforded any weight.[22]

From a jurisdictional perspective, a taxpayer may rely on decisions from courts of appeals outside of the circuit of the taxpayer's residency. Conversely, the taxpayer must consider adverse authority outside the taxpayer's own circuit; nevertheless, applicable decisions from the circuit of the taxpayer's residency will control regardless of the decisions of other circuits.[23] A significant point is that a taxpayer may not disregard an adverse decision of the Tax Court that has been overruled by a court of appeals unless the circuit overruling the Tax Court decision is the circuit of the taxpayer's residency.[24]

Another tool used in determining whether there is substantial authority for a tax position is to compare the substantial authority standard with other reporting levels of confidence. Reg. 1.6662-4(d)(2) states that the substantial authority standard is less stringent than the more-likely-than-not standard but more stringent than the reasonable basis standard. A tax position meets the more-likely-than-not standard when it has a greater than 50% likelihood of being upheld. A tax position has a reasonable basis when it is reasonably based on one or more of the authorities used under the substantial authority test.[25] While the reasonable basis standard has not been quantified in the Regulations, the reasonable basis standard is presumably a lower standard than the realistic possibility standard, which is defined as a position having a 33% likelihood of prevailing.[26]

Does that make the substantial authority standard a tax position with a 25% chance of prevailing or 50% chance of prevailing?[27] It matters not because, thankfully, the combined analysis of the application of law to the facts and the weight of the authority take the process out of the sometimes nonsensical task of assigning a percentage chance of prevailing. Indeed, some practitioners might argue that while the Regulations clearly place the substantial authority test below the more-likely-than-not test (in terms of percentage of likelihood), in reality there is little difference between the process of making a determination under the two tests when they are analyzed objectively.

Despite the detailed nature of the Regulations that determine whether substantial authority for a tax position exists, there remains very little guidance on how to determine whether substantial authority exists in cases where facts and circumstances are determinative of the legal issue. As discussed below, various circuit courts have struggled with this issue and dealt with facts and circumstances cases in different ways.

Substantial Authority: Case Law

At least five circuits have wrestled with how to determine if substantial authority exists in facts and circumstances cases. The result of these holdings can be summarized into three categories:

(1) The Fourth and Ninth Circuits compare the facts at hand to the facts in published opinions cited by the taxpayer and make a determination of whether the facts of the instant case are materially distinguishable from the facts in the cases cited as authority. If the courts find the instant facts not to be materially distinguishable from the cases cited by the taxpayer as authority, substantial authority is found to exist. Obviously, the question does not arise unless the taxpayer has lost the substantive tax issue so the reviewing court has determined that some degree of distinction exists. The substantial authority question is whether the distinction is material.

(2) In the Eleventh and Fifth Circuits, it would appear that only some evidence in support of a taxpayer's position is necessary to establish substantial authority.

(3) The Sixth Circuit requires considerable and ample evidence for a finding of substantial authority, a difficult burden for the taxpayer to carry since the court has already found some type of distinction exists between the taxpayer's facts and the facts in the cases on which the taxpayer is relying.

Fourth and Ninth Circuits. The Fourth and Ninth Circuit reasoning is exemplified in *Antonides*, 65 AFTR 2d 90-521, 893 F2d 656 (CA-4, 1990), *aff'g* 91 TC 686 (1988); *Norgaard*, 68 AFTR 2d 91-5302, 939 F2d 874 (CA-9, 1991), *aff'g in part and rev'g in part* TC Memo 1989-390, PH TCM 89390 ; and *Little*, 79 AFTR 2d 97-990, 106 F3d 1445 (CA-9,1997), *aff'g* TC Memo 1993-281, RIA TC Memo 93281 .

Antonides. The issues dealt with by the Fourth Circuit in *Antonides* were whether a taxpayer engaged in his yacht business with the intent to make a profit and, if not, whether the taxpayer had substantial authority for the position that the yacht business was a for-profit activity.

The taxpayer and two other individuals decided to jointly acquire a yacht to operate as a rental, and formed a partnership to hold the yacht. The yacht was purchased and then leased back to a boat club that would then charter the yacht out to its members. The rental paid by the boat club to the partnership was a fixed amount. The yacht purchase was financed with a note from the taxpayer and his partners and the note had a fixed amortization. The boat club prepared financial projections for the taxpayer showing that the yacht would not be able to generate any net income because the fixed debt service on the yacht exceeded the fixed rent payment from the boat club.

The appeals court affirmed the Tax Court's holding that the taxpayer had not engaged in the yacht business with the intent to make a profit because the financial projections demonstrated that the taxpayer could not have expected to do much more than break even, even when considering expected appreciation of the yacht. The Fourth Circuit also affirmed the Tax Court's holding that there was no substantial authority for the taxpayer's position. The appeals court reasoned that three of the cases cited by the taxpayer as substantial authority for his position were materially distinguishable from the facts in *Antonides* because, unlike the taxpayer, the yacht owners in the cited cases were not bound to a fixed yacht rental agreement and thus had the potential to generate more income by chartering the yacht. The Fourth Circuit also reasoned that the facts in one of the cases cited by the taxpayer were materially distinguishable from the instant facts because in that case the financial projections demonstrated there was a possibility for that taxpayer to turn a profit.

Norgaard. The taxpayers in *Norgaard*, who frequently bet on horse races, deducted their gambling losses from their gambling winnings on their tax return. The taxpayers substantiated their gambling losses through losing race tickets. The IRS disallowed the gambling losses, arguing that the losing race tickets were not sufficient substantiation for the losses.

The Tax Court held for the IRS and it also upheld the Service's imposition of a substantial understatement penalty against the taxpayers. It found that the taxpayers did not keep adequate records of their winnings, there were discrepancies between tickets reported to the IRS and those presented at trial, and the taxpayers had unreported gambling winnings of an unknown amount.

On appeal, the Ninth Circuit upheld the Tax Court's disallowance of the gambling loss but reversed the Tax Court's holding that the taxpayers did not have substantial authority for their position. As support for finding there was substantial authority for the taxpayer's position, the appeals court cited 15 cases in which the Tax Court allowed partial or full deductions for gambling losses when the taxpayer presented losing tickets, partial records, and credible testimony. The Ninth Circuit then pointed out several Tax Court cases that disallowed gambling losses where the only support was losing race tickets. The court of appeals then stated that the credibility of the taxpayer is critical in these cases and concluded that there was substantial authority for the taxpayers' position. One can only assume that the court found the testimony of the taxpayers credible and that tipped the scales in their favor.

Little. Following *Norgaard*, in 1997 the Ninth Circuit again addressed the issue of substantial authority, this time in a case involving whether real estate the taxpayer sold was "dealer" property.

The taxpayer spent all of his time working with real estate investments, either through his wholly owned S corporation or individually. The S corporation bought foreclosure properties and sold them within one year of purchase. The S corporation reported all of the sales as ordinary income. The taxpayer also held many properties in his individual capacity, which he held for at least a year before selling. The taxpayer then reported these sales as long-term capital gain.

At issue on appeal was whether the taxpayer had substantial authority for his reporting position that the property he held and sold as an individual was not dealer property. For support, the taxpayer relied on *Austin*, 3 AFTR 2d 647, 263 F2d 460 (CA-9, 1959), where the Ninth Circuit held that sales of real property by an attorney were not sales of dealer property because the attorney's primary career was the practice of law and the sales transactions were initiated by the purchasers rather than the attorney.

In *Little*, the court affirmed the Tax Court's holding that the taxpayer did not have substantial authority for his position. The Ninth Circuit reasoned that substantial authority did not exist because the facts were materially distinguishable from the facts in *Austin* that the taxpayer relied on. In *Little*, the appeals court reasoned, the taxpayer spent most of his time on his real estate businesses, whereas in *Austin* the taxpayer's primary business activity was practicing law and real estate investment was merely a secondary activity.

Eleventh and Fifth Circuits. The second approach taken by the circuits in determining whether substantial authority exists in facts and circumstances cases is that substantial authority will be found if there is some evidence in support of a taxpayer's position. This approach, taken by the Eleventh and Fifth Circuits, is exemplified in *Osteen*, 76 AFTR 2d 95-6013, 62 F3d 356 (CA-11, 1995), *aff'g in part and rev'g in part* TC Memo 1993-519, RIA TC Memo 93519 ; *Streber*, 81 AFTR 2d 98-1498, 138 F3d 216 (CA-5, 1998), *rev'g* TC Memo 1995-601, RIA TC Memo 95601 ; and *Martens*, 87 AFTR 2d 2001-1249, 250 F3d 744 (CA-5, 2001), *modifying* TC Memo 2000-46, RIA TC Memo 2000-046 .

Osteen. The taxpayers in *Osteen* were involved in a horse breeding activity. The Tax Court held there was no intent to carry on the activity for profit and that there was no substantial authority for the taxpayers' position. The Eleventh Circuit affirmed the case as to the holding on the merits, it being a fact question and there being no clear error on the part of the Tax Court.

Nevertheless, with respect to whether there was substantial authority for the taxpayers' position—and thus whether there was an exception to the substantial underpayment penalty—the court wrestled with the conceptual incongruity of applying a legal authority standard to a fact issue. According to the Eleventh Circuit, "[t]he application of a substantial authority test is confusing in a case of this kind. If the horse breeding enterprise was carried on for profit, all of the deductions claimed by the Osteens would be allowed. There is no authority to the contrary. If the enterprise was not for profit, none of the deductions would be allowed. There is no authority to the contrary. Nobody argues, however, not even the Government, that because the taxpayers lose on the factual issue, they also must lose on what would seem to be a legal issue."

After the appellate court criticized the Tax Court for the absence of some sort of explanation of why there was not substantial authority to support the Osteens' case, the court further acknowledged that "there are no court decisions to give us guidance" and noted that the Regulations were "unsatisfactory in application to an all or nothing case of this kind," i.e., a facts and circumstances decision.

The Eleventh Circuit then succinctly summarized 15 horse breeding cases in which the taxpayers prevailed and noted that even though the cases might be distinguishable, if for no other reason than those taxpayers won but the Osteens lost, the distinctions were not material. The appellate court found that the 15 cases did constitute substantial authority for the Osteens' position.

The court further reasoned that where both sides presented evidence supporting their respective positions, a circuit court could not reverse the decision of the Tax Court regardless of which party came away the winner because the reviewing court could not say the decision was clearly erroneous. In fact, the Tax Court would have had to be affirmed even if it had decided Osteen for the taxpayers. Only in a case first decided in favor of the taxpayer, and in which IRS obtained a reversal under the clearly erroneous rule, could it be argued that from an evidentiary standpoint there was not substantial authority. That is, in a facts and circumstances case the test is evidentiary, matching the facts to the relevant cases, not a weighing of legal authority.

The Eleventh Circuit essentially established that, in facts and circumstances cases, substantial authority is established if the record in the trial court contains some evidence that is not materially distinguishable from the facts in the cases the taxpayer relies on as substantial authority. This approach differs from that in the Fourth and Ninth Circuit, which essentially appear to adopt an all-or-nothing approach. In the latter two circuits, if the trial court distinguishes the taxpayer's authority for the purpose of deciding the critical facts that control the substantive tax issue, the same cases could not be used to support a substantial authority determination.

Streber. The Fifth Circuit in *Streber* applied *Osteen's* reasoning in a case that presented facts likely to never be seen again. A father held joint venture interests on behalf of his two daughters. The venture subsequently sold its underlying property and distributed the proceeds to the daughters. After consultation with a tax lawyer, the daughters, unsophisticated in tax law and the principles of partnerships, adopted a reporting position to the effect that the assignment of the joint venture interests was ineffective and that when the two daughters received the cash distributions, it was, in essence, a gift of cash from the father, who should be allocated the gain in the sale by the joint venture. Notwithstanding the lack of wisdom exhibited by his advice to his clients, the tax lawyer felt strongly enough about his position to compel him to go to the IRS and reveal it, confident that the IRS would pursue the father for not only the capital gains tax but gift taxes as well.[28] The IRS did not see the situation in the same light as the daughters' tax advisor, and pursued both father and daughters in the form of a whipsaw case.

The whipsaw case was decided favorably to the father in the Tax Court, which further found that a negligence penalty and a substantial underpayment penalty should be assessed against the daughters. The daughters appealed only the penalties and not the case on the merits.

The Fifth Circuit determined that the negligence penalty did not apply because the daughters relied on the advice of counsel. It further decided that the substantial understatement penalty did not apply on two grounds. First, with respect to the negligence penalty, the daughters relied on the advice of counsel (showing reasonable cause and good faith). Second, the taxpayers presented some evidence supporting the finding of a factual position that a gift of the joint venture interest had not been accomplished before the sale. The court's decision on this second ground was based entirely on the reasoning of *Osteen*.

A vigorous dissent in Streber basically said that Osteen was wrongly decided, that the existence or non-existence of substantial authority is purely and simply an analysis of legal authorities, and pointed to the Regulations that list the authorities which can be relied on to support a substantial authority defense.[29] Under a literal interpretation of the dissent, there could never be a substantial authority defense to a substantial understatement penalty charged to a taxpayer in a fact issue case. But if the daughters did not have substantial authority for their position, why would the IRS not have gone after only them, instead of pursuing both parties in a whipsaw case?

The problem with the notion that the substantial authority exception to a substantial underpayment penalty cannot exist in a fact-based case decided against the taxpayer is that, in most tax cases, the ultimate fact question is not as simple as asking whether the fact occurred or did not occur.[30] It is normally decided in a facts and circumstances analysis that is established by regulatory or case law factors. In addition, a factual finding often turns on the finding of one or more predicate facts. For example, in *Streber* the substantive legal issue turned entirely on one fact issue: whether the father made a completed gift to his daughters under Texas law. That issue required predicate fact determinations of whether the father intended to make a gift, whether the father delivered the property to his daughters, and whether the daughters accepted the property under Texas law. This in turn required a thorough analysis of Texas case law, which revealed, if nothing else, that there was Texas case law supporting the daughters' position.

Martens. In 2001, the Fifth Circuit again addressed the issue of whether a taxpayer had substantial authority for a tax position in a facts and circumstances case. In *Martens*, the taxpayers, an attorney and his wife, owned stock in a family business run by the attorney's mother. The taxpayers paid various creditors of the business and treated the advances as loans to the business. Some years later, the taxpayers wrote the loans off as a bad debt and took the loss as a deduction on their return.

The Tax Court held that the bad debt was not a business expense and therefore not deductible by the taxpayers because the taxpayers were not employees of the business. The Tax Court also upheld a substantial understatement penalty assessed against the taxpayers.

The Fifth Circuit affirmed the Tax Court's holding with regard to the deductibility of the expenses but reversed the holding regarding the substantial understatement penalty. Following *Streber*, the appellate court held that there was substantial authority for the taxpayers' position because "there was evidence going both ways, and a multiplicity of authority existed...."

Sixth Circuit. The third approach to determining whether substantial authority exists in a facts and circumstances case is that taken by the Sixth Circuit. Like the Fifth and Eleventh Circuits, the Sixth independently considers the record in determining whether substantial authority exists. But unlike the Fifth and Eleventh Circuits, the Sixth Circuit requires *considerable* and *ample* evidence for a finding that substantial authority existed.

The Sixth Circuit's approach is exemplified in *Estate of Kluener*, 82 AFTR 2d 98-6151, 154 F3d 630 (CA-6, 1998), *aff'g in part and rev'g in part* TC Memo 1996-519, RIA TC Memo 96519 . The taxpayer in *Kluener* owned C corporations with substantial NOLs. He transferred appreciated horses to one of the corporations and had the corporation sell the horses, thereby sheltering the gain. There were facts that indicated a need for capital in the corporation, and the taxpayer's witnesses testified that this was the business purpose for the transfer. A year or so later, the taxpayer caused the corporation to distribute the proceeds from the horse sale to himself. The IRS argued that the transfer of the horses to the corporation should be disregarded and the taxpayer be treated as the seller.

The IRS and the taxpayer each cited two cases (one circuit court case and one Tax Court case) in support of its position. The Tax Court agreed with the IRS on the substantive issue and also agreed that the taxpayer was liable for an understatement penalty because he did not have substantial authority for his position. On appeal, the Sixth Circuit affirmed on the substantive tax issue but reversed the Tax Court's holding that the taxpayer did not have substantial authority for his position.

The appellate court first acknowledged that a conflict existed among the other circuits regarding how to determine whether substantial authority exists in cases where facts and circumstances are determinative. As a threshold issue, the court first considered whether "authority," in the context of substantial authority, should include factual evidence as well as legal sources. Following *Osteen*, the Sixth Circuit held that factual evidence is authority to be considered in a substantial authority determination because the Section 6662 Regulations contain two provisions requiring the examination of the relevant facts and no provisions explicitly precluding the consideration of facts.

In addition, the Sixth Circuit reasoned that a court must examine the facts to determine a legal source's relevance and thus its authoritative weight. But the court disagreed with Osteen regarding the amount of evidence required to constitute "substantial" authority. The Sixth Circuit interpreted *Osteen* to require only that some evidence support the taxpayer's position in order for substantial authority to exist; the court, citing the dissent in *Streber*, concluded substantial authority requires a taxpayer to present "considerable or ample authority."

After defining the legal standard for substantial authority in a facts and circumstances case, the court of appeals set out to compare the legal authorities cited by the taxpayer to the facts in *Kluener*. The court found that considerable factual evidence existed to support the finding that the taxpayer transferred the horses to the corporation for a valid, non-tax business purpose. The Sixth Circuit also found that this evidence was substantial in relation to the contrary evidence. Finally, the court held that despite some factual differences between the cases cited by the taxpayer and the facts in *Kluener*, the cited cases were substantial legal authority for the taxpayer's position.

FREQUENTLY LITIGATED ISSUES

Practitioners are frequently engaged to assist taxpayers in ascertaining the proper tax return reporting for legal issues that are determined based on facts and circumstances. The analysis of whether there is substantial authority for those positions must begin with a comparison of the taxpayer's facts to the facts found in authority supporting the position. Often, those tax issues are usually controlled by a laundry list of factors (established by either the Regulations or case law) that decide the ultimate fact question, and those facts and circumstances cases have been inconsistently decided. This makes it very difficult to determine whether substantial authority for a tax position exists because the underlying fact patterns in those cases are not materially distinguishable.

