Texas Tax Lawyer

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TAX SECTION
STATE BAR OF TEXAS

www.texastaxsection.org

TO MOVE DIRECTLY TO AN ARTICLE CLICK ON THE TITLE

TABLE OF CONTENTS

FROM OUR LEADER:

- The Chair's Message
  Alyson Outenreath, Texas Tech University, School of Law

SPECIAL RECOGNITIONS, UPCOMING EVENTS, AND SECTION INFORMATION:

- Leadership Roster (2015-2016)
- Committee Chairs and Vice Chairs (2015-2016)
- Calendar (2015-2016)
- 2016 – 2017 Leadership Academy – Applications Now Available

ARTICLES:

- Gift Tax Returns: Finding and Fixing Problems
  Celeste C. Lawton, Norton Rose Fulbright
- New IRS Guidance Limits Future Rulings on Tax-Free Spin-Off Transactions
  Sam Merrill, Thompson & Knight LLP
  Lee Meyercord, Thompson & Knight LLP
  David Wheat, Thompson & Knight LLP
- IRS Changes Rules for Private Foundation Grants to Foreign Charities
  Tyree Collier, Thompson & Knight LLP
  David Rosenberg, Thompson & Knight LLP
- IRS Takes Another Stab at Proposed Issue Price Regulations – A Step in the Right Direction, but Practical Questions Remain
  Victoria N. Ozimek, Bracewell & Giuliani LLP
  Brian P. Teaff, Bracewell & Giuliani LLP

- Credit Where Due? Recent Policy Change May Affect Texas Tax Refund Claims
  Kirk Lyda, Jones Day
  Karen H. Currie, Jones Day

PRACTITIONER'S CORNER:

- Advanced Tax Law: Oil & Gas
  Crawford Moorefield, Strasburger & Price, LLP

- 2015 Comptroller Briefing and CLE

  - Constitutional Restrictions on State Taxation
    Sam Megally, K&L Gates LLP
    Sarah Pai, Comptroller of Public Accounts

  - Texas Comptroller Update: Administrative Procedures Act
    Ira Lipstet, DuBois, Bryant & Campbell LLP

  - Overview of Unclaimed Property
    William S. King, Keane
    Charolette Noel, Jones Day

  - Overview of the Doctrine of Legislative Acceptance
    David E. Colmenero, Meadows, Collier, Reed, Cousins, Crouch & Ungerman, L.L.P.

COMMITTEE ON GOVERNMENT SUBMISSIONS:

- Comments on Proposed Amendments to 34 T.A.C. §§ 9.1051-9.1054 and 9.1059, and Proposed New 34 T.A.C. § 9.1060, concerning Agreements for Limitation on Appraised Value of Property for School District Maintenance and Operations Taxes July 31, 2015

  Sam Megally, K&L Gates LLP
  Charolette Noel, Jones Day

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CHAIR'S MESSAGE

Greetings from Lubbock!

As you know, in recent years we have increased dramatically the activity and national profile of our Section. And we are off to another great start for the 2015-2016 year.

The Officers and Council of the Section met this summer to review and reaffirm our goals for the Section and to set an ambitious agenda for the year. Our goals are: (1) to provide world-class education through accessible and relevant CLE; (2) to work to improve the substance and administration of state and federal tax laws; (3) to use our knowledge, experience and resources to provide pro bono legal services to those who cannot afford the services of tax lawyers; (4) to enhance the profile of our Section and our members; (5) to develop future leaders of the Section through our Leadership Academy; (6) to engage in our student scholarship program and regularly contact students through presentations at law schools and through other communications to promote the practice of tax law; and (6) to have fun while working toward these goals.

We would also like this year to be a year of outreach.

- First, we want to focus on outreach to you, our members, by increasing our communications and by planning networking events in various cities throughout this fiscal year. Even in today's age of email and conference calls, we still need opportunities to meet each other face-to-face in order to develop relationships to help guide us through our careers.
- Second, we want to focus on outreach to grow our membership. Our Section offers numerous member benefits, most importantly access to the 24/7 free online CLE library, which contains not only advanced tax law programs, but also primer and nuts and bolts courses that many non-tax lawyers would find beneficial to their practices. Growing our membership by reaching out to these lawyers will enhance our profile and reputation and will also provide more lawyers with access to all of the great member benefits we provide.