In facts and circumstances cases, courts typically set up the contest with the factors (whether established by the Regulations or case law) that are to be considered when determining whether the taxpayer will prevail on the substantive issues. The courts then analyze the facts presented against the required factors in a methodic, orderly presentation. In more cases than not, the courts simply conclude that either the taxpayer wins or the government wins. And in most of these cases, the courts offer no reasoning other than to conclude that the weight of the factors did or did not support the taxpayer's position. Where the taxpayer loses on the substantive position, next comes the very cloudy analysis of whether there was substantial authority for the taxpayer's position, notwithstanding that the reporting position was found to be erroneous.

It is clear that a taxpayer can lose on the merits of a case but still be within the penalty safety zone of substantial authority.[31] Indeed, the Regulations themselves allow the mathematical possibility of such a result. If, on a mathematical probability basis, the substantial authority position is less probable than the more-likely-than-not standard[32] (which has a probability greater than 50%), then substantial authority has a probability of 50% or less. How much less, we do not know. Thus, it is quite possible that a taxpayer with a losing substantive position nevertheless will have substantial authority for that position.

The myriad of Tax Court decisions involving facts and circumstances determinations, such as Section 183 hobby loss cases (almost all of which are memorandum decisions), simply do not provide guidance on the process of applying the substantial authority test to fact issues. For the most part, these cases simply analyze the facts in the record against the regulatory factors (which is appropriate), then draw a conclusion about whether the weight of the favorable facts falls to the IRS or to the taxpayer. Then, with respect to the cases in which the IRS prevails on the substantive issue, the Tax Court turns to the Section 6662 question of substantial authority. In many decisions, the Tax Court simply concludes that substantial authority does not exist without offering any analysis as to why not.[33] While the Tax Court has not historically provided much guidance to the tax practitioner trying to determine whether substantial authority exists for a facts and circumstances position, the circuit courts have been more thoughtful on the subject.

The Fourth and Ninth Circuits will consider precedent to be substantial authority for a position so long as the instant facts are not materially distinguishable from the facts in the cases cited as authority. Indeed, in *Antonides*, the Fourth Circuit stated that the weight of the authorities for the tax treatment of an item is determined by the same analysis that a court would be expected to follow in evaluating the treatment of the item. This statement could be interpreted to mean that if a taxpayer did not carry his burden of proof and thus did not prevail on the reporting position that an activity was engaged in for profit, the taxpayer will automatically lose his position on substantial authority.

Another way of looking at this statement is that where the taxpayer lost on the substantive issue, a court should ignore the facts of the case before it in determining whether substantial authority exists. This cannot be the correct interpretation, however. First, the Regulations explicitly state that facts are to be considered in making a substantial authority determination. In addition, since mathematically the test of substantial authority is a standard less than the taxpayer's burden of proof to prevail, it is incorrect to say that if the taxpayer loses the substantive position he also must lose on a substantial authority analysis. Notwithstanding this reasoning, the *Antonides* court seemed to acknowledge the principle that to lose on the merits is to lose the substantial authority argument, which is problematic for taxpayers in the Fourth Circuit and possibly the Ninth Circuit.

In contrast to the approach taken by the Fourth and Ninth Circuits, the Eleventh, Fifth, and Sixth Circuits have taken the approach that to "ignore the facts is to impose the [substantial understatement] penalty," and therefore those courts take the facts of the case into consideration as authority in determining whether substantial authority exists in cases that turn solely on issues of fact.[34] In the Fifth and Eleventh Circuits, the courts take the position that if the taxpayer's case has some facts in common with authority cited as precedent then substantial authority will be found. The Sixth Circuit, while considering the facts of the case in its analysis, will not find that the taxpayer has substantial authority unless the taxpayer has "considerable and ample" factual authority. Thus, the Sixth Circuit test seems to be that there has to be more than just some facts in common with the authority cited as precedent by the taxpayer, but the taxpayer can lose on the substantive issue and still be found to have substantial authority for that issue.

CONCLUSION

All tax issues require an analysis of the relevant facts, but those tax issues that are specifically required to be decided on a case-by-case basis by analyzing the facts and circumstances against an established checklist of factors present a higher probability of getting inconsistent results from the various courts having jurisdiction over tax cases. Accordingly, in a facts and circumstances case the analysis is more difficult when a tax practitioner is required to conclude whether substantial authority exists with respect to the fact pattern presented.

Unfortunately, the Regulations offer very little guidance. The Tax Court decisions develop very little reasoning to support their conclusions. The few appellate opinions that have addressed the issue are, in large part, inconsistent. Part of the problem may rest with tax counsel litigating the issue because, as a general rule, counsel focuses not on the asserted penalty but on the more pressing problem of the substantive tax issue. As in all situations where the legal authorities evolve into a confusing state, the substantial authority test cries out for Treasury or the IRS to promulgate clarifying and reconciling rules.

Practice Notes

When preparing a case in which the issue will be resolved through a facts and circumstances analysis, counsel will focus, appropriately, on the substance. Nevertheless, the question of whether the taxpayer had substantial authority for the position taken should not be ignored, in the event an appeal will be taken should the taxpayer lose at trial.

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[1] Michael L. Cook and Corby Brooks are with the law firm of Winstead, P.C. in Austin, Texas.
[2] See generally Lipton and Walton, "Tax Return Preparer Penalty Final Regulations," 110 JTAX 229 (April 2009).
[3] Reg. 1.6662-4(d).
[4] Examples of tax issues where facts and circumstances tests are determinative of the legal issue include the Section 183 "hobby loss" issue, whether property is "dealer property" or eligible for capital gain treatment under Section 1221, "reasonable compensation" cases under Section 162, and cases involving "debt vs. equity."
[5] Sections 6662(a) and (b).

[6] Section 6662(d)(1)(A); Reg. 1.6662-4(b)(1).
[7] Reg. 1.6662-1(b); see also Section 6664(c)(1).
[8] Section 6662(d)(2)(B); Regs. 1.6662-4(e)(1) and (2).
[9] Section 6694(a)(1); Reg. 1.6694-2(a)(1).
[10] Id.
[11] See Internal Revenue Manual 20.1.6.2.1 (referral to OPR is mandatory when a Section 6694 penalty is asserted against a practitioner and is closed agreed by examiners, sustained in Appeals, or closed without Appeals).
[12] Reg. 301.7701-15(a).
[13] Regs. 301.7701-15(b)(1) and (b)(2)(i).
[14] Section 6694(a)(2); Reg. 1.6694-1(a)(1).
[15] Reg. 1.6662-4(d)(2); Notice 2009-5, 2009-3 IRB 309 (until further guidance is issued, solely for purposes of Section 6694(a) "substantial authority" has the same meaning as in Reg. 1.6662-4(d)(2)).
[16] Reg. 1.6662-4(d)(2); Notice 2009-5, 2009-3 IRB 309 (until further guidance is issued, solely for purposes of Section 6694(a) "substantial authority" has the same meaning as in Reg. 1.6662-4(d)(2)).
[17] Reg. 1.6662-4(d)(3)(i).
[18] Id.
[19] Id.
[20] Reg. 1.6662-4(d)(3)(iv)(C).
[21] Reg. 1.6662-4(d)(3)(iii).
[22] Id.
[23] Reg. 1.6662-4(d)(3)(iv)(B).
[24] Id.
[25] Reg. 1.6662-3(b)(3).
[26] It is commonly stated that the realistic possibility confidence level is higher than the reasonable basis level, even though the Regulations do not appear to explicitly state as much. But given that a taxpayer can defend against the Section 6662 negligence penalty by merely having a position with a realistic possibility of success while a taxpayer must disclose a position with reasonable basis to defend against the same penalty, the Regulations seem to imply that the reasonable basis confidence level is lower than the realistic possibility confidence level. See Regs. 1.6662-3(a) and (b)(1); see Reg. 1.6662-3(b)(3) (defining the reasonable basis standard); see former Reg. 1.6692-2(b) (defining the realistic possibility standard).
[27] The substantial authority standard, like the reasonable basis standard, has never been quantified and it makes sense to not do so, as many practitioners would argue should be the case for the more-likely-than-not standard.
[28] The tax advisor was not aware, or had forgotten, that under Section 6901(a)(1)(A)(iii) the IRS can pursue both the donee as well as the donor for gift taxes.
[29] Now found in Reg. 1.6662-4(d)(3)(iii).
[30] This problem was recently acknowledged in Southgate Master Fund, LLC, DC Tex., 8/18/09. The court held that a taxpayer had substantial authority for its position in an economic substance case. The taxpayer had obtained tax opinions, on which it based its substantial authority argument. The court noted that the judicial doctrines regarding economic substance were "amorphous, require[d] intensive fact-finding, and generally lack[ed]the sort of black-letter, multi-part tests that allow for definitive answers." The court then noted that the taxpayer's opinions "were properly framed as educated guesses in light of what the IRS might find and what a court might conclude, bolstered by substantial statements of fact and law...." The court then concluded that the taxpayer had substantial authority for its position. This case will be analyzed in depth in an upcoming issue of The Journal.
[31] See, e.g., Osteen, 76 AFTR 2d 95-6013, 62 F3d 356 (CA-11, 1995), aff'g in part and rev'g in part TC Memo 1993-519, RIA TC Memo 93519 ; Streber, 81 AFTR 2d 98-1498, 138 F3d 216 (CA-5, 1998), rev'g TC Memo 1995-601, RIA TC Memo 95601 .
[32] Reg. 1.6662-4(d)(2).
[33] See, e.g., Osteen, supra note 30; Jarret, TC Memo 1993-516, RIA TC Memo 93516 ; Curtis, TC Memo 1994-15, RIA TC Memo 94015.
[34] Estate of Kluener, 82 AFTR 2d 98-6151, 154 F3d 630 (CA-6, 1998).

A, B and C's of Mergers, Stock For Stock Acquisitions and Stock For Asset Reorganizations

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A, B AND C'S OF MERGERS, STOCK FOR STOCK ACQUISITIONS AND STOCK FOR ASSET REORGANIZATIONS

By: *Ryan T. Gardner*[1]

Introduction:

Many practitioners engage in tax-free reorganizations in the form of mergers, stock for stock acquisitions and stock for asset reorganizations. The name "tax-free reorganizations" is partially misleading, since to the extent there is cash or non-qualifying property (i.e., property other than an equity interest in the purchasing entity) (hereafter "Boot") received by the target entity's shareholders, the transaction will be partially taxable. These "tax-free reorganizations" can take on a variety of forms, but this article is limited to the below tax-free reorganizations consisting of mergers, stock for stock acquisitions and stock for asset reorganizations (hereafter "Tax-Free Reorganizations") which take the form of eight different types of transactions consisting of:

(1) three types of mergers (i.e., Straight Merger,[2] Forward Subsidiary Merger,[3] and Reverse Subsidiary Merger[4]);

(2) three types of solely stock for stock acquisitions (i.e., "B",[5] Subsidiary "B"[6] and Forced "B"[7]); and

(3) two types of stock for asset reorganizations (i.e., "C"[8] and Subsidiary "C"[9]).

To assist practitioners involved in this type of practice, I have prepared this article to: (1) provide an overview of the general requirements for Tax-Free Reorganizations; (2) provide a visual reference of what transpires in each type of reorganization; and (3) provide a quick reference under the visual reference for the requirements of each type of reorganization.

Requirements of Tax-Free Reorganizations:

Tax-Free Reorganizations,[10] require the following elements to be satisfied:

(1) business purpose;

(2) continuity of shareholder interest (hereafter "COI");

(3) continuity of business enterprise (hereafter "COBE") and for certain reorganizations, a related requirement, the acquisition of "substantially all" of the assets; and

(4) if proposed regulations become final, exchange of net asset value.

Business purpose: To qualify as a Tax-Free Reorganization, the acquisition by the acquiring entity (hereafter "Purchasing") of the acquired entity (hereafter "Target") must satisfy the business purpose requirement.[11] This means that Purchasing's acquisition of Target must have a business purpose and cannot be principally motivated for tax reasons.[12] Although a precise definition of "business purpose" remains unclear, practitioners should consider drafting into their acquisition agreements a business purpose for the transaction. The Internal Revenue Service ("IRS") requires a corporate-level business purpose,[13] however cases have held a shareholder-level business purpose will suffice.[14] Treasury Regulation 1.368-2(g) looks to the business purpose of both Purchasing and Target by providing the transaction "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization."[15]

When the parties are not related and are dealing at arm's length, the business purpose requirement will normally not be a concern as such transaction is not a "tax avoidance" transaction. However, if the parties are related or one party is indifferent to the tax consequences, the business purpose of the transaction becomes a key component. Another key point to remember is that just because Purchasing and Target structure the acquisition as a Tax-Free Reorganization, rather than as a taxable asset or stock purchase, such structuring does not constitute a tax avoidance motive proscribed by the business purpose requirement.[16]

Continuity of Shareholder Interest: To qualify as a Tax-Free Reorganization, the acquisition by Purchasing of Target must satisfy the COI requirement.[17] COI requires that, in substance, *a substantial part* of the value of the proprietary interests in Target be preserved.[18] Therefore, instead of being cashed out or receiving property for stock, Target's shareholders must receive a substantial part of some sort of equity interest in Purchasing. The type of equity in which Target's shareholders must receive depends on the type of reorganization. For example, in a Straight Merger, the COI requirement requires Purchasing's stock and securities whereas in stock for stock reorganizations and stock for asset reorganizations, the COI requirement requires "solely voting stock" of Purchasing.[19] Under current regulations, the lowest COI requirement, which is found in Straight Mergers, provides that 40% or more of the total pre-reorganization value of Target's outstanding stock must be exchanged for Purchasing's stock and securities in the reorganization.[20] COI is a facts and circumstances test.[21]

In analyzing the COI requirement, any distribution to Target's shareholders prior to the reorganization could be treated as Boot and cause the COI requirement to not be satisfied.[22] Furthermore, if Purchasing, or a related person,[23] acquires some of Target's stock pre-reorganization for cash in connection with the reorganization, such stock purchase will not be counted towards satisfying the COI requirement.[24] Finally, if the stock provided to Target's shareholders in the reorganization is redeemed or acquired by Purchasing, or a related person,[25] such transaction could cause COI requirement to fail.[26]

Continuity of Business Enterprise: To qualify as a Tax-Free Reorganization, the acquisition by Purchasing of Target must satisfy the COBE requirement.[27] This means that Purchasing or purchasing's subsidiary ("Subsidiary") must either:

(1) continue Target's historic business (i.e., business continuity); or

(2) use a significant portion of Target's historic business assets in a business (i.e., asset continuity).[28]

If Target has more than one line of business, number (1) above is satisfied if Purchasing continues a significant line of Target's business.[29] COBE is a facts and circumstances test.[30]

Substantially All: In certain Tax-Free Reorganizations (i.e., Forward Subsidiary Merger,[31] Reverse Subsidiary Merger[32] and "C" and Subsidiary "C"),[33] Purchasing must acquire "substantially all" of Target's assets in the acquisition.[34] Although the "substantially all" requirement is not a part of the COBE requirement, it is similar and related to COBE in the fact that both require Purchasing to acquire a certain threshold of Target's assets. The IRS considers substantially all for letter ruling purposes to require that Target must transfer at least 90% of the fair market value of its net assets, and at least 70% of the fair market value of the gross assets that it held immediately before the transfer (hereafter the "70% / 90% test").[35] For purposes of the above 70% / 90% test, the assets Target held immediately before the transfer include all payments to dissenters and all redemptions and distributions (except for regular, normal distributions) made by the Target immediately preceding the transfer and that are part of the plan of reorganization.[36] Solely for purposes of "C" and Subsidiary "C" reorganizations, liabilities assumed with respect to acquired properties are ignored in the "substantially all" test, unless any Boot (cash or other property) is received by Target's shareholders, in which case the liabilities assumed are also considered Boot.[37]

<u>Exchange of Net Asset Value:</u> If Proposed Treasury Regulation Sections 1.368-1(b)(1) and 1.368-1(f) become final, to qualify as a Tax-Free Reorganization, the acquisition by Purchasing of Target must satisfy the exchange of net asset value. An exchange of net value would require both a surrender of net value and a receipt of net value.[38] A surrender of net value would be tested by reference to the Target's assets and liabilities.[39] A receipt of net value would be tested by reference to Purchasing's assets and liabilities.[40] The purpose of the net value requirement would be to prevent transactions that resemble insolvent liquidations from qualifying for nonrecognition treatment.[41]

In asset reorganizations (i.e., Mergers (excluding Reverse Subsidiary Merger) and "C" and Subsidiary "C" reorganizations), the exchange for net asset value is satisfied if:

(1) the fair market value of the property transferred by Target to Purchasing (or its Subsidiary) exceeds the sum of:
   (a) the amount of Target's liabilities assumed by Purchasing (or its Subsidiary) in connection with the exchange; and
   (b) the amount of any Boot received by Target in connection with the exchange; and
(2) the fair market value of the issuing corporation (i.e., Purchasing) assets exceed the amount of its liabilities immediately after the exchange.[42]

In stock reorganizations (i.e., Reverse Subsidiary Mergers and B, Subsidiary B and Forced B), the exchange for net asset value is satisfied if:

(1) the fair market value of Target's assets exceeds the sum of:

(a) the amount of Target's liabilities immediately before the exchange; and

(b) the amount of Boot received by the Target's shareholder in connection with the exchange; and

(2) the fair market value of the issuing corporation (i.e., Purchasing) assets exceeds the amount of its liabilities immediately after the exchange.[43]

Charts:

The following charts summarize the application of the above Tax-Free Reorganization requirements to the eight different types of reorganizations discussed in this article.

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1 Ryan T. Gardner is with the law firm of Locke Lord Bissell & Liddell LLP.

2 *See* Code § 368(a)(1)(A).

3 *See* Code § 368(a)(2)(D).

4 *See* Code § 368(a)(2)(E).

5 *See* Code § 368(a)(1)(B).

6 *See* Code § 368(a)(1)(B); *see also* Treas. Reg. § 1.358-6(c)(3) and Rev. Rul. 56-613, 1956-2 C.B. 212.

7 *See* Rev. Rul. 67-448, 1967-2 C.B. 144; Rev. Rul. 74-564, 1974-2 C.B. 124.

8 *See* Code § 368(a)(1)(C).

9 *See* Code § 368(a)(2)(C).

10 Code §§ 368(a)(1)(E)(i.e., "E" reorganizations) and (a)(1)(F)(i.e., "F" reorganizations) do not need to satisfy elements (2) through (4).

11 *See* Gregory v. Helvering, 293 U.S. 465 (1935).

12 *See* Gregory; *see also* Wortham Mach. Co. v. United States, 375 F.Supp. 835 (D. Wyo. 1974), *aff'd* 521 F.2d 160 (10th Cir. 1975); American Bronze Corp. v. Commissioner, 64 T.C. 1111 (1975); Laure v. Commissioner, 653 F.2d 253 (6th Cir. 1981).

13 *See* Treas. Reg. § 1.368-2(g)(*providing* the transaction "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization."); *see also* T.A.M. 84-52-004 (Jul. 9, 1984).

14 *See* Lewis v. Commissioner, 10 T.C. 1080 (1948), *aff'd* 176 F.2d 646 (1st Cir. 1949), *see also* Wortham Mach. Co.; Survuant v. Commissioner, 162 F.2d 753 (8th Cir. 1947).

15 Treas. Reg. § 1.368-2(g).

16 *See* Gregory.

17 *See* Treas. Reg. § 1.368-1(e)(1).

18 *See* Treas. Reg. § 1.368-1(e)(1).

19 See I.R.C. §§ 368(a)(1)(A), (a)(1)(B) and (a)(1)(C).

20 *See* Treas. Reg. § 1.368-1T(e)(2)(v)(examples 1 and 5); *see also* F.T.C.2d ¶ F-3602.

21 *See* Treas. Reg. § 1.368-1(e)(1)(i).

22 *See* Treas. Reg. § 1.368-1(e)(1)(ii).

23 *See* Treas. Reg. § 1.368-1(e)(3) for definition of related person.

24 *See* Treas. Reg. § 1.368-1(e)(7)(example 4).

25 *See* Treas. Reg. § 1.368-1(e)(3) for definition of related person.

26 *See* Treas. Reg. § 1.368-1(e)(1)(i) and (3).

27 *See* Treas. Reg. § 1.368-1(d)(1).

28 *See* Treas. Reg. § 1.368-1(d)(1).

29 *See* Treas. Reg. § 1.368-1(d)(2)(ii).

30 *See* Treas. Reg. § 1.368-1(d)(1).

31 *See* Treas. Reg. § 1.368-2(b)(2).

32 *See* Treas. Reg. § 1.368-2(j)(3)(iii).

33 *See* I.R.C. § 368(a)(1)(C).

[34] "Substantially all" applies to the following reorganizations: Forward Subsidiary Merger (*see* I.R.C. §§ 368(a)(2)(D)); Reverse Subsidiary Merger (*see* I.R.C. § 368(a)(2)(E)); "C" (*see* I.R.C. § 368(a)(1)(C)); Subsidiary "C" (*see* I.R.C. §§ 368(a)(2)(D) and 368(a)(1)(C)).

[35] *See* Rev. Proc. 77-37, 1977-2 C.B. 568.

[36] *See* Rev. Proc. 86-42, 1986-2 C.B. 722 amplifying Rev. Proc. 77-37, 1977-2 C.B. 568.

[37] *See* I.R.C. § 368(a)(2)(B).

[38] *See* Prop. Treas. Reg. § 1.368-1(f)(1).

[39] *See* Prop. Treas. Reg. § 1.368-1(f)(1).

[40] *See* Prop. Treas. Reg. § 1.368-1(f)(1).

[41] *See* Prop. Treas. Reg. § 1.368-1(f)(1).

[42] *See* Prop. Treas. Reg. § 1.368-1(f)(2)(i) - (ii); *see also* F.T.C.2d ¶ F-3821.

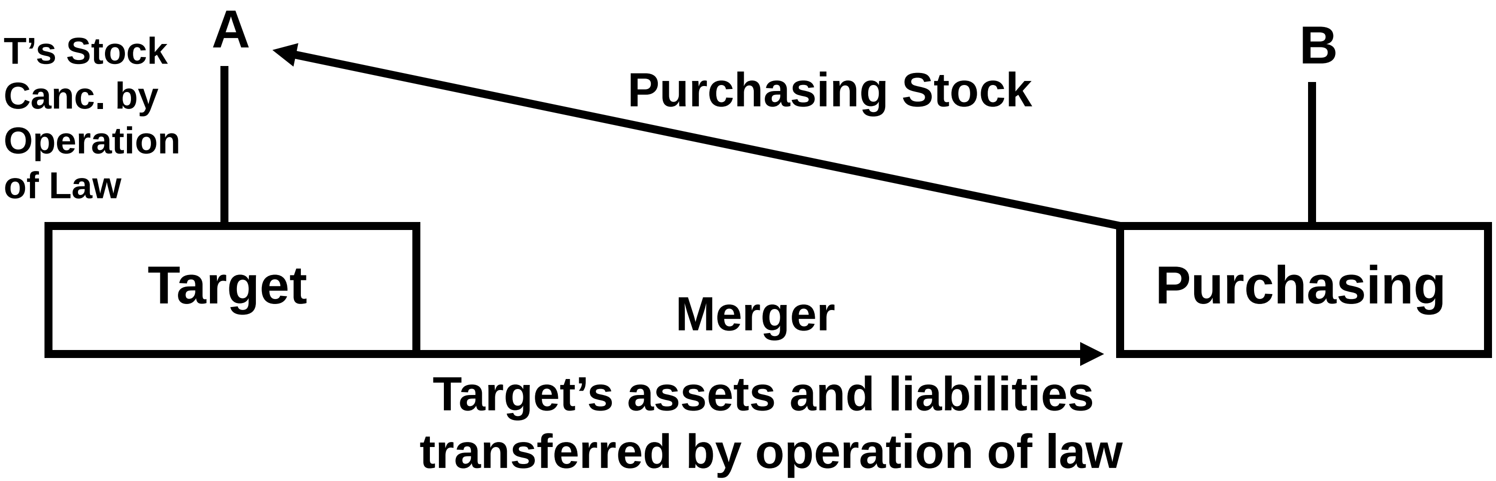
[43] *See* Prop. Treas. Reg. § 1.368-1(f)(3)(ii); *see also* F.T.C.2d ¶ F-3822. In a Reverse Subsidiary Merger, the controlled corporation (i.e. the Subsidiary) would be treated as the Target.

A, B and C's of Mergers, Stock for Stock Acquisitions and Stock for Asset Reorganizations

By Ryan T. Gardner

RETURN TO TABLE OF CONTENTS

Straight Merger (368(a)(1)(A))



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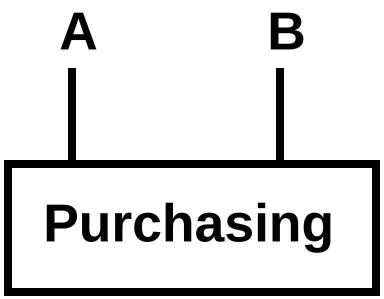
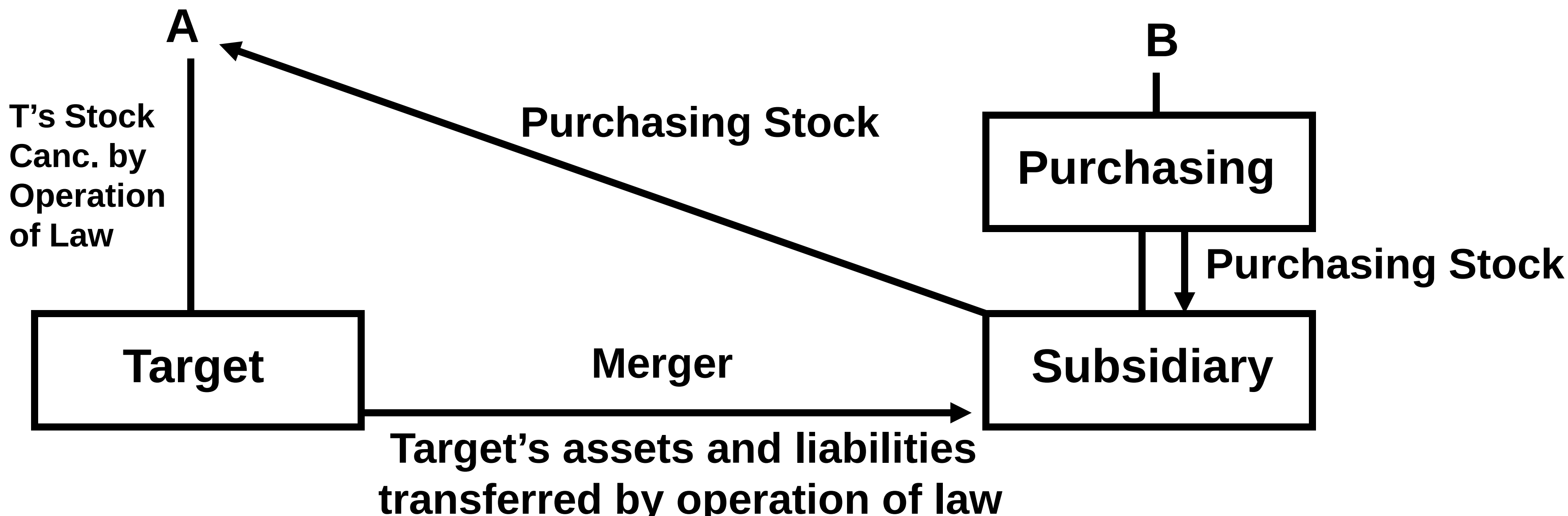


Requirements:

- Consummated pursuant to state or federal law;
- Purchasing's stock to A, with COI for A (i.e., shareholders) at least to 40% (voting stock not required); and
- Target's assets and liabilities transferred by law (no substantially all requirement);
- Consider disregarded LLC or QSub (if Purchasing is an S Corp.) to prevent assumption of liabilities (see examples in Treas. Reg. 1.368-2(b)(1)(iii)).

Forward Subsidiary Merger (368(a)(2)(D))



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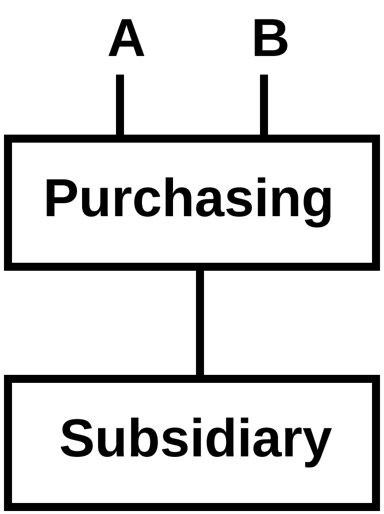
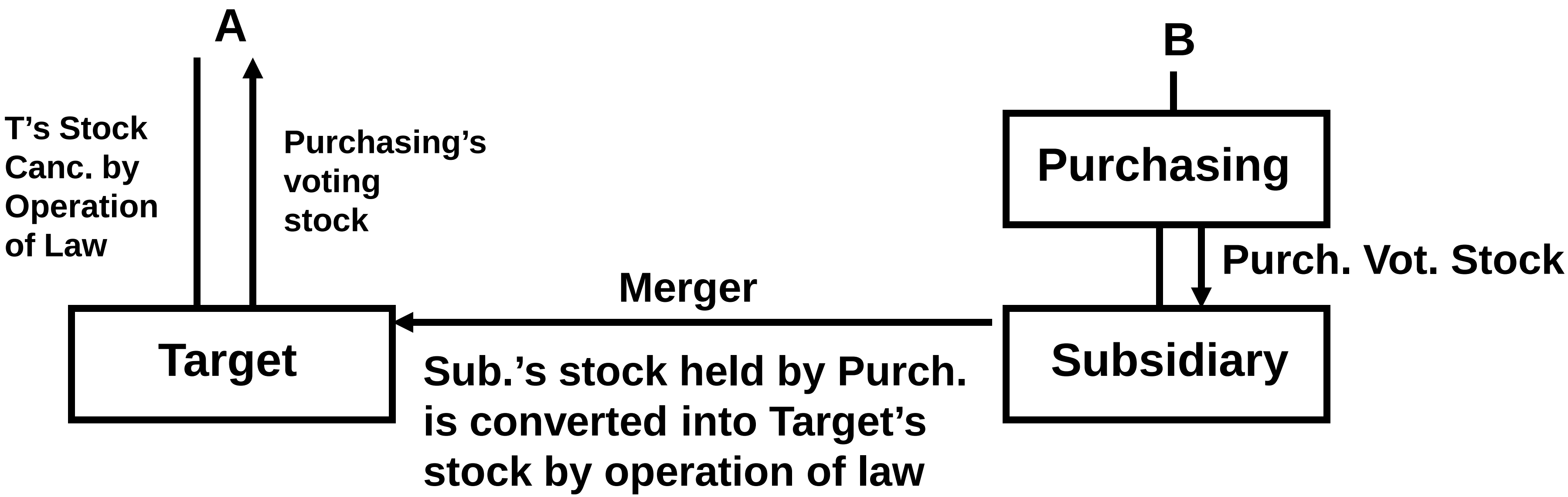


Requirements:

- Consummated pursuant to state or federal law;
- Purchasing's stock to A with COI for A (i.e., shareholders) at least to 40% (voting stock not required, however Subsidiary's stock not allowed);
- Substantially all of Target's and Subsidiary's assets (liabilities allowed);
- Subsidiary can be old and cold or newly formed; &
- IRS's position, Subsidiary must be first tier (drop down of assets generally allowed).

Reverse Subsidiary Merger (368(a)(2)(E))



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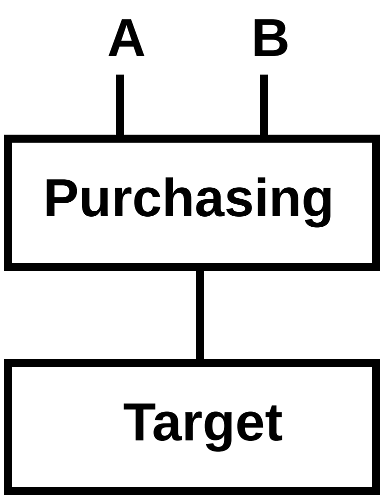
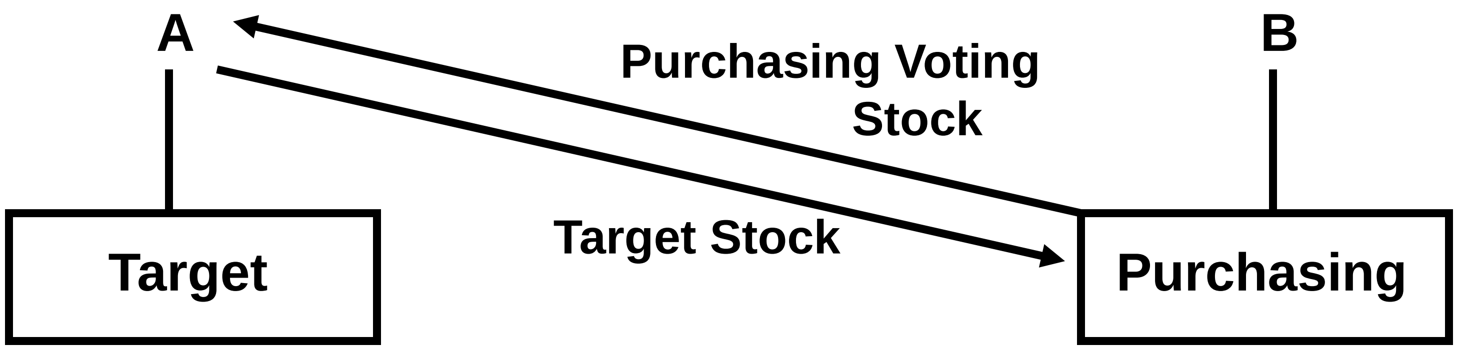


Requirements:

Consummated pursuant to state or federal law;
Purchasing's voting stock to A, with COI for
A (i.e., shareholders) at least to 80%
(Subsidiary's stock not allowed);
Substantially all of Subsidiary's and Target's
assets held by Target (liabilities allowed)
IRS's position, Subsidiary must be first tier
(drop down of assets generally allowed).

“B” (368(a)(1)(B))



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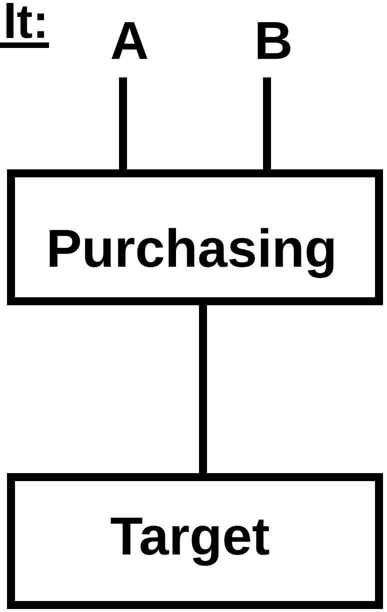
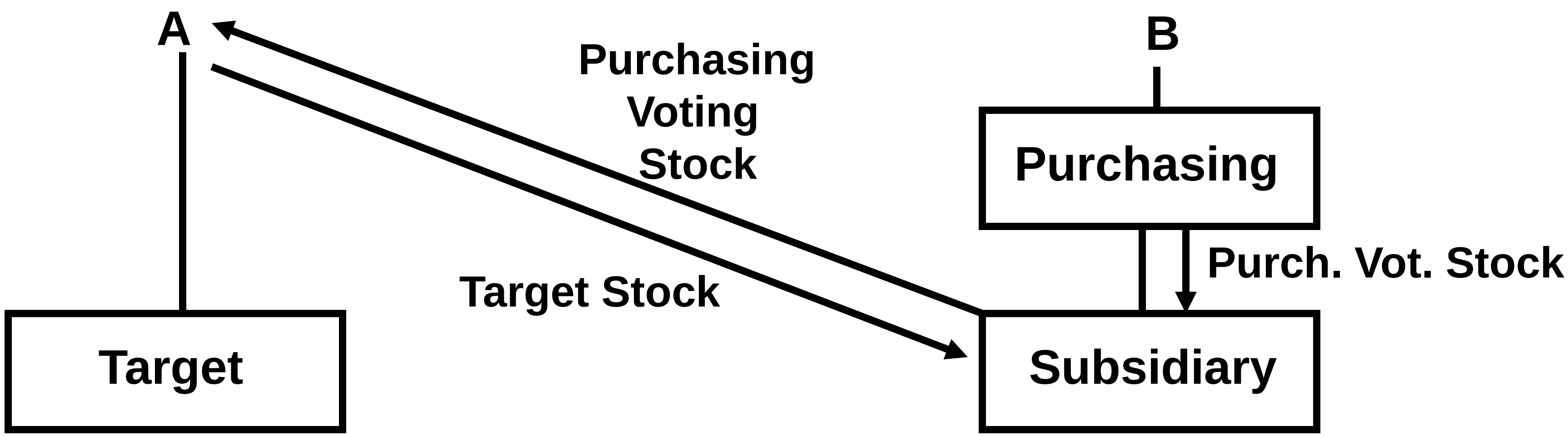


Requirements:

- Purchasing’s voting stock solely in exchange for
- Target’s stock (at least 80%) (previously acquired Target stock by Purchasing does not count towards 80% if not purchased with Purchasing’s voting stock);
- No Boot.