To achieve these goals and carry out our agenda, we need your help and participation. If you are not already involved in our Section's activities, or, if you would like to become more involved, please call (806.834.8690) or email me (alyson.outenreath@ttu.edu). There is a place for you, and we want you to be involved!

Below are a few highlights of the Section's activities and some recent updates:

CLE
Under the leadership of our CLE chair, Michael Threet (michael.threet@haynesboone.com), the Section provides both live and web-based CLE. I would like to mention just a few of the CLE projects that are currently in the works. We are updating the 24/7 free online CLE library. It will have a fantastic new look, contain many new programs, and will be extremely user friendly. I will send an eblast out when it's ready, which will be soon!

On Thursday, November 12, 2015, in Dallas, and Friday, November 13, 2015, in Houston, the International Tax Committee will host the 18th Annual International Tax Symposium. We have a superb line-up of speakers. And there are networking events in each city.

Other upcoming live CLE events include: The Advanced Tax Law Course (co-sponsored with TexasBarCLE) on October 29-30, 2015, in Houston; Tax Law in a Day on February 11, 2016, in Houston, and our Annual Property Tax Conference that will be presented next spring.

Online registration for all live CLE events is now available on our website: http://www.texastaxsection.org/

Texas Tax Lawyer
Under Michelle Spiegel's guidance, the *Texas Tax Lawyer* provides some of the best and most relevant tax articles, model forms, and updates on tax law. We hope you noticed our new streamlined and updated cover, which made its inaugural debut in this edition. Please join a committee online today to start participating by writing an article for our upcoming Winter and Spring editions of the *Texas Tax Lawyer*: http://www.texastaxsection.org/

Government Submissions
The Section seeks volunteers to draft letters to the IRS, Treasury, Texas Comptroller, and other governmental entities recommending changes to proposed regulations and tax policies. Each of our substantive committees is working on at least one comment project on federal or state tax law. Bob Probasco and Henry Talavera lead our Committee on Government Submissions ("COGS") and coordinate our comment projects with the leaders of our substantive committees. We need your help. Last year, we provided eleven comment projects to federal and state tax authorities, and we hope to meet or exceed that total this year. Any Section member can get involved. Please contact Bob Probasco (robert.probasco@probascotaxlaw.com) or Henry Talavera (htalavera@polsinelli.com.

Pro Bono
In addition, the Section has an award winning Tax Court pro bono program. Under the leadership of our Pro Bono Chair, Juan Vasquez (juan.vasquez@chamberlainlaw.com), we assist individuals who cannot afford to pay for the services of a tax lawyer by advising pro se taxpayers who appear at calendar calls of the United States Tax Court held in various Texas cities. Through the VITA program, Section members help lower-income taxpayers in the preparation of their federal income tax returns, with a focus on helping qualified taxpayers take the earned income tax credit. In addition, under the leadership of Joe Perera (joseph.perera@strasburger.com) we are involved with the VITA Adopt-a-Base program where the Section works with the military and the IRS to help train services members to be volunteer return preparers. This helps members of our armed forces and their families have access to free tax preparation services. Lastly, under the leadership of Henry Talavera (htalavera@polsinelli.com) and Susan Wetzel (susan.wetzel@haynesboone.com), the Section recently became involved with the Pension Rights Center, where Section members assist Texas residents in securing retirement benefits. This is important work. Please get involved.

Leadership Academy
Applications are now available! Under the leadership of Dan Baucum (dbaucum@canteyhanger.com) and Christi Mondrik (cmondrik@mondriklaw.com), the Section sponsors a Leadership Academy program every other year to instill leadership skills and help guide the next generation of Texas tax lawyers in taking ownership of their careers. The application deadline is January 15, 2016. Applications are available on our website: http://www.texastaxsection.org/

Law School Outreach
Under the leadership of Abbey Garber, we continue to expand our law school outreach program by hosting a "Tax Career Day" panel to educate students on the practice of tax law. This year our goal is to visit each law school in Texas! To date, we have visited Texas Tech University School of Law, Texas A&M University School of Law, and SMU Dedman School of Law. Please contact Abbey (abbey.b.garber@irscounsel.treas.gov) if you would like to get involved.

* * *

The above are just a few highlights of the activities of the Tax Section. Please check out our website to learn more: http://www.texastaxsection.org/

It's also never too early to start thinking about the people who will serve as officers next year and who will be filling expiring Council positions. This year's Nominating Committee consists of: Andrius Kontrimas (andrius.kontrimas@nortonrosefulbright.com); Elizabeth Copeland (elizabeth.copeland@strasburger.com); Tina Green (tgreen@capshawgreen.com); Mary McNulty as an alternate (mary.mcnulty@tklaw.com); and myself as an ex officio member. Nominations for Chair-Elect, Secretary, Treasurer, or an Elected Council Member position can be submitted to any member of the Nominating Committee or to any Officer of the Section at any time on or before March 1, 2016.

Finally, I would like to thank my predecessor, Andrius Kontrimas, for his outstanding work in leading our Section last year and for his many years of service to the Section. In addition to motivating the entire Section to work together to achieve an extremely productive year, he was instrumental in implementing our new website.

Please let me or one of my fellow officers, David Colmenero/Chair-Elect (dcolmenero@meadowscollier.com), Stephanie Schroepfer/Secretary (stephanie.schroepfer@nortonrosefulbright.com), and Catherine Scheid/Treasurer (ccs@scheidlaw.com), know if you have any thoughts, ideas, or suggestions to enhance the Tax Section.

Thank you. I look forward to working with all of you and to a great year. Get involved. It's fun.

Alyson Outenreath

TAX SECTION
THE STATE BAR OF TEXAS

LEADERSHIP ROSTER

2015 - 2016

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TAX SECTION

THE STATE BAR OF TEXAS

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2015-2016

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1.	**Annual Meeting**	**David Gair** Gray Reed & McGraw, P.C. 1601 Elm Street, Suite 4600 Dallas, Texas 75201 214-954-4135 dgair@grayreed.com	N/A (Planning Committee)
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	COMMITTEE	CHAIR	VICE CHAIR
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	COMMITTEE	CHAIR	VICE CHAIR
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17.	**Newsletter**	**Michelle Spiegel** Mayer Brown, LLP 700 Louisiana Street, Suite 3400 Houston, Texas 77002 713-238-3000 mspiegel@mayerbrown.com	TBD

	COMMITTEE	CHAIR	VICE CHAIR
18.	**Pro Bono**	**Juan F. Vasquez, Jr.** Chamberlain, Hrdlicka, White, Williams & Aughtry, LLP 1200 Smith Street 14th Floor Houston, Texas 77002 112 East Pecan Street, Suite 1450 San Antonio, Texas 78205 713-654-9679 juan.vasquez@chamberlainlaw.com	**Jaime Vasquez** Chamberlain, Hrdlicka, White, Williams & Aughtry, LLP 112 East Pecan Street, Suite 1450 San Antonio, Texas 78205 210-507-6508 jaime.vasquez@chamberlainlaw.com **Derek Matta** Cantrell and Cantrell 3700 Buffalo Speedway, Suite 520 Houston, Texas 77098 713-333-0555 dmatta@cctaxlaw.com **Joe Perera** Strasburger & Price 2301 Broadway Street San Antonio, Texas 78215 210-250-6119 Joseph.perera@strasburger.com **Vicki L. Rees** Teacher Retirement System of Texas 1000 Red River Austin, TX 78701 512-542-6400 vicki.rees@trs.texas.gov **Tiffany L. Hamil** Law Office of Tiffany L. Hamil, PLLC Turley Law Center, Suite 316 6440 N Central Expy Dallas TX 75206 214-369-0909 info@dfwtaxadvisor.com
19.	**Leadership Academy**	**Daniel Baucum** Munsch Hardt Kopf & Harr, PC 500 N. Akard Street, Suite 3800 Dallas, Texas 75201-6659 214-855-7500 dbaucum@munsch.com **Christi Mondrik** Mondrik & Associates 11044 Research Blvd., Suite B-400 Austin, Texas 78759 512 542-9300 cmondrik@mondriklaw.com	N/A (Planning Committee)