RETURN TO TABLE OF CONTENTS

Subsidiary “B” (368(a)(1)(B))



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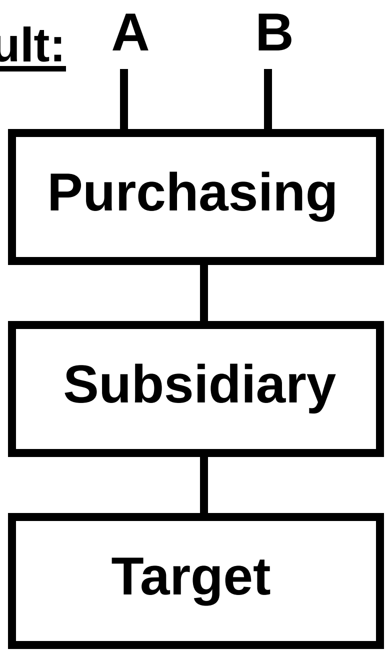
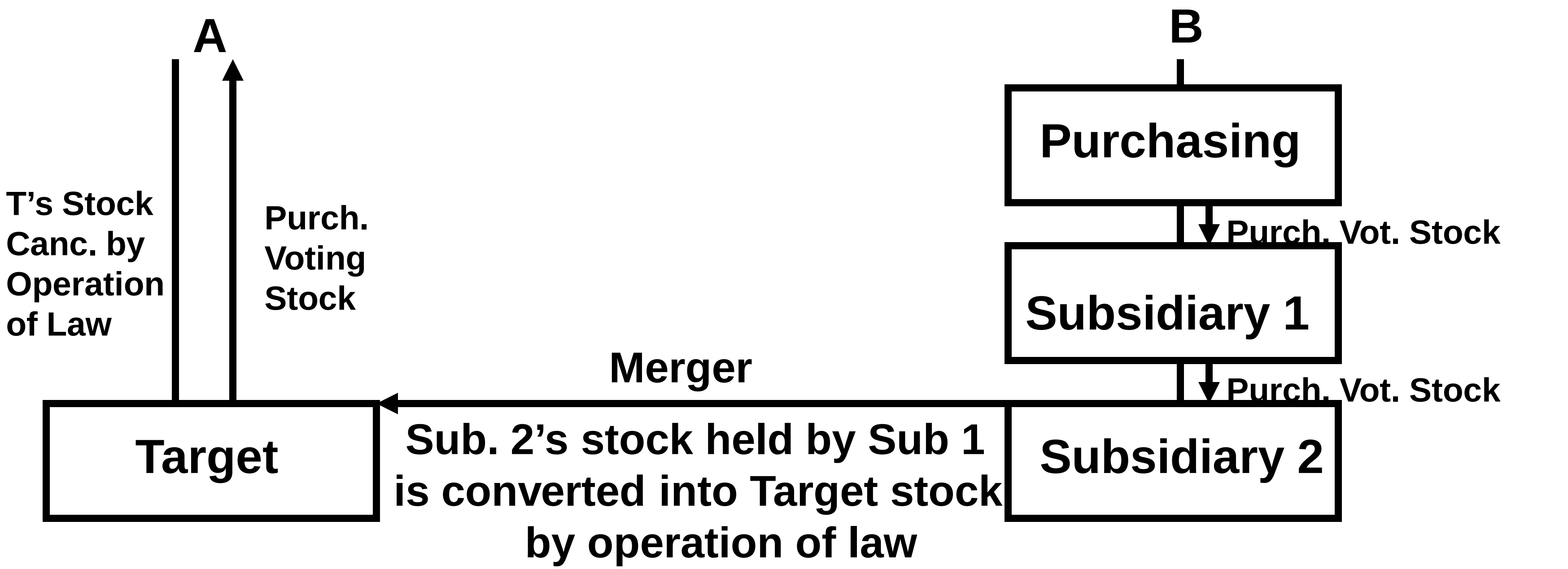


Requirements:

- Purchasing’s voting stock solely in exchange for
- Target’s stock (at least 80%) (previously acquired Target stock by Purchasing does not count towards 80% if not purchased with Purchasing’s voting stock);
- No Boot;
  IRS position, Subsidiary must be first tier (drop down of assets generally allowed).

Forced "B" (Rev. Rul. 67-448)



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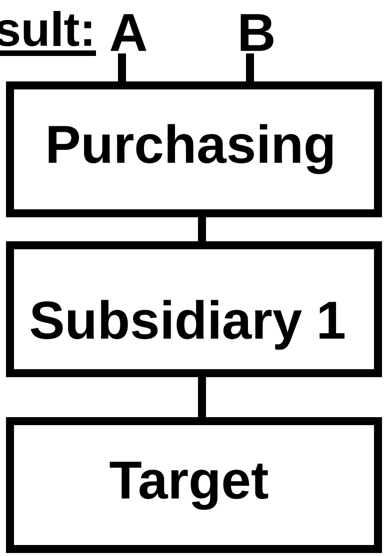
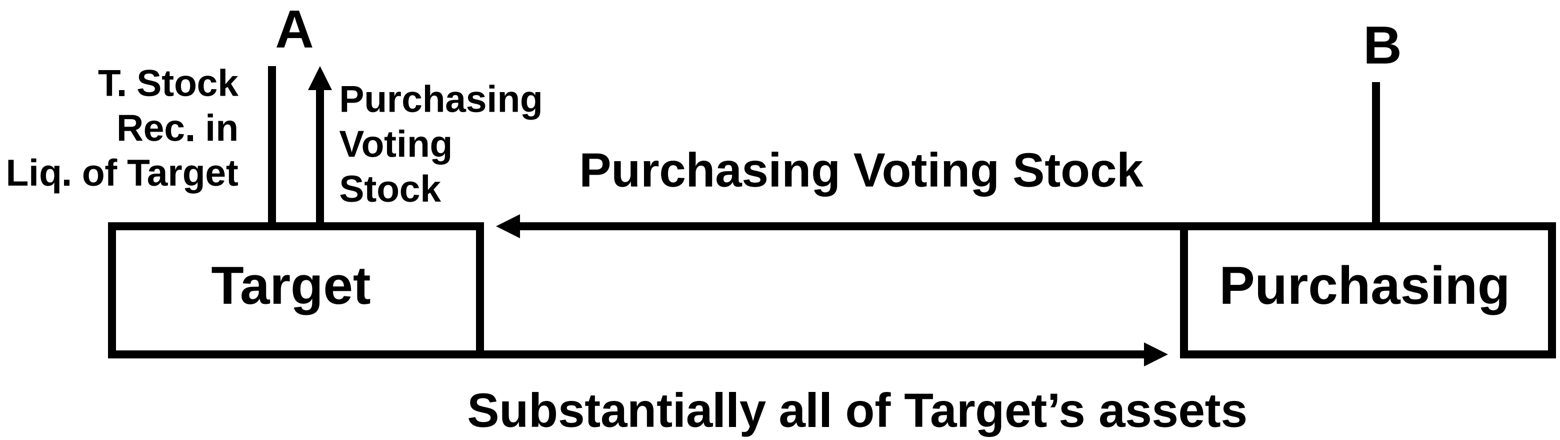


Requirements:

- Merger consummated pursuant to state or federal law;
  Subsidiary 2 newly formed and immediately mergers into Target;
  Purchasing's voting stock solely in exchange for;
- Target's stock, at least 80%;
- Subsidiary can be first or second tier (Reverse Triangular Merger allows only first tier) (drop down of assets generally allowed).

“C” (368(a)(1)(C))



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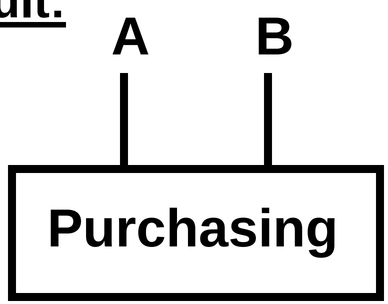
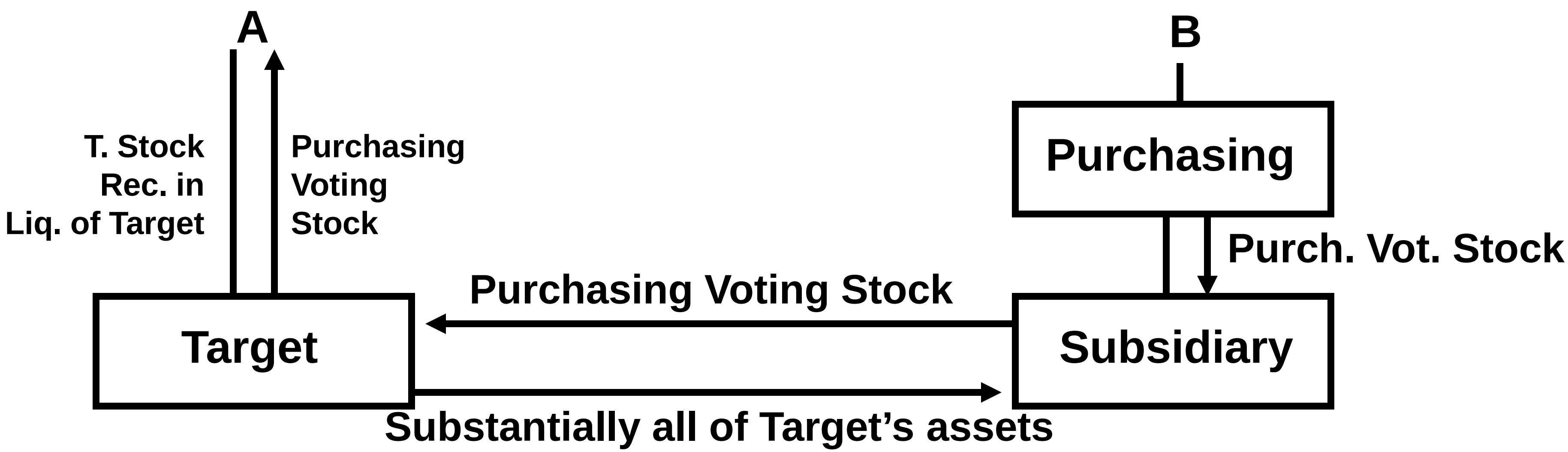


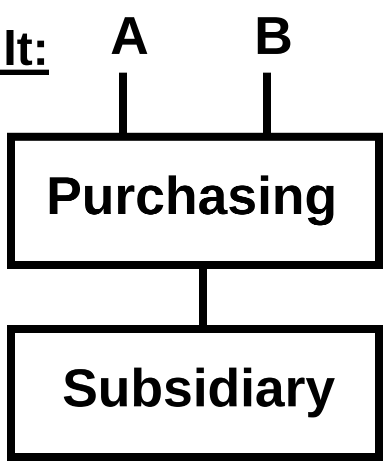
Requirements:

- **Purchasing voting stock in exchange for;**
  Substantially all of Target’s assets;
  Boot allowed up to 20% (Liabilities are considered Boot if any other Boot is received).

Subsidiary “C” (368(a)(2)(C))



Result:



Requirements:

- **Purchasing voting stock in exchange for;**
  Substantially all of Target’s assets;
  Boot allowed up to 20% (Liabilities are considered Boot if any other Boot is received).
- **Subsidiary must be first tier.**

RETURN TO TABLE OF CONTENTS

Recent Tax Case Expands "Sickness" Exclusion

Robert W. Wood
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RECENT TAX CASE EXPANDS "SICKNESS" EXCLUSION

By Robert W. Wood[1]

"You make me sick," may be a familiar refrain on TV sitcoms. It can even figure into playful banter between spouses. Yet the phrase seems to be cropping up in earnest more and more frequently in litigation.

The notion that conduct has a causal link to sickness—*real* sickness, not mere upset—is becoming more and more accepted. In her latest report to Congress in January 2010, U.S. Taxpayer Advocate Nina Olson made this a point. She has argued for parity between the taxation of emotional and physical injuries.[2] She even asks Congress to amend Section 104 to make emotional distress recoveries tax-free.[3]

This is no emotional appeal. The Taxpayer Advocate uses scientific data to back up her views that there are decidedly physical elements of depression and other disorders. Many medical health professionals now acknowledge the biological causes of mental disorders. They also acknowledge that many mental disorders show up as physical symptoms.[4]

Moreover, Olson suggests that present tax law conflicts with public policy and even with expressed Congressional intent. The Taxpayer Advocate refers to mental health parity legislation passed in 2008 which generally requires parity from heath insurance plans that offer medical/surgical benefits as well as mental health/substance abuse benefits. Such plans are specifically now required to provide parity in treatment limitations and financial requirements.[5]

In other words, there should be no discrimination or distinction between physical and mental. Olson argues that this recent expression of Congressional intent recognizes the equal status of physical and mental illness. Plainly, she says, that conflicts with the 1996 version of Section 104.

Proving Sickness

Axiomatically, sometimes things are exactly what you call them. This is often proven true concerning the tax treatment of settlement payments. Optimally, you want a clear statement in the settlement agreement as to *why* the payment is being made.[6] The IRS and the courts are not bound by such language, or by any tax characterization included, but they do consider it.[7]

Thus, you may want not only to say *why* the payment is being made, but to go on to say something about the tax treatment of the item. That is particularly true if you will assert it is tax-free under Section 104. On the latter point, you may want to specifically negate the issue of a Form 1099. After all, if a payment is truly excludable under Section 104, it should not be subject to a Form 1099 reporting.[8] At a minimum, however, you certainly want to identify the nature of the payment.

Of course, merely reciting the nature of a payment does not make the recitation accurate. Such a recitation also does not foreclose the IRS (or another agency) from going behind the language of the settlement agreement to investigate further. Yet it is nearly always a starting point.[9] Sometimes it is the ending point too.[10] In the vast majority of cases, in all types of litigation, therefore, you should try to agree on such language.

Much litigation involves not one claim, but many. There may be multiple payments made to resolve multiple claims. That is why it is often appropriate (and sometimes downright necessary) to allocate a gross settlement payment among multiple claims, sprinkling dollar amounts among several categories. Armed with the facts, the discovery responses and pleadings, it is normally possible to develop a range of alternatives for such an allocation.

Optimally, this is done prior to (or as a part of) settlement negotiations. Sometimes I've had to do it after a settlement, and sometimes at tax time the year after the settlement. There can still be principled ways to allocate a recovery after the fact, but it is always better to do so before the settlement is finalized.

Recognizing Sickness

The recent Tax Court decision in *Julie Leigh Domeny v. Commissioner*[11] is an important new case helping to expand and clarify the scope of the Section 104 exclusion. Like most Section 104 cases these days, *Domeny* arose out of an employment dispute. Domeny commenced working for Pacific Autism Center for Education (PACE) in 2000. Four years before that, she was diagnosed with multiple sclerosis (MS).

At the onset of her MS, she had a variety of physical problems, including numbness, fatigue, light-headedness, vertigo, and sometimes a burning sensation behind her eyes. Due to side effects from the prescribed treatment, she chose to manage her symptoms without medications. In fact, one reason she took the job with PACE post-diagnosis was that her position there offered her the chance to work in an environment where she would not spend much time on her feet.

Her work involved community development, fundraising, and writing grants, and she felt a certain symbiosis between autism and her own MS. But in 2004, and under PACE's new executive director, Domeny experienced a variety of workplace problems. They caused her MS symptoms to flare up. Then in November of 2004, she learned that the director of PACE was embezzling funds from the personal accounts of PACE students.

Domeny complained to PACE's board and was assured they would handle it. Understandably, through, she felt tension and worry as the weeks wore on. It was upsetting to be raising funds for PACE knowing that those funds were being embezzled.

Over the next few months, Domeny advised her superiors of the unhealthy work environment on several occasions. She noted her continuing stress over the embezzlement and over the organization's failure to act. She continued to have elevated stress and experienced an intensification of her MS symptoms.

Finally, on March 8, 2005, she visited her primary care physician. He determined she was too ill to work because of her MS symptoms, and that she should not return until after March 21, 2005. Her symptoms at that point included vertigo, shooting pain in both legs, difficulty walking due to numbness in both feet, a burning sensation behind her eyes, and extreme fatigue.

Domeny's physician notified PACE of his diagnosis by facsimile on March 8, 2005, giving instructions that she should stay home until at least March 21, 2005. PACE's executive director called Domeny immediately thereafter, and he terminated her as of March 15, 2005. After that call, Domeny's physical MS symptoms started "spiking," including shooting pain up her legs, fatigue, burning eyes, spinning head, vertigo, and lightheadedness.

Domeny contacted a lawyer about her discharge, and her lawyer was able to negotiate a settlement without filing suit. The settlement agreement was entitled "Severance Agreement and Release of Claims," and noted that she had various potential causes of action or legal rights. The catalog of these legal rights included claims for termination of employment; rights under the California Fair Employment and Housing Act; rights under the Civil Rights Act of 1964, the Americans with Disabilities Act, the Age Discrimination in Employment Act, the Family and Medical Leave Act or the California Family Rights Act, the Fair Labor Standards Act, the California Labor Code or California Wage Orders, and any claims for breach of contract, breach of the covenant of good faith and fair dealing, invasion of privacy, infliction of emotional distress, defamation, and misrepresentation.