TAX SECTION
OF
THE STATE BAR OF TEXAS

2015 – 2016 CALENDAR

June 2015	
10 - 12	**Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
18	**2015 – 2016 Tax Section Council Planning Retreat** Grand Hyatt San Antonio San Antonio, TX 1:00pm – 4:00pm
18	**2015 Tax Section Annual Meting Speaker's Dinner** Biga on the Banks San Antonio, TX
19	**2015 Tax Section Annual Meeting Program** Henry B. Gonzales Convention Center San Antonio, TX 8:00 am – 4:40 pm
22	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
23	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
July 2015	
16 - 18	**Texas Bar College** Summer School Galveston, TX
24 - 25	**SBOT Bar Leaders Conference** Westin Galleria Houston, TX
July 30 - Aug. 4	**ABA Annual Meeting** Hyatt Regency Chicago, IL
August 2015	
July 30 - Aug. 4	**ABA Annual Meeting** Hyatt Regency Chicago, IL

7	**SBOT Chair and Treasurer Training** Texas Law Center Austin, TX 10:30am – 2:30pm
17	**Tax Section Officer Planning Retreat** Houston, TX 11:45am – 3:45pm
18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
September 2015	
11	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Hosted by Meadows, Collier, Reed, Cousins, Crouch & Ungerman 901 Main Street, Suite 3700 Dallas, TX 75202 214-744-3700 10:30am – 12:30pm Dial-in information will be distributed via email
17	**Deadline for Appointment of Tax Section Nominating Committee** Per Bylaws, posted to Tax Section website in June 2015
17 - 19	**ABA Tax Section Fall Meeting** Sheraton Chicago Hotel & Towers Chicago, IL
21	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court El Paso, TX
21	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
22	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
25	**UT CLE Texas Margin Tax Conference** AT&T Conference Center Austin, TX
28	**Outreach to Law Schools** Texas Tech University School of Law Lubbock, TX

28	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court San Antonio, TX
28	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Lubbock, TX
October 2015	
5	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
5	**State and Local Tax Committee Annual Comptroller Briefing** **Co-Sponsored with TSCPA and TEI** Austin, TX
12	**Submission Deadline - Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Michelle Spiegel, mspiegel@mayerbrown.com
15	**Outreach to Law Schools** Southern Methodist University Dedman School of Law Dallas, TX
19	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Dallas, TX
20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
23	**Council of Chairs Meeting** Texas Law Center Austin TX
26	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
29 - 30	**Advanced Tax Law Course** **Co-Sponsored with TexasBarCLE** Crowne Center Houston – River Oaks Houston, TX
November 2015	
12	**18th Annual International Tax Symposium** **Co-Sponsored with TSCPA** Cityplace Conference Center Dallas, TX

13	**18th Annual International Tax Symposium** **Co-Sponsored with TSCPA and Houston CPA Society** Houston CPA Society Houston, TX
13	**Meeting of Council** Hosted by Norton Rose Fulbright 1301 McKinney Street, Suite 5100 Houston, TX 77010 713-651-5482 10:30am – 12:30pm Dial-in information will be distributed via email
16	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Dallas, TX
17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
30	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Dallas, TX
December 2015	
7	**Pro Bono Committee Calendar Call Assistance** United States Tax Court Houston, TX
15	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
January 2016	
8	**Nomination Period Opens for 2016 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2016 • Nomination forms to be posted on website and distributed via eblast • Submit nomination forms to Tax Section Secretary: Stephanie Schroepfer (stephanie.schroepfer@nortonrosefulbright.com)
15	**Application Deadline – Tax Section Leadership Academy**
19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am

22	**Meeting of Council, Committee Chairs, and Committee Vice Chairs Meeting** Hosted by Jones Day 2727 North Harwood Street Dallas, TX 75201 214-220-3939 10:30am – 12:30pm Dial-in information will be distributed via email
28 – 30	**ABA Tax Section Midyear Meeting** JW Marriott LA Live Los Angeles, CA
TBD	**Application Period Opens for Law Student Scholarship Program**
February 2016	
5	**Submission Deadline - Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Michelle Spiegel, mspiegel@mayerbrown.com
3 – 9	**ABA Midyear Meeting** San Diego, California
11	**Tax Law in a Day CLE** Houston, TX
16	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
26	**Council of Chairs Meeting** Texas Law Center Austin, TX
March 2016	
1	**Nomination Deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
22	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
24 - 25	**Leadership Academy Program (1st of 4 programs)** San Antonio, TX
April 2016	
1	**Nominating Committee's Report Due to Council** (Per Bylaws, deadline is at least 10 days before April 15, 2016 Council meeting)

15	**Meeting of Council** Hosted by Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, TX 77010 713-651-5482 10:30am – 12:30pm
15	**Council Vote and Selection of Recipient of 2016 Outstanding Texas Tax Lawyer Award**
19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
22	**Submission Deadline - Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Michelle Spiegel, mspiegel@mayerbrown.com
TBD	**Law Student Scholarship Application Deadline**
TBD	**Property Tax Conference** Thompson Conference Center Austin TX
May 2016	
TBD	**Law Student Scholarship Award Decisions Made**
5 – 7	**ABA Tax Section May Meeting** Grand Hyatt Washington, DC
24	**Government Submissions Call (COGS)** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
June 2016	
8 – 10	**Annual Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
15 - 17	**Leadership Academy Program (2nd of 4 programs)** Fort Worth, TX
16	**2016 Tax Section Annual Meeting Speaker's Dinner** TBD
16	**Presentation of Law Student Scholarship Awards** Award Presentations at State Bar Annual Meeting, Speakers' Dinner TBD
17	**2016 Tax Section Annual Meeting Program** For Worth Omni and Convention Center Fort Worth, TX
17	**Presentation of 2016 Outstanding Texas Tax Lawyer Award** Award Presentation During Tax Section Annual Meeting Program

21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
TBD	**2016 – 2017 Tax Section Council Planning Retreat**
July & Aug 2016	
July 30 – Aug. 4	**ABA Annual Meeting** San Francisco CA
Sept 2016	
23 - 23	**Leadership Academy (3rd of 4 programs)** Houston, TX
TBD	**Annual Texas Comptroller's Meeting**
Jan. 2017	
19	**Leadership Academy (4th of 4 programs)** Austin, TX

TAX SECTION
STATE BAR OF TEXAS

Program Dates:

1. March 24-25, 2016
   San Antonio
2. June 15-17, 2016
   Fort Worth
   (in conjunction w/ SBOT annual meeting)
3. Sept. 22-23, 2016
   Houston
4. January 19, 2017
   Austin

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Leadership Academy Application Deadline

January 15, 2016

(application available at www.texastaxsection.org)

Applicant Qualifications

- ***3-6 years' tax law experience***
- ***State Bar Tax Section Members Only***
- ***Must commit to all four sessions***

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- *Top-notch leadership training on client development, public speaking, and getting the most out of your tax law practice*
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GIFT TAX RETURNS:
FINDING AND FIXING PROBLEMS

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State Bar of Texas
39th ANNUAL
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June 10-12, 2015
Dallas

CHAPTER 12

TABLE OF CONTENTS

I. INTRODUCTION 1

II. CIRCUMSTANCES IN WHICH GIFT TAX RETURN MUST BE FILED 1

III. COMMON ERRORS FOUND IN GIFT TAX RETURNS 1
- A. Gift-Splitting 1
- B. Exclusion from GST Tax 2
- C. Deemed Allocation of GST Exemption 3
  - 1. Contingent General Power of Appointment 4
  - 2. Formulaic General Power of Appointment 5
  - 3. Hanging *Crummey* Withdrawal Powers 5