The settlement agreement awarded a total of $33,308, and specified the following categories:

- $8,187.50 as compensation to Domeny, that would be reported as compensation (but paid to her lawyer);
- A second $8,187.50, also paid to her attorney; and
- $16,933 (paid directly to Domeny).

Domeny did not attend the negotiations between PACE's lawyer and her own lawyer. When she received her $16,933 settlement, she understood it was to compensate her for physical injuries that occurred in a hostile work environment which PACE allowed to exist over an extended period. Domeny's intense MS symptoms continued to prevent her from working until sometime in 2006.

<u>Connecting the Dots</u>

Domeny reported the first $8,187.50 as compensation income, and reported and deducted the legal fees. She excluded the $16,933 from income. The sole question in the case was whether the $16,933 settlement was excludable under Section 104.

The Tax Court found it clear that Domeny's exposure to a hostile and stressful work environment had exacerbated her MS symptoms. In fact, it reached a point where she was unable to work. Her doctor confirmed it. Domeny had notified her employer of her condition, and a short time later, she was fired.

She then met with a lawyer, and the lawyer and PACE's lawyer worked out a settlement. The settlement agreement contained a blanket release of all claims, and the payments were divided up. However, there was no specific or express statement of the payor's intent in making the payments. Did PACE intend to pay Domeny for physical sickness?

Despite an express statement on this point, Judge Gerber of the Tax Court said an inference could be drawn from the terms of the settlement agreement. Indeed, the manner in which PACE agreed to pay out the settlement revealed a recognition of Domeny's claim and condition. The $33,308 settlement was segregated into three distinct payments.

One payment of $8,187.50 was reflected as employee compensation due to Domeny, which PACE agreed to pay directly to her attorney. Domeny reported that exact amount as wage compensation on her 2005 federal income tax return.

A second $8,187.50 was also sent directly to her attorney, and PACE issued no Form 1099 or Form W-2 was issued to Domeny for that amount. The remaining $16,933 was paid to Domeny directly, with no withholding. However, PACE did issue a Form 1099-MISC reflecting this payment as "non-employee compensation."

Tax Reporting Inferences

Judge Gerber found that the differing tax and reporting treatments of these three payments demonstrated that PACE was aware that at least part of her recovery may not have been subject to tax due to physical illness. Coupled with that inference, the Tax Court was influenced by the fact that Domeny had advised PACE of her illness *before* her employment was terminated. Judge Gerber also found it likely that her attorney represented her circumstances to PACE in the course of settlement negotiations.

In short, it appeared that PACE must have taken her physical sickness into account. Indeed, Domeny had made no other claim. To the Tax Court, that meant it was reasonable to believe that PACE intended to compensate Domeny for her acute physical illness caused by her hostile and stressful work environment. To the Tax Court, this taxpayer demonstrated that her work environment exacerbated her existing physical illness.

There's been much talk of causation in tax cases, and yet this case was about PACE making Domeny's health worse, not making it bad to begin with. Yet in a footnote, the court noted that: "it is of no consequence that Petitioner had the MS condition before the flare-up caused by her hostile work environment."[12] Judge Gerber was satisfied that the *only* reason Domeny received the $16,933 payment was to compensate her for her physical injuries as manifested in her physical illness.

This may be a mere question of semantics, but Judge Gerber appears to have concluded that the payment was for "physical illness" which is a physical injury within the meaning of Section 104(a)(2). Surely it is a very small step to conclude that, in fact, the taxpayer's payment was made on account of her physical sickness, which would be no less excludable under Section 104(a)(2).

More Cases

It may be difficult for clients to see the forest for the trees. It is also difficult to examine one's own circumstances dispassionately. There are, after all, many other tax cases in which Section 104 has been examined in the context of employment claims. In some of these, there are some pretty significant physical events or physical consequences befalling plaintiffs.

Yet in most Section 104 cases, it is difficult for plaintiffs to convince the IRS or the Tax Court that they were paid on account of personal physical injuries or personal physical sickness.

Take *Justin W. Hansen v. Commissioner*.[13] Hansen was a mineworker who was assaulted by his supervisor.

Hansen's supervisor threw him to the ground and pushed his face into limestone powder. Later, the supervisor came to Hansen's home and assaulted him there too, bruising him and producing a small cut on Hansen's foot. Hansen called the police, and filed a complaint with the Mine Safety and Health Administration. A few days later, Martin Marietta, which operated the mine, fired him.

Hansen went to a lawyer. When he received a settlement of $120,000, you might think Hansen had a pretty good case that some (or all) of it should be excludable under Section 104. The settlement agreement allocated $20,000 to back wages (on a Form W-2) and the other $100,000 to "emotional distress and attorneys' fees." Hansen didn't report the $100,000 and landed in Tax Court.

Despite having some pretty good physical facts, the Tax Court (Judge Chiechi) had an easy time concluding that this payment was for "emotional distress and legal fees" just as the settlement agreement said it was. The Tax Court even noted that Martin Marietta had issued a Form 1099-MISC for the $100,000, further confirming (in the Tax Court's eyes) that the payor viewed the payment as taxable. (Judge Chiechi's observation on the Form 1099 stands in contrast to Judge Gerber's in *Domeny*.)

Physical Effects?

In many tax cases involving Section 104, there is little or no physical injury, no assault and no bruising. It often looks as if a taxpayer who is claiming some kind of sickness is really just claiming emotional distress. Consider *Jon E. Hellesen v. Commissioner.*[14] Mr. and Mrs. Hellesen were both State Farm employees and both were fired.

Both claimed they suffered extreme and severe emotional distress, including lack of concentration, loss of self-esteem, embarrassment, anxiety, humiliation, and stress. Mr. Hellesen also claimed physical problems as a result of his termination. They included escalations in chest pain and aching pain and loss of sensitivity on the right side of his forehead, increased blood pressure, weight loss, upset stomach, irregular bowel movement, headaches, and emotional instability. He had one appointment each with two different physicians, but did not provide a diagnosis or even proof of medical expense.

Judge Vasquez of the Tax Court methodically reviewed the catalog of events and conditions, and clearly did not think too much was going on that was too serious. Yet Judge Vasquez seems to hang his hat primarily on the settlement agreement itself, noting that the settlement agreement did not allocate any portion of the amount among these claims. Furthermore, Judge Vasquez noted, physical injuries or sickness were not even alleged in the complaint. Not surprisingly, the Tax Court found Section 104 inapplicable.

In *Marion J. Wells*,[15] the court considered the aftermath of an employment dispute over alleged gender discrimination. The taxpayer claimed that the discrimination led to her depression. However, the settlement agreement had ascribed the payment to "emotional distress due to depression." The settlement agreement specified that a Form 1099 would be issued, and it was. The Tax Court (Chief Special Trial Judge Panuthos) had an easy time concluding (on the government's motion for summary judgment) that there was no material issue of fact, and that this payment simply was not excludable.

In *Emblez Longoria v. Commissioner*,[16] a New Jersey State trooper claimed racial discrimination and physical injuries. Longoria faced several physical incidents, including being forced to inhale noxious chemical agents during a training exercise that he said caused burning in his lungs. He was also singled out for extra laps of the swimming pool which he claimed sickened him.

More seriously, Longoria's requests for backup to help with a suspect were ignored. As a result, he injured his back when a suspect resisted arrest. Finally, at one point, other troopers piled gear in his locker. Longoria claimed he was injured when he opened the locker, dislodging its contents.

What about Longoria's settlement agreement? It was woefully plain, releasing everything but providing no tax allocation. He was paid a lump sum of $156,667 and received a Form 1099. Trying to exclude the payment, he landed in Tax Court.

The Tax Court opinion is well-reasoned and thorough, and seems to reflect some misgivings. Judge Gustafson notes that Longoria clearly experienced various physical incidents. He even had some physical injuries. The problem was that none of these injuries was alleged in his complaint.

The court simply found that it could not agree that the State of New Jersey had agreed to settle *because* of any of these physical claims. Given that Longoria had the burden to prove what damages were paid on account of physical injuries or physical sickness, the court felt compelled to treat the entire amount as taxable.

<u>Cause and Effect</u>

The Tax Court's Judge Gerber (who decided the *Domeny* case) came out differently in *Paul J. and Allen C. Prinster v. Commissioner.*[17] Paul Prinster was fired and suffered mental distress. He claimed that his hypertension, hyperlipidemia, and other ailments were caused by his mental distress. He received a $76,500 settlement and despite receiving a Form 1099, claimed it was not income.

Judge Gerber found that Prinster did not sufficiently show that his ailments resulted from his termination. In fact, Judge Gerber commented that the record showed he had *already* been suffering from hyperlipidemia, and that any other symptoms could have been the product of his diet and lifestyle. He simply failed to carry his burden of proof. The settlement was therefore taxable.

Prinster is a nice contrast with *Domeny*. Judge Gerber discerns the former to be an employment dispute, not unlike the kinds of disputes that often produce emotional distress and even physical ailments. But there was a fundamental lack of follow through, from complaint to diagnosis.

In contrast, *Domeny* involved patently serious illness and demonstrable causation. True, PACE did not *cause* the MS, but it clearly exacerbated it. PACE's actions clearly caused the uptick in Domeny's symptoms. Moreover, they were not symptoms of emotional distress; they were symptoms of physical illness that were substantial enough to constitute a physical injury.

It was Judge Goeke who reached the "no exclusion" holding in *Hartford and Josephine Shelton v. Commissioner*.[18] Shelton had been employed by Dial Corp. and suffered sexual harassment. As a result of the harassment, she developed severe emotional problems and sought medical help.

She took anti-depressants and other medication. She filed a claim with the EEOC, and eventually signed a release under which she received $123,500. She was issued a Form 1099 for the entire amount, but claimed it was all excludable under Section 104.

Judge Goeke had an easy time with this one. He concluded that although Shelton may have suffered physical injury as a result of her sexual harassment, her settlement payment was not excludable. (Interestingly, Judge Goeke refers to it as physical injury, not physical sickness.) The settlement agreement itself said that the money was for emotional pain, suffering, inconvenience, and mental anguish. Physical injury was not mentioned.

<u>Is it Soup Yet?</u>

We all like bright lines. For this reason, the "observable bodily harm" standard developed by the IRS in the wake of the 1996 statutory change is understandable. It may even be a convenient line. Yet it has not worked very well, and it is unjust.

Anyone wanting to argue the administrative efficiency of the bright line "observable bodily harm" standard may want to review the Tax Court's collected cases over the last few years.[19] For that matter, you could even look at the court's current docket. As the Taxpayer Advocate has pointed out, there are a huge number of these Section 104 cases. That can't be efficient. The Tax Court judges have to deal with these cases. They are very repetitive, seem to put the court in a no-win position, and must be frustrating to handle.

Yet most Americans have an excuse for continuing to litigate the murky scope of the exclusion provided by Section 104. Perhaps dedicated tax professionals may be chargeable with the knowledge that the Service expects observable bodily harm for an exclusion. However, most people still don't know this. It is not even easy to articulate what is and isn't excludable, even if you read all that the Service and the Tax Court issues.

On that topic, the Service hasn't exactly done a great job with its regulations. The Section 104 regulations were unchanged from 1970 (long before the 1996 statutory change) to 2009. Finally in 2009, proposed regulations were issued.[20] Yet even after this hiatus of 13 years after the 1996 sea change, the 2009 regulatory iteration failed to include *any* information about what *physical* means, about what physical *sickness* means, or about the causal link that needs to be shown. That is a shame.

Of course, the Service has issued many private letter rulings. One of the most notable is the bruise ruling, Letter Ruling 200041002.[21] There, the Service lays down its (arguably) sensible approach to bifurcating damages in a serious sexual assault and harassment case arising in the employment context. Yet neither that ruling nor any since has discussed the tougher case, where physical sickness is arguably caused by or exacerbated by the defendant. (The *Domeny* case is clearly correct, and I hope the IRS embraces it.)

I say "arguably" in the preceding paragraph because in most litigation there is a settlement, not a judgment. Rarely is there a judicial finding that the defendant *actually caused* the harm. It may be quite clear that the plaintiff *says* so and that the defendant denies it. Yet if most cases settle (which they do), it follows that in most cases there is no definitive causal finding of who did what to whom.

The settlement agreement (even one that is properly specific as to the nature of the payment and its character for tax purposes), will usually be clear that the defendant is not admitting anything. One can read the situation as involving a defendant willing to pay something for fear that it *will* be found to have caused it. That ought to be all the causation one needs.

The Service has (appropriately) presumed observable bodily harm in some circumstances, but that alone does not fix the problem. Indeed, as laudable as the Service was in Chief Counsel Advice 200809001[22] (presuming observable bodily harm in a sex abuse case at least on particular facts), it doesn't say anything about physical sickness.

Just what is physical sickness, anyway? Is it physical illness? Is it physical illness giving rise to physical injury? Should the semantics matter?

Of course, the statute is quite clear that it excludes from income damages paid on account of physical injuries *or* physical sickness. Judge Gerber seems right to use the preferred nomenclature, finding that the $16,933 payment to Domeny "was to compensate her for her physical injuries." Yet through much of the opinion, he uses the term "physical illness," presumably a synonym for physical sickness.

Most of the tax cases that have expressly raised the physical sickness wing of Section 104 have been lackluster. In contrast, *Domeny* is a bell ringer. Excluding the payment, Judge Gerber says that the taxpayer "has shown that her work environment exacerbated her existing physical illness." Despite the lack of specific wording in the settlement agreement, that, he ruled, was the reason for the defendant's payment.

Conclusion

Judge Gerber's decision in *Domeny* is an important and laudable one. The facts presented in the case have the ring of truth, and Judge Gerber's reasoning and conclusions are surely correct. As Taxpayer Advocate Nina Olsen points out, we seem to be learning more all the time about the nexus between physical and mental, between action and illness.

Of course, there may be some taxpayers who will claim they were "made sick" and who may exaggerate such claims. However, that is not a reason to deny the righteous the appropriate tax treatment for their recoveries.

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available at www.taxinstitute.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

[2] See National Taxpayer Advocate, 2009 Annual Report To Congress, Dec. 31, 2009, p. 351 *et seq*., Doc 2010-174 or 2010 TNT 4-19.

[3] See *id.* at 352.

[4] See National Institutes of Health (NIH), The Science of Mental Illness, available at http://science.education.nih.gov/supplements/nih5/mental/guide/info-mental-b.htm; Nancy C. Andreasen, The Broken Brain: The Biological Revolution in Psychiatry 277 (1984).

[5] See Pub. Law No. 110-343, Div. C, §§ 511-512, 122 Stat. 3765, 3881 (2008).

[6] See *Pipitone v. U.S.*, 180 F.3d 859, 863 (7th Cir. 1999).

[7] Se, *e.g. Taggi v. U.S*., 835 F. Supp. 744 (S.D.N.Y. 1993), *aff'd*, 35 F.3d 93 (2d Cir. 1994); *see also Robinson v. Comm'r*, 102 T.C. 116 (1994), *aff'd in part, rev'd in part on other grounds*, 70 F.3d 34 (5th Cir. 1995*); Bradley v. Comm'r*, T.C. Memo 2005-223, *aff'd by unpublished op*., 209 Fed. Appx. 40 (2d Cir. 2006).

[8] See Form 1099-MISC instructions.

[9] See Wood, Tax Treatment of Settlements and Judgments, Vol. 103, No. 9, Tax Notes (May 31, 2004), p. 1134.

[10] See *McKay v. Comm'r*, 102 T.C. 396 (1995), vacated on other grounds, 84 F.3d 433 (5th Cir. 1996); and *Threlkeld v. Comm'r*, 87 T.C. 1294 (1986).

[11] T.C. Memo 6975-08 (Jan. 13, 2010).

[12] See Tax Court Op., at n. 7.

[13] T.C. Memo 2009-87, Doc. 2009-9580, 2009 TNT 80-9.

[14] T.C. Memo 2009-143, Doc. 2009-13919, 2009 TNT 116-9.

[15] T.C. Memo 2010-5 (2010).

[16] T.C. Memo 2009-162, Doc. 2009-15184, 2009 TNT 126-16.

[17] T.C. Sum. Op. 2009-99, Doc. 2009-14983, 2009 TNT 124-47.

[18] T.C. Memo 2009-116, Doc. 2009-11892, 2009 TNT 99-7.

[19] See Wood, Post-1996 Section 104 Cases: Where Are We Eight Years Later?, Tax Notes (Oct. 4, 2004) p. 68.

[20] See REG-127270-06; 2009-42 IRB 534; Doc 2009-20411 or 2009 TNT 176-6.

[21] July 17, 2000.

[22] Nov. 27, 2007.

State Bar of Texas
Section of Taxation State and Local Tax Committee's Comments Concerning the Texas Comptroller's Draft Rule 3.582 as published in the Texas Register, October 30, 2009

Matthew Larsen
Baker Botts

COMMENTS CONCERNING THE TEXAS COMPTROLLER'S DRAFT RULE 3.582 AS PUBLISHED IN THE TEXAS REGISTER ON OCTOBER 30, 2009

The State and Local Tax Committee of the Section of Taxation submitted the attached set of comments to the Comptroller's proposed margin tax rule 3.582(e), recommending the deletion of language which would have called into question the continuing practical viability of the passive entity exemption - it provided that income identified by the Tax Code as passive could nonetheless fail to be passive if it arose out of a taxpayer's "operations," and it also suggested that an entity's otherwise passive income from a subsidiary might not be passive if the subsidiary were controlled by the entity or an affiliate. The Comptroller recently published a final version of the rule which excluded all of the language that the Committee recommended be deleted, and cited the Committee's comments in the rule preamble explaining the decision to strike the language.

The final rule also deletes a proposed rule provision characterizing distributive income from a partnership as non-passive to the extent the distributive income consisted of rent earned by the partnership. The Committee commented on this provision in November 2008, following which the Comptroller deferred implementing the provision for one year. The Committee reiterated its objection to the provision in its most recent comments.

A review of the Committee's comments may prove helpful to practitioners working with the passive entity exemption, because the Comptroller's final rule and preamble indicates a tacit agreement with the thrust of the Committee's analysis.

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, Alyson Outenreath, and by the Chair of the Committee, Matthew Larsen. The comments were reviewed and substantive contributions were made by Ira Lipstet, another of the Committee's Vice Chairs, as well as by David Colmenero and Geoffrey Polma. The comments were also reviewed and approved by Daniel Baucum as Chair and Cynthia Ohlenforst as reviewer for the Section's Committee on Government Submissions, and by the Chair of the Section, Tyree Collier.

Although many of the members of the Section 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 members (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. INTRODUCTION

Our comments are in response to certain proposed changes to Comptroller Rule 3.582(e) as published in the Texas Register on October 30, 2009 ("Proposed Rule 3.582(e)"). As discussed below, we believe that certain elements of Proposed Rule 3.582(e) appear to be inconsistent with a proper construction of the Texas Tax Code and desirable tax policy, and, if implemented, should not be enforced retroactively.

II. PROPOSED RULE 3.582(e)

On October 30, 2009, the Comptroller's Office published in the Texas Register the following proposed changes to Comptroller Rule 3.582(e) concerning passive entities (changes underlined):

> (e) Conducting an active trade or business. To be considered a passive entity, an entity may not receive more than 10% of its federal gross income for the period on which margin is based from conducting an active trade or business. Income described by subsection (c)(2) of this section, may not be treated as income from conducting an active trade or business, <u>if the income is not part of the receiving entity's operations and is merely an investment. If the investment is in another entity, the investing entity or an affiliated entity or individual, may not control the investee. For example, if a partnership buys bonds issued by an entity, interest income from the bonds would be considered passive income. However, if a partnership is in the business of making loans, interest income from the loans would not be considered passive income</u>.

III. COMMENTS TO PROPOSED CHANGES

A. The language "if the income is not part of the receiving entity's operations and is merely an investment" and the related example should be removed.

The issue addressed in this Section III.A specifically concerns the addition of the language "if the income is not part of the receiving entity's operations and is merely an investment" and the related example comprising the last two sentences of Proposed Rule 3.582(e) (collectively referred to herein as the **"Operational Language"**).

As discussed below, we believe the addition of the Operational Language to Comptroller Rule 3.582(e) appears contrary to the plain reading of the relevant statutory provisions, resulting in an interpretation that is contrary to an entire section of the Texas Tax Code (**"TTC"**)[1] – namely TTC § 171.0003(a-1). Such a result would seem to go beyond the rulemaking authority of the Comptroller's Office, as administrative rules cannot conflict with the applicable underlying statutory provisions. Also, the Operational Language does not appear to be supported by legislative intent.

1. Statutory Language

TTC § 171.0003, "Definition of a Passive Entity," reads as follows:

(a) An entity is a passive entity only if:

(1) the entity is a general or limited partnership or a trust, other than a business trust;

(2) during the period on which margin is based, the entity's federal gross income consists of at least 90 percent of the following income:

(A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company;

(B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;

(C) capita1 gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities; and

(D) royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and

(3) the entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.

(a-1) In making the computation under Subsection (a)(3), income described by Subsection (a)(2) may not be treated as income from conducting an active trade or business.

2. Statute is Unambiguously Written

a. Statutory construction principles support a conclusion that the Operational Language is inconsistent with TTC §§ 171.0003(a)(2) and 171.0003(a-1)

TTC §171.0003 excludes "a passive entity" from the definition of "taxable entity." In order to qualify as passive under TTC §171.0003, an entity must be formed as a general partnership, a limited partnership, a limited liability partnership or a non-business trust. The entity must also derive at least 90% of its federal gross income for the period on which margin would be based from those certain enumerated passive sources listed in TTC §171.0003(a)(2). Less than 10% of the entity's federal gross income may be derived from the conduct of an "active trade or business." Under TTC §171.0003(a-1), income that falls into one of the passive categories described by TTC §171.0003(a)(2) may not be treated as derived from an active trade or business. Accordingly, if income is described by TTC §171.0003(a)(2), the plain face of TTC § 171.0003(a-1) mandates that such income is passive income regardless of whether it is also capable of characterization as active income.

As currently in effect, Comptroller Rule 3.582(e) mirrors the above TTC statutory provisions. The text of Comptroller Rule 3.582(e) currently provides:

> (e) Conducting an active trade or business. To be considered a passive entity, an entity may not receive more than 10% of its federal gross income for the period on which margin is based from conducting an active trade or business. Income described by subsection (c)(2) of this section, may not be treated as income from conducting an active trade or business.

The only function of TTC § 171.0003(a-1) is to provide that an item of income otherwise categorized as passive income pursuant to TTC § 171.0003(a)(2) cannot be deemed active income. The Operational Language would require a result different from the result mandated by TTC § 171.0003(a-1). If income otherwise falling into a category of passive income as provided for in TTC § 171.0003(a)(2) must also be tested by the "investment" versus "operational" requirement set out in the Operational Language, then income enumerated as passive under § TTC 171.0003(a)(2) could not be *per se* passive income. This *per se* characterization of income enumerated as passive by TTC §171.0003(a)(2) as non-active income is the sole function of TTC § 171.0003(a-1). Therefore, the addition of the Operational Language to Comptroller Rule 3.582(e) would contravene TTC § 171.0003(a-1). .

A maxim of statutory construction is that each provision of a statute must be construed in the context of the entire statute of which it is a part.[2] TTC §171.0003(a)(2) gives effect to the mandate of TTC §171.0003(a-1). As discussed above, the latter provision specifies that an item of income otherwise categorized as passive income pursuant to TTC §171.0003(a)(2) cannot be deemed active income. Also, as discussed above, there is nothing in the statute that changes this result, regardless of whether such income enumerated as passive in TTC § 171.0003(a)(2) is also capable of characterization as active income. The addition of the Operational Language therefore appears to result in the provisions of TTC § 171.0003 not being construed in the context of the entire statute.

Although it is a maxim of statutory construction that statutes should not be interpreted in a manner "that will render the statute meaningless,"[3] it is an even more important maxim of statutory construction that statutes may not be interpreted in a manner that contradicts the statutory language. Thus, while we understand that the Operational Language may have been drafted to give additional meaning to the 10% active trade or business language of TTC §§ 171.0003(a)(3) and 171.0004, the Operational Language t accomplishes this at the significant cost of directly contradicting TTC § 171.0003(a-1).

Moreover, it is possible to find meaning in the 10% active trade or business requirement using a less problematic interpretation. Under one reasonable alternative interpretation, TTC §§ 171.0003(a)(3) and 171.0004 are meaningful because there are scenarios in which an entity could meet the 90% test but fail the 10% active trade or business test even if TTC § 171.0003(a-1)'s directive that passive income cannot be active income is followed. One such scenario is made possible because distributive losses are excluded from passive income under TTC § 171.0003(a)(2)(B) but are taken into account in calculating federal gross income. For example, assume a partnership has $100 of federal gross income, consisting of $90 of passive interest income, a $10 partnership distributive loss, and $20 in active income. In this situation, the 90% test is passed because passive income equals 90% of federal gross income ($90 interest income/ $100 federal gross income). However, the 10% test is failed because the trade or business income equals 20% of gross income ($20 active income/ $100 federal gross income).

Another reasonable view is that TTC § 171.0003(a)(3) and TTC § 171.0004 are simply an attempt to provide examples of non-passive items - income from royalties, patents, trademarks, and other intangible assets held by an entity that are used in the active trade or business of one or more related entities (TTC § 171.0004(d)) - as an illustrative contrast to the passive income items enumerated by TTC § 171.0003(a)(2). For example, it t is not uncommon for statutes to offer examples of what does not fall within an exemption, even though listing examples of non-exempt items is arguably surplusage if the exempt items are clearly delineated.

In light of these points, it would not seem reasonable to argue that the Operational Language must be implemented as a necessary solution to a statutory construction problem. While reasonable minds may differ as to how impactful the active trade or business requirement is under the statute, , a reading of the active trade or business requirements that is consistent with the remainder of the statutory provisions regarding passive entities is preferable to the Comptroller's proposed interpretation which arguably gives greater meaning to TTC §§ 171.0003(a)(3) and 171.0004 but which wholly ignores TTC § 171.0003(a-1).

Although the Comptroller has the authority to adopt administrative rules, such rule-making authority is limited by the requirement that the rules adopted cannot ". . . conflict with the law of this state or the constitution of the state or the United States."[4] Texas courts have stated that the determining factor in determining whether an administrative agency has exceeded its rule-making authority is "that the rule's provision's must be in harmony with the general objectives of the Act involved."[5] A court may give weight to the construction placed upon the statute by the agency charged with its administration, but only if the "construction is reasonable and does not contradict the plain language of the statute."[6] As discussed above, statutory construction principles indicate that the Operational Language is inconsistent with 171.0003(a-1) in its entirety. Accordingly, we believe the Operational Language goes beyond the Comptroller's rule-making authority.

b. Legislative history and the doctrine of legislative acceptance do not appear to support addition of the Operational Language to Comptroller Rule 3.582(e)

We are unable to locate any legislative history indicating that the Legislature intended to qualify TTC § 171.0003(a-1) with the Operational Language. We believe if the Legislature had intended for TTC § 171.0003(a-1) to be qualified in any way it would have specified that qualification directly. Indeed, the Legislature displayed great specificity in another instance in which it intended otherwise passive income to be treated as active income. The Legislature specifically included in the definition of "passive income" federal gross income from "royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests."[7] However, the Legislature further specified in the TTC that this type of income should not be treated as passive income where it was "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."[8] Because the Legislature has explicitly defined a situation in which income falling within a general passive income category should be treated as active income, absent a similarly explicit statutory provision, it does not seem likely that the Legislature intended to recharacterize items falling within any category of passive income as active income in other situations.[9]

We believe the Legislature would have used this similar level of specificity if it had intended for TTC § 171.0003(a-1) to be qualified. As discussed above, TTC § 171.0003(a-1) is clear on its face. Moreover, the 10% active trade or business requirement in TTC § 171.0003(a)(3) has clear application on its own standing without the addition of the Operational Language to Comptroller Rule 3.582(e). Accordingly, effectively adding the Operational Language to TTC § 171.0003(a-1) via a Comptroller Rule when such is neither supported by the underlying statute nor legislative intent is an interpretation that is apt to invite controversy. If the Legislature had intended a consequent of such significance, we believe it would have clearly stated so.

In addition, we believe the doctrine of legislative acceptance shows that the Operational Language is not supported by the Legislature's intent. Texas courts have long held that, if an ambiguous statute is construed by an administrative officer and re-enacted without substantial change, the Legislature is presumed to have been familiar with that construction and adopted it. See *Tex. Dept. of Prot. Serv. v. Mega Child Care, Inc.*, 145 S.W.3d 170, 176 (Tex. 2004); *Humble v. Calvert*, 414 S.W.2d 172 (Tex. 1967). Current Comptroller Rule 3.582 was adopted effective January 1, 2008, and includes no reference to the Operational Language. Subsequently, the 2009 Legislature amended the franchise tax code without making any statutory changes along the lines of the Operational Language. Under the doctrine of legislative acceptance, the Legislature is therefore presumed to have adopted the construction of current Comptroller Rule 3.582 without the Operational Language.

c. The Operational Language may not be desirable tax policy because it will be complicated and difficult to administer

Although the concept behind the Operational Language may seem simple on an initial reading, it may prove difficult to implement. Proposed Rule 3.582(e) does not define the term "operations" or provide guidance for determining whether an item of income is "part of" these operations. The term "operations" might potentially be defined quite broadly, such that it swallows up almost all of a potentially passive entity's activities. For example, would an investment fund be considered to be "in the business" of generating income from investments, such that its otherwise passive income from these investments would be considered income from "operations?" Would a holder of a portfolio of nonoperating mineral interests be disqualified as a passive entity because it is "in the business" of holding these assets? Would principles analogous to the ordinary income/capital gain principles in the federal tax arena be applied? The proposed language could (arguably) treat any sort of capital gain income as not being passive – which would be clearly inconsistent with the nature of transactions giving rise to such income. The type of regulatory framework that would be required to properly develop this approach goes considerably beyond the statute and the current rules. It is likely that legislature intended to avoid this very problem by drawing a bright line with § 171.0003(a-1).

B. The language "if the investment is in another entity, the investing entity or an affiliated entity or individual, may not control the investee" should be removed

The issue addressed in this Section III.B. specifically concerns the addition of language to Comptroller Rule 3.582(e) providing that income otherwise passive under TTC § 171.0003(a)(2) is recharacterized as active income under the following circumstance: "If the investment is in another entity, the investing entity or an affiliated entity or individual, may not control the investee" (referred to herein as the **"Investee Language"**).

As an initial matter, the meaning of the Investee Language is unclear. One potential reading is that the Investee Language is simply an extension of the Comptroller's current rule regarding the qualification of income from sales of securities as passive income - i.e., that an interest in an entity can be a "security" for this purpose only if the owner has a non-controlling interest in the entity. *See* Comptroller Rule 3.582(b)(10). In other words, the Investee Language may be intended to apply solely to income from the sale of an interest in a controlled investee. Although (as reflected in previous comments by the Committee) we disagree with the definition of "security" in Rule 3.582(b)(1), if the Investee Language applies solely to income from the sale of an interest in a controlled investee, we suggest that the Investee Language be amended to make this clear.

An alternative reading - which would be a significant departure from the current rules - is that any income from a controlled investee, including dividend or distributive income, cannot be passive.

For the identical reasons discussed above relating to the Operational Language, we believe the addition of the Investee Language to Comptroller Rule 3.582(e) goes against maxims of statutory construction, is beyond the rule-making authority of the Comptroller, and is not supported by legislative intent.[10] These concerns apply to each of the above alternative readings of the Investee Language; however, they are significantly amplified if the second alternative interpretation is adopted. The second interpretation would seem to destabilize one of the main objectives of the passive entity provisions: the creation of a mechanism to simplify franchise tax reporting and payment for entities whose primary objective is to hold and manage interests in other entities.

Consider, for example, one of the ways in which the Investee Language seems to create an undesirable outcome from a tax policy perspective. Assume a limited partnership owns two pieces of appreciated real estate. If the limited partnership were to sell the real estate, all income generated from both pieces of real estate will constitute capital gain income and no rental income will be generated. Now assume the limited partnership segregates the real estate into two lower-tier partnerships for liability protection purposes. Under the Investee Language, the parent partnership will be receiving non-passive income because it controls the investees, and is therefore not a passive entity. The parent partnership would have to pay tax on its distributive share of gain from the real estate because the two lower-tier partnerships are passive entities and the parent partnership's total revenue would include its distributive shares of income from the two lower-tier partnerships. The Investee Language would punish this common and legally advisable business structure by causing the loss of the passive entity characterization. We fail to understand the Comptroller's rationale for penalizing a taxpayer for using it. As illustrated by the above example, we believe the Investee Language would lead to undesirable tax policy.

C. If adopted, the proposed rule should not be given retroactive effect

If adopted in its current form, the effective date of the Operational Language and the Investee Language would be for reports originally due on or after January 1, 2008. In contrast, with respect to the proposed changes to subsections (c)(2)(B) and (d)(1) relating to rental income (which the Committee believes should be reexamined for the reasons set forth in previous comments), the effective date is for reports originally due on or after January 1, 2010.

When the Comptroller adopts an administrative rule that has retroactive effect, a reviewing court "must also determine whether application of the new policy to a party who relied on the old is so unfair as to be arbitrary and capricious."[11] Case law indicates retroactive application of a new administrative rule would be considered arbitrary and capricious when such new administrative rule is inconsistent with prior agency policy interpretations, case law, and other authorities.[12] As discussed above in Sections II and III, both the Operational Language and the Investee Language are inconsistent with the plain language of the applicable statutory provisions of TTC § 171.0003. There also are no previous Comptroller policy interpretations, case law or other authorities providing taxpayers notice that the Comptroller's Office intended to apply the provisions of TTC § 171.0003 in a way inconsistent with the plain language of the statute. In fact, some taxpayers believe that representatives of the Comptroller's Office have represented to them - albeit informally - that the Comptroller's Office views the active trade or business test as superfluous.

Therefore, we believe retroactive application of both the Operational Language and the Investee Language may be considered so unfair as to be arbitrary and capricious. We understand that the Comptroller's Office implemented the delayed effective date for the rental income language because the Comptroller's Office acknowledged that such new position would have taken taxpayers and practitioners by surprise. It is just as likely - and perhaps more so - that both the Operational Language and the Investee Language will take taxpayers and practitioners by surprise because, as discussed above, both appear inconsistent with the plain language of TTC § 171.0003. As a matter of desirable tax policy, if the Operational Language and/or the Investee Language is adopted, which for the reasons discussed above, we do not believe should be the case, at a minimum, the Comptroller's same rationale for the 2010 effective date concerning the rental language should apply equally to the Operational Language and the Investee Language. In order to give comparable notice as was given with the rental language, the effective date would need to be no earlier than for reports due January 1, 2011 or later. Delaying the effective date until January 1, 2012 may even be justified so as to give the Legislature a chance to review - and determine whether to adopt or overrule - these potentially far-reaching changes to the passive entity provisions.

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.

Subchapter V. FRANCHISE TAX

34 TAC §3.582

The Comptroller of Public Accounts adopts an amendment to §3.582, concerning margin: passive entities, with changes to the proposed text as published in the October 30, 2009, issue of the *Texas Register* (34 TexReg 7557).

The definition of federal gross income in subsection (b)(3) that references Internal Revenue Code, §61(a) is deleted and new language is added to define federal gross income as the income that is reported on an entity's federal income tax return, to the extent the amount reported complies with federal income tax law. The amended definition more accurately reflects our current policy.

Subsection (g) is expanded to clarify the reporting requirements for passive entities. New paragraph (1) is added to clarify that only a passive entity that has notified the comptroller or secretary of state that it is doing business in Texas must file an information report the first year that it qualifies as passive and is not required to file a subsequent report, as long as the entity continues to qualify as passive. New paragraph (2) is added to clarify that a passive entity that has not notified the comptroller or the secretary of state that it is doing business in Texas will not be required to register with or file a franchise tax report with the comptroller's office. New paragraph (3) is added to clarify that any passive entity that no longer qualifies as passive must file a franchise tax report for the period in which the entity does not qualify as passive, and any subsequent periods, until the entity once again files as a passive entity. New paragraph (4) states that an entity that receives notification from the comptroller asking if the entity is taxable must reply to the comptroller within 30 days of the notice.

We received comments from various groups. Following is a summary of the comments received and the responses.