IV. DUTY OF ADVISOR TO FIND AND FIX PROBLEMS 6
- A. Duty to Find Tax Return Related Problems 6
- B. Duty to File or Amend Return 8

V. CONCLUSION 9

GIFT TAX RETURNS: FINDING AND FIXING PROBLEMS

I. INTRODUCTION

The vast majority of (if not all) estate planning lawyers or other tax advisors who represent clients with respect to estate planning matters will undoubtedly have at least one client who has made one or more taxable gifts but has failed to file a gift tax return or has filed a gift tax return containing errors. As such, it is important for the advisor to know when a gift tax return must be filed and how to spot errors made in a gift tax return. After an error is discovered, the advisor must know his or her duties to help the client correct the error. This paper will first discuss the circumstances in which a gift tax return must be filed. The paper will then discuss common errors found in gift tax returns. Finally, this paper will discuss what duty an advisor has to inquire into the client's gifting history and to advise the client to file a gift tax return or amend an erroneous gift tax return.

II. CIRCUMSTANCES IN WHICH GIFT TAX RETURN MUST BE FILED

The Instructions for Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, provide that a citizen or resident of the United States must file a gift tax return whether or not any tax is due if one of the following transfers was made:

- A gift of a present interest in an amount greater than the gift tax annual exclusion under Internal Revenue Code section 2503(b) ($14,000 per donor, per donee in 2015), <u>unless</u> such gift:

  (i) was to the donor's spouse (unless that gift was a terminable interest other than a life estate with the spouse's unlimited power to appoint the entire interest in all circumstances or unless the donor's spouse is not a U.S. citizen and the total gifts made to such spouse during the year exceeded $145,000 in 2015); or

  (ii) was a transfer to a political organization, payment that qualified for the educational exclusion, or payment that qualified for the medical exclusion.

- A gift of a future interest regardless of the amount of the gift.
- A gift of a partial interest to charity or split-interest gift conveying a lead or remainder interest to charity such as a charitable remainder trust or charitable lead trust.
- A gift to the donor's spouse if the gift was of a terminable interest (other than a life estate with the spouse's unlimited power to appoint the entire interest in all circumstances). The donor must file a gift tax return to make the qualified terminable interest property (QTIP) election in order to qualify the gift for the marital deduction, if applicable.
- A gift to the donor's spouse if the donor's spouse was not a U.S. citizen and the total gifts made to such spouse during the year exceeded $145,000 in 2015.

Pursuant to section 6075 of the Internal Revenue Code, a gift tax return generally is due no later than April 15 of the year after a gift was made, but the due date for filing the return may be extended by six months.[1] Notwithstanding the foregoing, the due date for filing a gift tax return may be earlier than April 15 if the donor died and the donor's estate tax return (with extensions) is due prior to April 15 (or the extended due date of the gift tax return, if applicable).[2]

The due date for filing a donor's gift tax return may be extended by the donor extending the time in which to file the donor's income tax return or by filing Form 8892, Application for Automatic Extension of Time to File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax. Section 6075(b)(2) of the Internal Revenue Code provides that any extension of time granted to the donor for the filing of the donor's income tax return "shall be deemed to be also an extension of time granted" to the taxpayer for filing the donor's gift tax return.[3] If the donor's income tax return is not extended, the donor may file Form 8892 to request an automatic six-month extension of time in which to file the gift tax return.[4] The extension of time in which to file a gift tax return does not extend the time to pay the gift or generation-skipping transfer ("GST") taxes.[5]

III. COMMON ERRORS FOUND IN GIFT TAX RETURNS

A. Gift-Splitting

Federal gift tax law permits gifts made by only one spouse to a third party to be considered for gift tax purposes as being made one-half by the donor spouse and one-half by the nondonor spouse if the spouses were married <u>at the time</u> the gift was made and neither remarried during the remainder of the calendar year and if both spouses were citizens or residents of the United States.[6] Both spouses must consent to splitting any gifts; however, under certain circumstances, only

[1] I.R.C. § 6075(b)(1), (2).
[2] *Id.* § 6075(b)(3).
[3] *Id.* § 6075(b)(2).
[4] Treas. Reg. § 25.6081-1(a), (b).
[5] *Id.* § 25.6081-1(c).
[6] I.R.C. § 2513.

the donor spouse may be required to file a gift tax return.

Once an election has been made to split gifts, the election is irrevocable unless the election is revoked prior to the due date of the gift tax return (including extensions).[7] Likewise, if either spouse files a gift tax return and the election to split gifts is not made, the election may not be made after the due date for filing the return has passed.[8]

"If a gift is of community property, it is considered made one-half by each spouse. For example, a gift of $100,000 of community property is considered a gift of $50,000 made by each spouse, and each spouse must file a gift tax return."[9] Thus, as a general rule, community property should not be split.

Community property gifts should only be split if any gifts of separate property were made and the spouses wish to split the separate property gifts. The reason for this is because, if spouses elect to split any gifts, the election will apply to <u>all gifts</u> made by either spouse during the calendar year other than any gift which is not eligible for gift-splitting.[10] A spouse does not have the ability to pick and choose to have certain gifts split while not splitting other gifts.

Gifts that are not eligible for gift-splitting include gifts of property by a donor spouse to a third party if the nondonor spouse has a general power of appointment over such property. In addition, if a donor spouse makes a gift of property to a trust of which the nondonor spouse is a beneficiary, a portion of the gift may not be eligible for gift-splitting.[11] In that event, the "consent is effective with respect to the interest transferred to third parties only insofar as such interest is ascertainable at the time of the gift and hence severable from the interest transferred to [the nondonor] spouse."[12] The portion of the gift allocated to a third-party is eligible for gift-splitting, but the portion allocated to the nondonor spouse is not eligible. If the gift to the third party cannot be ascertained, then none of the gift qualifies for gift-splitting.[13]

If a client provides the tax advisor with a gift tax return wherein the client and his or her spouse has split gifts, the advisor should review the return to ensure that the gifts were properly split. It is not uncommon for the advisor to find that the donor has split some gifts but not others or to find that the donor has split a gift to a trust of which the donor's spouse is a beneficiary.

B. Exclusion from GST Tax

A donor may make a gift to any donee of an amount up to $14,000 in 2015 without that amount being subject to gift tax or requiring the filing of a gift tax return.[14] This amount is referred to as the "gift tax annual exclusion."

The gift tax annual exclusion is available for a gift of a present interest.[15] The Treasury Regulations define a "present interest" in property as an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property."[16] Most gifts in trust will not qualify for the annual exclusion because a gift in trust is generally considered to be a gift of a future interest in property. However, a gift to a trust that meets the qualifications under 2503(c) of the Internal Revenue Code will qualify for the annual exclusion,[17] and a gift to a trust with respect to which a trust beneficiary has the power of withdrawal (i.e., a *Crummey* power) may qualify for the annual exclusion.[18]

The fact that a gift will qualify for the annual exclusion for gift tax purposes does not mean that the gift will qualify for the so-called "GST annual exclusion". However, this fact is lost upon some tax return preparers who assume that if a gift to a trust qualifies for the gift tax annual exclusion, the allocation of GST exemption is unnecessary.

Generally, a direct skip that is a nontaxable gift will have an inclusion ratio of zero (i.e., the direct skip is excluded from the GST tax without the donor having to allocate GST exemption).[19] However, an exception exists if the gift is made to a trust unless (i) during the life of an individual, no portion of the trust property