The Texas Society of Certified Public Accountants (TSCPA), Crow Holdings and other practitioners recommended that we withdraw language added to subsection (c)(2)(B) and (d)(1) that did not allow rental income that flows from a partnership to a partner to be considered passive. They stated that the statute on its face provides that net distributive income from a partnership or limited liability company is passive income and the statute does not state any circumstances in which all or part of the net distributive income should retain its character as nonpassive when it flows to the partner. The comptroller has withdrawn the amendment and the related amendment to subsection (a).

The State Bar of Texas, Section of Taxation (SBOT) and the TSCPA recommended that the language added in subsection (e) regarding conducting an active trade or business be withdrawn as the added language contradicts Tax Code, §171.0003(a-1) which designates certain sources of income as passive, regardless of how the income was earned. Although the comptroller believes that the legislature did not intend for income from active operations to be included in passive income, she agreed that the current language of the statute does not provide this differentiation and has withdrawn the amendment and the related amendment to subsection (a).

This amendment is adopted under Tax Code, §111.002, which provides the comptroller with the authority to prescribe, adopt and enforce rules relating to the administration and enforcement of the provisions of Tax Code, Title 2.

The amendment implements Tax Code, §171.0003.

§3.582.Margin: Passive Entities.

(a) Effective Date. The provisions of this section apply to franchise tax reports originally due on or after January 1, 2008.

(b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise:

(1) Active trade or business--For the purposes of this section only:

(A) an entity conducts an active trade or business if the activities include active operations that form a part of the process of earning income or profit, and the entity performs active management and operational functions;

(B) activities performed by the entity include activities performed by persons outside the entity, including independent contractors, to the extent that the persons perform services on behalf of the entity and those services constitute all or part of the entity's trade or business; or

(C) an entity conducts an active trade or business if assets, including royalties, patents, trademarks, and other intangible assets, held by the entity are used in the active trade or business of one or more related entities.

(2) Business trust--An entity as defined by Internal Revenue Code, Treasury Regulation, §301.7701-4(b).

(3) Federal gross income--Income that is reported on the entity's federal income tax return, to the extent the amount reported complies with federal income tax law.

(4) General partnership--A partnership as described in Revised Partnership Act, Article 6132b-1.01 et. seq., or Business Organizations Code, Title 4, Chapter 152, or an equivalent statute in another jurisdiction.

(5) Limited liability partnership--A partnership registered pursuant to Revised Partnership Act, Article 6132b-3.08, or Business Organizations Code, Title 4, Chapters 152 and 153, Subchapter H, or an equivalent statute in another jurisdiction.

(6) Limited partnership--A partnership formed pursuant to Revised Partnership Act, Article 6132a-1, or Business Organizations Code, Title 4, Chapter 153, or an equivalent statute in another jurisdiction.

(7) Net capital gains--Net capital gains as defined under the Internal Revenue Code.

(8) Net gains--Net gains as defined under the Internal Revenue Code.

(9) Non-controlling interest--For the purposes of this section only, an interest that is less than or equal to 50% that is held by an investor, either directly or indirectly, in an investee.

(10) Security--

(A) an instrument defined by Internal Revenue Code, §475(c)(2), where the holder of the instrument has a non-controlling interest in the issuer/investee;

(B) an instrument described by Internal Revenue Code, §475(e)(2)(B), (C), (D);

(C) an interest in a partnership where the investor has a non-controlling interest in the investee;

(D) an interest in a limited liability company where the investor has a non-controlling interest in the investee; or

(E) a beneficial interest in a trust where the investor has a non-controlling interest in the investee.

(c) Qualification as a passive entity:

(1) to qualify as a passive entity, the entity must be one of the following for the entire period on which the tax is based:

(A) general partnership;

(B) limited partnership;

(C) limited liability partnership; or

(D) trust, other than a business trust; and

(2) at least 90% of an entity's federal gross income for the period on which margin is based must consist of the following sources of income:

(A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlements or termination payments with respect to a financial instrument, and income from a limited liability company;

(B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;

(C) net capital gains from the sale of real property, net gains from the sale of commodities traded on a commodities exchange, and net gains from the sale of securities; and

(D) royalties from mineral properties, bonuses from mineral properties, delay rental income from mineral properties and income from other nonoperating mineral interests including nonoperating working interests not described in subsection (d)(2) of this section.

(d) The income described by subsection (c)(2) of this section, does not include:

(1) rent; or

(2) 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.

(e) Conducting an active trade or business. To be considered a passive entity, an entity may not receive more than 10% of its federal gross income for the period on which margin is based from conducting an active trade or business. Income described by subsection (c)(2) of this section, may not be treated as income from conducting an active trade or business.

(f) Activities that do not constitute an active trade or business:

(1) ownership of a royalty interest or a nonoperating working interest in mineral rights;

(2) payment of compensation to employees or independent contractors for financial or legal services reasonably necessary for the operation of the entity; and

(3) holding a seat on the board of directors of an entity does not, by itself, constitute conduct of an active trade or business.

(g) Reporting requirement for a passive entity. If an entity meets all of the qualifications of a passive entity for the reporting period, the entity will owe no tax; however, the entity may be required to file an information report subject to the following paragraphs:

(1) A partnership or trust that is registered with the comptroller's office or with the secretary of state's office must file an information report as a passive entity for the first report that it qualifies as passive. An entity that has filed as passive on a previous report will not be required to file subsequent franchise tax reports, as long as the entity continues to qualify as passive.

(2) A partnership or trust that qualifies as a passive entity for the period upon which the franchise tax report is based, and is not registered with the comptroller's office or with the secretary of state's office, will not be required to register with or file a franchise tax report with the comptroller's office.

(3) Any passive entity, whether or not it is registered with the comptroller's office or with the secretary of state's office, that no longer qualifies as passive, must register with the comptroller's office and file a franchise tax report for the period in which the entity does not qualify as passive, and any subsequent periods, until the entity once again files with the comptroller's office as a passive entity.

(4) If a passive entity receives notification in writing from the comptroller asking if the entity is taxable, the entity must reply to the comptroller within 30 days of the notice.

This agency hereby certifies that the adoption has been reviewed by legal counsel and found to be a valid exercise of the agency's legal authority.

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Comptroller of Public Accounts

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For further information, please call: (512) 475-0387

[1] Hereinafter, all section references are to the TTC unless otherwise provided.
[2] *Continental Cas. Ins. Co.*, 19 S.W.3d at 398.
[3] *Texas Orthopedic Ass'n v. Texas State Bd. Of Podiatric Medical Examiners*, 2008 WL 678526 (Tex. App. – Austin 2008).
[4] *See, e.g.,* Tex. Tax Code § 111.002; Comp. Dec. 43,251 (Oct. 23, 2003).
[5] *See, e.g., Gerst v. Oak Cliff Savings and Loan Ass'n*, 432 S.W. 2d 702 (Tex. 1968); Comp. Dec. 43,251 (Oct. 23, 2003).
[6] *See, e.g., Tarrant Appraisal Dist. v. Moore*, 845 S.W.2d 820, 823 (Tex. 1993); Comp. Dec. 43,251 (Oct. 23, 2003).
[7] Tex. Tax Code §171.0003(a)(3)(D).
[8] Tex. Tax Code §171.0003(b)(2).
[9] The existence of the tiered partnership rules of TTC §171.1015 is additional evidence that the Legislature was capable of great specificity in expressing its intent regarding income earned at the partnership level versus income attributable to its owners.
[10] *See infra* Section II.
[11] *See, e.g., Southwestern Bell Telephone Co. v. Combs*, 978 S.W.2d 638 (1998).
[12] *See id.*

RETURN TO TABLE OF CONTENTS

Sample Conduit Trust Form

Daniel H. McCarthy and Laurel Stephenson
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SAMPLE CONDUIT TRUST FORM

Daniel H. McCarthy
Laurel Stephenson[1]

Individual retirement accounts[2] ("IRAs") can present challenges to attorneys in designing and implementing an estate plan for a client. Set forth below is a brief description of certain issues faced in planning with an IRA which can be addressed through the use of a conduit trust.[3]

Designated Beneficiary Issue

The minimum required distribution rules contained in Code Section 401(a)(9) mandate that a certain amount of the IRA balance be distributed out from the IRA annually to the participant (after his/her "Required Beginning Date," as defined in Code Section 401(a)(9)(C)) or the beneficiary(ies) designated by the participant to receive the IRA at death. The balance of the IRA is permitted to grow in a tax-deferred manner.

The extent of the ability of a successor to an IRA to continue to be able to take advantage of the tax-deferred growth of assets inside the IRA depends upon the identity of the beneficial recipient(s) of the IRA named by the IRA participant. If the named recipient is not a "designated beneficiary" for the minimum distribution requirement purposes set forth in Code Section 401(a)(9)[4], then the balance of the IRA must be distributed out (i) by December 31st of the year in which the 5th anniversary of the participant's death falls or (ii) if the participant had reached his or her "required beginning date" before death, over the participant's remaining actuarial life expectancy as of the participant's death.

Individuals qualify as designated beneficiaries, as do beneficiaries of trusts which meet certain requirements.[5] The inclination of many clients is to opt for simplicity and designate a spouse or children on the beneficiary designation when opening an IRA at a financial institution. However, that may not be advisable for several reasons.

Asset Protection Issue

Texas law provides that "*a person's right to the assets held in . . . any individual retirement account . . . is exempt from attachment, execution, and seizure for the satisfaction of debts unless the plan, contract, or account does not qualify under the applicable provisions of the Internal Revenue Code*."[6] While the statute does not explicitly differentiate between an IRA created by a person or an IRA inherited from another person, the Bankruptcy Court has found that under Texas law a creditor of a beneficiary of an inherited IRA may reach the assets inside the IRA.[7]

In order to protect an IRA from the creditors of a beneficiary it is necessary to designate a trust as the beneficiary recipient of the IRA in order to take advantage of spendthrift protection afforded to non-self settled trusts under Texas law. However, the concern of many attorneys is in ensuring the trust is structured in order to satisfy the requirements of Treas. Reg. Section 401(a)(9)-4.

Conduit Trust Solution

If a trust meets the definition of a conduit trust set forth in Treas. Reg. §1.409(a)(9)-5, A-7(c)(3), Example 2, then the oldest individual beneficiary of that Trust will be deemed the designated beneficiary of any IRA payable to the Trust for purposes of the minimum distribution requirements of Section 401(a)(9). Consequently, the "minimum required distributions" for that IRA will typically be calculated based upon a presumed withdrawal of the IRA's contents over that beneficiary's life expectancy, determined as of the participant's death. This typically translates into a longer period of deferral than the default 5-year payout or a payout over the participant's remaining actuarial life expectancy (if death occurred past the required beginning date). This ability to "stretch out" the withdrawal of the IRA's contents correspondingly maximizes the opportunity for the continuation of the income tax deferred growth of the assets inside of the IRA.

The look through trust requirements generally require (i) the trust be valid under state law; (ii) the trust is irrevocable or will be irrevocable upon the death of the IRA participant; (iii) the beneficiaries are identifiable; and (iv) the trust document is provided to the IRA custodian by October 31 of the calendar year following the death of the IRA participant. Please note that these requirements require careful analysis, especially with respect to the identification of beneficiaries.

A conduit trust can also offer the asset protection benefits of a spendthrift trust in order to protect the inherited IRA from a beneficiary's creditors or a divorcing spouse. A conduit trust can also prevent a beneficiary who may not have the desired financial maturity from accessing the assets in the IRA and dissipating them in a prodigal manner.

The following trust is intended to meet the requirements of a look through trust for purposes of Treas. Reg. §1.401(a)(9)-4.[8] This particular trust form creates a conduit trust within the confines of another trust agreement and is not intended to serve as a standalone trust. However, it is possible and may be preferable in some situations to create a standalone conduit trust.

Additionally, it is often desirable for a parent's IRA to be distributed at death among separate conduit trusts for the children. In doing so, each child may use his or her own life expectancy for establishing the minimum required distributions for that child's trust's share of the IRA. In order to accomplish that result, the IRA must be divided at death into separate accounts for the various trusts in accordance with Treas. Reg. 1.401(a)(9)-8, A-2(a)(2). A sample beneficiary designation form accommodating that approach is attached as well.

SAMPLE CONDUIT TRUST

ARTICLE XV
PROVISIONS REGARDING CONDUIT TRUSTS CREATED TO HOLD THE SURVIVING TRUSTOR'S RETIREMENT BENEFITS

Section 15.1. Purpose for and Designation of Trusts .

A. Notwithstanding any provision of this Trust Agreement to the contrary, in the event an issue of the Trustors survives the Surviving Trustor, the Surviving Trustor intends to provide for (i) each Retirement Benefit owned by such Trustor to pass at such Trustor’s death to one (1) or more Conduit Trusts (as defined below) created under this Trust Agreement for the benefit of the Trustors’ surviving issue, in such shares as such Trustor shall direct in the beneficiary designation form applicable for such Retirement Benefit and (ii) Separate Accounts (within the meaning of Internal Revenue Code Section 401(a)(9) and Treasury Regulation §1.401(a)(9)-8, A-3) to be created from any such Retirement Benefit so allocated to two (2) or more such Conduit Trusts created hereunder to accommodate the allocation so provided in such beneficiary designation.

B. Each issue of the Trustors for whose primary benefit such a Trust described in Section 15.1.A is to be created shall be referred to in such beneficiary designation and accordingly this instrument as the "Beneficiary" of such Trust, and such Trust shall be named for him or her followed by the words “Exempt Conduit Trust," if the Inclusion Ratio (as defined in Internal Revenue Code (“Code”) Section 2642) of such Trust is zero (0), or “Nonexempt Conduit Trust,” if the Inclusion Ratio of such Trust is one (1), after taking into account the allocation (if any) of the Surviving Trustor’s generation-skipping transfer tax exemption (as set forth in Code Section 2631) thereto. Notwithstanding the preceding, if any such Conduit Trust would otherwise have an Inclusion Ratio greater than zero (0), but less than one (1) as of the Surviving Trustor's death after taking into account the allocation (if any) of the Surviving Trustor's generation-skipping transfer tax exemption thereto, then such Conduit Trust shall be divided into two (2) separate Conduit Trusts for the benefit of the Beneficiary of such Conduit Trust to be so divided (the "Original Conduit Trust"), and (i) one separate Trust so created shall receive a fractional share of the total value of the Original Conduit Trust equal to its applicable fraction (as defined in Code Section 2642) and shall be named for such Beneficiary followed by the words "Exempt Conduit Trust" and consequently assigned an Inclusion Ratio equal to zero (0) and (ii) the other resulting Trust shall receive that fractional share of the total value of the Original Conduit Trust that is equal to the excess of one (1) over the applicable fraction described in (i) and shall be named for such Beneficiary followed by the words "Nonexempt Conduit Trust" and consequently assigned an Inclusion Ratio equal to one (1). In dividing the Original Conduit Trust, the Trustee shall (as the Trustee shall elect) (a) divide the Original Conduit Trust on a fractional basis or (b) allocate assets to each of the Exempt Conduit Trust and Nonexempt Conduit Trust on a non pro rata basis, provided that in making such allocation, such assets are valued at their respective fair market values as of the date of the severance of such Original Conduit Trust in accordance with Treasury Regulation 26.2642-6(d)(4). Notwithstanding the preceding, for ease of reference, an Exempt Conduit Trust or a Nonexempt Conduit Trust may sometimes be referred to herein simply as a "Conduit Trust" if the context of such reference is applicable regardless of the status of such Trust for generation-skipping transfer tax purposes.

Section 15.2. Distributions During Term of Conduit Trusts. Each year, beginning with the year of the Surviving Trustor's death, the following shall apply with regard to the administration of each Conduit Trust created hereunder.

A. The Trustee of any such Conduit Trust shall withdraw from each of (i) the Surviving Trustor's Retirement Benefit(s) held by and/or payable to such Conduit Trust (if the beneficiary designation form applicable with respect thereto directs that such be held by and/or payable entirely to such Conduit Trust) and (ii) each Separate Account(s) held by and/or payable to such Conduit Trust, as the case may be, the Minimum Required Distribution applicable thereto for such year and distribute such amount (net of expenses properly charged thereto) as soon as reasonably practicable as follows:

1. The Trustee shall distribute to the Beneficiary such amount of such Minimum Required Distribution as is necessary for the health, education, maintenance, and support of the Beneficiary. To the extent such Minimum Required Distribution is not distributed in its entirety to the Beneficiary under the preceding sentence, it shall be distributed to any one or more of the Beneficiary's living issue as necessary for the health, education, maintenance, and support of any such issue.

2. To the extent such Minimum Required Distribution is not distributed in its entirety in accordance with Section15.2.A.1 above, the Trustee shall distribute the balance of such Minimum Required Distribution to the Beneficiary, or if the Beneficiary is then deceased, to his or her then living issue, per stirpes.

3. The Trustee may also, at any time and from time to time, withdraw from (i) and/or (ii) described above in Section 15.2.A, as applicable, and immediately distribute, such additional amount or amounts (net of expenses properly charged thereto) as the Trustee shall deem necessary for the health, education, maintenance, and support of any or all of the Beneficiary and the issue of the Beneficiary who are living from time to time; provided, however, that in determining whether to make any such distribution to an issue of the

Beneficiary, the Surviving Trustor directs the Trustee to be mindful of the Trustors' intent that the primary purpose of this Trust is to provide for the health, education, maintenance, and support of the Beneficiary during his or her lifetime (subject to the requirement that the Minimum Required Distribution applicable in any year in any event be distributed as set forth above).

4. Any distributions made pursuant to either Section 15.2.A.1 or Section 15.2.A.3 need not be distributed equally between or among, as the case may be, the Beneficiary and his or her issue. In making any such distribution, the Trustee shall consider all other resources available to the proposed recipient of such contemplated distribution (however, the Trustors suggest but do not require that any such distribution to a Beneficiary or any of his or her issue be made first from a Conduit Trust rather than from such Beneficiary's Exempt Trust or Nonexempt Trust). The Trustors are aware that a distribution to the issue of a Beneficiary from a Nonexempt Conduit Trust might be characterized at the time as a transfer subject to the Generation-Skipping Transfer Tax. The Trustors instruct the Trustee to take this consideration into account, along with the other standards listed above, prior to making any distributions to such issue from a Nonexempt Conduit Trust, if any.

5. Notwithstanding the preceding, the Trustors direct that each of the Conduit Trusts created hereunder shall only bear those expenses of trust administration that can be properly allocable thereto and borne thereby without impairing such Trust's ability to calculate the Minimum Required Distribution for any Retirement Benefit or Separate Account held by or payable to such Conduit Trust based upon the life expectancy of the Beneficiary of such Conduit Trust (the "Allocable Expenses"). Accordingly, except as provided in this paragraph, the Trustee of a Conduit Trust shall not, after September 30 of the calendar year

following the calendar year in which the Surviving Trustor's death occurs (or such earlier date as shall be established by IRS regulations or other guidance as the final date of determining whether such Trust meets the requirements for treatment of such Trust's beneficiaries as if they had been named directly as beneficiaries of any Retirement Benefit or Separate Account held by and/or payable to such Trust) (such applicable date, the "Date"), distribute to or for the benefit of the Surviving Trustor's estate, any charity, or any other nonindividual beneficiary any portion of a Retirement Benefit or Separate Account (as applicable). It is the Trustors' intent that each Retirement Benefit or Separate Account held by and/or payable to a Conduit Trust created hereunder as of the Date be distributed to or held for only individual beneficiaries, within the meaning of Code Section 401(a)(9). Accordingly, the Trustors direct that no portion of any Retirement Benefit or Separate Account may be used or applied after the Date for payment of any debts, taxes, expenses of administration, or other claims against the Surviving Trustor's estate (excluding for such purpose any Allocable Expenses); nor for payment of estate, inheritance, or similar transfer taxes due on account of the Surviving Trustor's death.

6. Notwithstanding any provision of this Trust Agreement to the contrary, any distribution made pursuant to this Section 15.2 shall only be made to the intended recipient or his or her legal guardian.

7. For purposes of this Section 15.2, notwithstanding any provision of this Trust Agreement to the contrary, a Beneficiary's "issue" shall exclude any individual who is such Beneficiary's "issue" by adoption if such individual is older than such Beneficiary.

B. <u>Administration of Trust Upon Its Beneficiary's Death</u>. Subject to Section [**RAP savings clause section]** and Section 15.2.C, a Conduit Trust created for a Beneficiary shall not terminate upon such Beneficiary's death but shall continue for the benefit of such deceased Beneficiary's issue living from time to time until (as applicable) each Retirement Benefit and each Separate Account held by and/or payable to such Conduit Trust has been exhausted through distributions thereto; provided, however, that if a Beneficiary and his or her issue should all die prior to such time, then such Conduit Trust shall continue to exist subsequent to the death of the survivor of such Beneficiary and his or her issue (i) for the benefit of the living issue of the Beneficiary's nearest lineal ancestor who is (A) an issue of the Trustors and (B) has issue living or (ii) if no such issue are then living, for the benefit of the Trustors' living issue (in such applicable event any reference in Sections 15.2.A through 15.2.A.6 to the "Beneficiary's living issue," "issue of the Beneficiary living from time to time" and words of like import shall be deemed a reference to such lineal ancestor's living issue or the Trustors' living issue, as applicable), with such Conduit Trust continuing to exist until (as applicable) each Retirement Benefit and each Separate Account held by and/or payable to such Conduit Trust has been exhausted through distributions thereto; provided, however, that if the Trustors' issue should all die prior to such exhaustion of each Retirement Benefit and Separate Account, then each such Retirement Benefit and each such Separate Account shall be distributed to **[preferred distribution]**.

C. General Power of Appointment by Will. Notwithstanding what is otherwise stated in Subsection 15.2.B above with respect to the administration of a Nonexempt Conduit Trust, if the generation-skipping transfer tax is in effect at its Beneficiary's death, then notwithstanding Subsection 15.2.B to the contrary, the following shall apply.

1. Testamentary General Power of Appointment. If such Beneficiary is survived by any issue (or if the Trust would otherwise be considered a "skip person" pursuant to Code Section 2613 subsequent to the Beneficiary's death), then such Beneficiary shall have

the power, exercisable by him or her alone and in all events (by a clause in his or her Last Will and Testament which refers specifically to this power of appointment and in which he or she exercises this power of appointment), to appoint the assets of such Beneficiary's Nonexempt Conduit Trust upon his or her death, or any portion thereof, in fee simple and free of Trust, to his or her estate, or in fee simple and free of Trust, or in trust, to any other persons or entities, in such shares, proportions, and amounts as he or she may determine.

2. Continuation of Trust To Extent Power Not Exercised. To the extent the foregoing general power of appointment is not exercised by a Beneficiary, such Nonexempt Conduit Trust (reduced by any federal estate and/or state death tax payable therefrom pursuant to Code Section 2207 or any similar provision under state law) shall continued to be administered in accordance with the terms of this Section 15.2; provided, however, that if the Inclusion Ratio (as defined in Code Section 2642) of such Trust is greater than zero (0) but less than one (1) subsequent to such Beneficiary's death, the Trustors strongly suggest (but do not require) that the Trustee of such Trust consider undertaking a qualified severance (as defined in Code Section 2642(a)(3)) with regard to such Trust.

3. Trustors' Intention. This Section 15.2.C is intended to cause the property held in a deceased Beneficiary's Nonexempt Conduit Trust upon his or her death to avoid being subject to an otherwise applicable (pursuant to Section 15.2.B) generation-skipping transfer tax and instead be subject to a testamentary general power of appointment exercisable by such Beneficiary in accordance with this Section 15.2.C. In so providing, the Trustors intend that (i) the inclusion of the property affected thereby in such Beneficiary's gross estate pursuant to Code Section 2041 may achieve a savings in transfer taxes by having an estate tax (if any), rather than a generation-skipping transfer tax, imposed on the property subject thereto and/or (ii)

such Beneficiary or his or her spouse may achieve a greater use of the exemption from generation-skipping transfer tax allowed to either of them pursuant to Code Section 2631.

Section 15.3. Definitions. The following definitions shall apply in administering each Conduit Trust.

A. Minimum Required Distribution. The “Minimum Required Distribution" for any year with regard to a Conduit Trust created hereunder shall mean, for each Retirement Benefit or Separate Account held by and/or payable to such Conduit Trust: (1) the value of such Retirement Benefit or such Separate Account determined as of the preceding year-end divided by (2) the Applicable Distribution Period applicable with respect thereto, or such greater amount (if any) as the Trustee shall be required to withdraw under the laws then applicable to such Trust to avoid penalty. Notwithstanding the foregoing, if more than one (1) Conduit Trust is created at the Surviving Trustor’s death to receive the contents of a Retirement Benefit, then the Minimum Required Distribution applicable with respect to each such Conduit Trust with regard to such Retirement Benefit for the year of the Surviving Trustor's death (which shall be withdrawn from such Retirement Benefit and immediately distributed in accordance with Section 15.2) shall mean such Trust's pro rata share (based upon the allocation of such Retirement Benefit between/among such Conduit Trusts at the Surviving Trustor’s date of death set forth in the beneficiary designation applicable with respect thereto) of (a) the amount that was required to be distributed to the Surviving Trustor during such year with respect to such Retirement Benefit under the Minimum Distribution Rules minus (b) amounts actually distributed to the Surviving Trustor with respect to such Retirement Benefit during such year; provided, however, that if only one (1) Conduit Trust is created upon the Surviving Trustor’s death to hold and/or receive payment from a Retirement Benefit, the amount calculated by subtracting (b) from (a) shall be considered entirely to be the Minimum Required Distribution with respect to such Conduit Trust and shall be withdrawn from such Retirement Benefit and immediately distributed in accordance with Section 15.2.

B. Applicable Distribution Period. The "Applicable Distribution Period" shall mean the remaining life expectancy period over which distributions must be made from a Retirement Benefit or Separate Account held by and/or payable to a Conduit Trust created hereunder, as described below and as further described in Treasury Regulation §1.401(a)(9)-5, A-5. If the Surviving Trustor's death occurred before the Surviving Trustor’s "required beginning date" with respect to a Retirement Benefit (or with respect to the Retirement Benefit from which any such Separate Account originated, as the case may be), the Applicable Distribution Period applicable with respect to such Retirement Benefit or such Separate Account held by and/or payable to a Conduit Trust created hereunder means the remaining life expectancy of the Beneficiary of such Conduit Trust. If the Surviving Trustor's death occurred on or after the Surviving Trustor’s "required beginning date" with respect to a Retirement Benefit (or with respect to the Retirement Benefit from which any such Separate Account originated, as the case may be), the Applicable Distribution Period applicable with respect to such Retirement Benefit or such Separate Account held by and/or payable to a Conduit Trust created hereunder means the longer of the remaining life expectancy of the Beneficiary of such Conduit Trust or the Surviving Trustor's remaining life expectancy as of the Surviving Trustor’s date of death.

C. Retirement Benefit. A "Retirement Benefit" shall mean one of the following types of assets payable to one (1) or more Conduit Trusts hereunder as a beneficiary or owned by one (1) or more of such Trusts: a qualified or nonqualified annuity; a benefit under a qualified or nonqualified plan of deferred compensation; any account in or benefit payable under any pension, profit-sharing, stock bonus, or other qualified retirement plan; any individual retirement account or trust; and any and all benefits under any plan or arrangement that is established under Code Sections 408, 408A, 457, 403, 401 or similar provisions of the Code. “Retirement Benefits” means all of such interests collectively.

D. Separate Account. A "Separate Account" shall mean a separate account created pursuant to Treasury Regulation § 1.401(a)(9)-8, A-3 with respect to a Retirement Benefit in the event such Retirement Benefit is collectively held by and/or payable to two (2) or more Conduit Trusts created under this Trust Agreement.

E. Retirement Plan. "Retirement Plan" shall mean the plan, trust, account, or arrangement under which any Retirement Benefit or Separate Account (as defined above) is held by and/or payable to a Conduit Trust created under this Trust Agreement.

F. Other Terminology. "Life expectancy," "Required Beginning Date," and other terms used in this Article XV shall be determined in accordance with Code Section 401(a)(9) and the Treasury Regulations promulgated thereunder.

Section 15.4. Trustors’ Intention. It is the Trustors’ intent that each Conduit Trust shall be recognized as a Trust described in Treasury Regulation § 1.401(a)(9)-5, A-7(c)(3), Example 2 so that such Conduit Trust’s Beneficiary's own life expectancy may be used in establishing the Applicable Distribution Period for the Retirement Benefit(s) or Separate Account(s), as the case may be, held by and/or payable with respect to such Trust. Consequently, notwithstanding any provisions of this Trust Agreement to the contrary, the Trustee's powers and discretions with respect to the administration of each separate Conduit Trust (including methods of accounting, bookkeeping, making distributions, and characterizing receipts and expenses) shall not be exercised or exercisable except in a manner consistent with allowing each separate Conduit Trust to be treated in a manner consistent with the Trustors' intent, as above described.

Section 15.5. Trustee's Duty to Implement Trustor's Intentions . Notwithstanding any provision of this Trust Agreement to the contrary, the Trustee of any Conduit Trust created hereunder shall execute and file with the administrator of any Retirement Benefit or Separate Account referenced herein such paperwork as may be determined to be necessary to effect the disposition of such Retirement Benefit or Separate Account described herein.

SAMPLE BENEFICIARY DESIGNATION

MIKE BRADY
SSN: _______________
SUPPLEMENT TO BENEFICIARY DESIGNATION FORM FOR INDIVIDUAL RETIREMENT ACCOUNT # ____________ (the "Account")

1. If my spouse, CAROL BRADY, survives me for any period of time and we remain married at my date of death, one-half (½) of the proceeds held in the Account as of my date of death (representing my spouse's community property interest) shall be distributed to my spouse outright and free of trust, and the other one-half (½) of such proceeds (representing my community property interest) shall be distributed to my spouse outright and free of trust, except to the extent my spouse disclaims part or all of the proceeds. Any proceeds which my spouse disclaims shall pass instead to the Trustee of the DISCLAIMER TRUST created under the BRADY LIVING TRUST, which (i) was established on July 20, 2009 by and between MIKE BRADY and CAROL BRADY, as Trustors; and MIKE BRADY and CAROL BRADY, as Co-Trustees. If my spouse and I die in such a manner that the order of our deaths cannot be determined, it shall be presumed that I survived my spouse.

2. If my spouse, CAROL BRADY, fails to survive me for any period of time, or if CAROL BRADY and I are not married at my date of death, then I hereby direct that the proceeds held in the Account as of my date of death pass as follows:

A. If an issue of mine survives me by at least ninety (90) days, such proceeds shall pass as described below:

1. I hereby direct that such proceeds be allocated, per stirpes, among those of my issue who survive me by at least ninety (90) days; provided, however, that any share so allocated to an issue of mine shall be held by/payable to the Trustee of the Conduit Trust (as defined in the BRADY LIVING TRUST) established thereunder for which such issue is designated as the "Beneficiary."

2. I direct that the share of the Account so allocated to each Conduit Trust as set forth above shall be treated as a separate account, payable solely to such Conduit Trust, within the meaning of Internal Revenue Code Section 401(a)(9) and Treasury Regulation §1.401(a)(9)-8, A-3. I further direct that the Account shall be deemed divided as of the date of my death as described above into separate accounts, with each such separate account so allocated payable to the corresponding Conduit Trust for purposes of determining the amount annually required to be distributed to such Conduit Trust's Beneficiary and/or such Beneficiary's issue under §401(a)(9) of the Internal Revenue Code. All investment gains and losses, contributions, and forfeitures associated with the Account subsequent to my death but prior to the establishment of such separate accounts shall be allocated among such separate accounts on a pro rata basis in a reasonable and consistent manner, as provided in Treasury Regulation § 1.401(a)(9)-8, A-3. A distribution from the Account to any Conduit Trust (or a transfer from the Account to a separate individual retirement account, still in my name and payable to a Conduit Trust) shall be charged

to that Conduit Trust's separate account (reducing its value for purposes of subsequent allocations of investment gains and losses, contributions, and forfeitures associated with the Account, as set forth above). The Conduit Trusts shall be entitled, by joint written instructions to the Administrator, to have the Account partitioned into multiple Accounts, corresponding to each Conduit Trust's separate interest in the Account, as of or at any time after my death, to the maximum extent such division is permitted by law to occur without causing a deemed distribution of the Account. Following such partition, the newly created separate Accounts shall be maintained as if each were an Account in my name payable solely to the applicable Conduit Trust, and no Conduit Trust shall have any further interest in or claim to any Account other than the separate Account representing such Conduit Trust's interest.

3. The Trustees of the Conduit Trusts by majority agreement (or by joint agreement, if there are only two (2) such Trustees) shall have the right to have the Account transferred to a different individual retirement account or trust of the same type (i.e., "traditional" or "Roth") as the Account, still in my name and payable to such Conduit Trusts in the same shares applicable as of the time of such transfer with regard to the Account, with the same or a different custodian or trustee, if at the applicable time such transfer is permitted by law to occur without causing a deemed distribution of the Account. Notwithstanding the preceding, if the Account has been partitioned pursuant to the preceding provisions hereof, the Trustee of a Conduit Trust shall have the right to have such Trust's separated Account transferred to a different individual retirement account or trust of the same type (i.e., "traditional" or "Roth") as the separate Account, still in my name and payable to such Conduit Trust, with the same or a different custodian or trustee, if at the applicable time such transfer is permitted by law to occur without causing a deemed distribution of such separated Account.

4. For purposes of this Beneficiary Designation, the following definitions shall apply:

a. The “Administrator” shall mean the custodian or trustee of the Account and its successors in that office.

b. The terms "issue" and “per stirpes” shall have the meaning attached to them in the BRADY LIVING TRUST.

5. As of the date of this supplement I have the following issue:

GREG BRADY, son

SSN: ______________________________

Date of Birth: ________________________

Address: _____________________________

Phone: _______________________________

PETER BRADY, son

SSN: ______________________________

Date of Birth: ________________________

Address: _____________________________

Phone: _______________________________

BOBBY BRADY, son

SSN: ______________________________

Date of Birth: ________________________

Address: _____________________________

Phone: _______________________________

B. If no issue of mine survives me by at least ninety (90) days, then I hereby direct that the proceeds held in the Account as of my date of death be distributed to the BRADY FAMILY FOUNDATION.

C. Regardless of who is named as beneficiary above, the Administrator shall provide to the Executor of my Estate or the Trustee of any Trust created under the BRADY LIVING TRUST such information regarding me, the Account, or my beneficiary(ies) as such Executor or Trustee (as applicable) may reasonably request in connection with the performance of such Executor's or Trustee's duties in such capacity (including, but not limited to, the preparation of any tax return), including information as to matters arising prior to such Executor's or Trustee's (as applicable) appointment in such capacity, to the same extent and on the same terms that such information would have been provided to me had I requested such. Any beneficiary, by accepting benefits hereunder, shall be deemed to have consented to the release of information in accordance with this Paragraph C.

______________ Date	______________________________ MIKE BRADY
______________ Date	______________________________ CAROL BRADY
______________ Date	______________________________ WITNESS

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[2] Section 408 of the Internal Revenue Code of 1986, as amended (the "Code") defines an individual retirement account. Many of the rules applicable to IRAs also apply with regard to qualified retirements plans in accordance with Section 401. However, a discussion of some of the unique aspects of planning for qualified retirement plans is beyond the scope of this article. Additionally, this article addresses planning for traditional IRAs, not Roth IRAs. All section references are to the Code.

[3] It is possible to structure a trust in which the oldest beneficiary of the trust qualifies as the designated beneficiary for purposes of Section 401(a)(9) rather than using a conduit trust. *See* PLRs 200438044, 200522012, and 200610026. However, the conduit trust has the advantage of being a clearly defined safe harbor described in Treas. Reg. §1.401(a)(9)-4, A 5.

[4] Section 401(a)(9) is applicable to IRAs by virtue of Code Section 408(a)(6).

[5] *See* Section 401(a)(9)(E) and Treas. Reg. §1.401(a)(9)-4, A 5.

[6] TEX. PROP. CODE. ANN. § 42.0021(a) (West 2008).

[7] *In re Jarboe*, 2007 WL 987314 (Bkrptcy. S.D. Texas 2007).

[8] The authors provide no assurances that this sample trust will be effective in a particular situation. The attached form was drafted in part based upon the sample Conduit Trust form contained in the invaluable "Life and Death Planning for Retirement Benefits, 6th Edition 2006" by Natalie Choate.