[7] I.R.C. § 2513(c); Treas. Reg. § 25.2513-3.
[8] I.R.C. § 2513(b); Treas. Reg. § 25.2513-2.
[9] Instructions for 2014 Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return.
[10] Treas. Reg. § 25.2513-1(b).
[11] *Id.*
[12] *Id.*
[13] *See* Rev. Rul. 56-439, 1956-2 C.B. 605 (ruling that a gift to a trust for the benefit of the donor's spouse, descendants, and spouses of descendants was not eligible for gift-splitting because the trustee's authority to make distributions in his sole discretion resulted in the value of the wife's interest being insusceptible of determination); *Wang v. Commissioner*, 31 T.C.M. (CCH) 719 (1972) (holding that the gift in trust for the donor's spouse did not qualify for gift-splitting because the distributions to the spouse were not limited by an ascertainable standard); *but see Robertson v. Commissioner*, 26 T.C. 246 (1956) (holding that a gift to a trust for the benefit of the nondonor spouse qualified for gift-splitting because the nondonor spouse's interest could be valued when there was no likelihood that the trustee would actually exercise the power to distribute principal when the trustee's distribution power was limited to an ascertainable standard and the trustee was required to take into account other sources of funds); Priv. Ltr. Rul. 200345038 (July 28, 2003).
[14] I.R.C. § 2503.
[15] *Id.*
[16] Treas. Reg. § 25.2503-3(b).
[17] I.R.C. 2503(c).
[18] *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).
[19] I.R.C. § 2642(c).

may be distributed to or for the benefit of any person other than such individual (i.e., the trust can have only one current beneficiary), and (ii) the assets of such trust will be included in the gross estate of such individual if the trust does not terminate before the individual dies (e.g., the assets are distributed to the individual's estate upon termination of the trust or the beneficiary has a general power of appointment).[20]

Most trusts that meet the qualifications under section 2503(c) of the Internal Revenue Code should qualify for the GST annual exclusion. However, most other trusts (e.g., irrevocable life insurance trusts) likely will not qualify for the GST annual exclusion even though a gift made to the trust qualifies for the gift tax annual exclusion. Therefore, whenever a tax advisor identifies that his or her client has made gifts to a trust which contains a Crummey withdrawal power (specifically including an irrevocable life insurance trust), the advisor should ask for copies of the client's gift tax returns to ensure that the allocation of GST exemption has been properly reported.

C. Deemed Allocation of GST Exemption

In 2001, Congress enacted section 2632(c) of the Internal Revenue Code. Section 2632(c) of the Internal Revenue Code provides that if a donor makes an indirect skip during such donor's lifetime, any unused portion of such donor's GST exemption will be automatically allocated to the transferred property to the extent necessary to make the inclusion ratio for such property zero. An "indirect skip" is defined as any transfer of property (other than a direct skip) to a GST trust.[21]

The enactment of section 2632(c) was intended to be helpful to donors who wished to allocate GST exemption to a transfer but failed to do so because, for example, the donor's "advisor inadvertently omitted making the election on a timely-filed gift tax return or submitted a defective election."[22] Congress intended for the automatic allocation of GST exemption to apply to transfers to any trust from which a generation-skipping transfer would be likely to occur;[23] therefore, Congress broadly defined the term "GST trust".

A GST trust is defined as a trust that <u>could</u> have a generation-skipping transfer unless one of the six exceptions listed under section 2632(c)(3)(B) of the Internal Revenue Code applies or unless the donor has elected to opt out of the deemed allocation rules.[24] A donor may elect to treat a trust as a GST trust regardless of whether such trust would otherwise qualify as a GST trust.[25]

Because the definition of a GST trust is very broad, it encompasses trusts that are not intended to be GST trusts. The definition is complex and, in some cases, ambiguous. As a result, many tax advisors agree that the deemed allocation rules should not be relied upon in determining whether GST exemption should be allocated to indirect skips.[26] However, not all tax return preparers adhere to this advice. Instead, an advisor may find himself or herself faced with reviewing a client's gift tax return which reports gifts to a trust but does not affirmatively allocate GST exemption. Thus, the advisor must determine whether the deemed allocation rules apply.

(1) The first exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a trust is not a GST trust if the trust agreement provides that more than 25% of the trust property must be distributed to or may be withdrawn by at least one individual who is a non-skip person (i) before such individual attains 46 years of age, (ii) on or before one or more dates specified in the trust agreement that will occur before the date that such individual attains 46 years of age, or (iii) upon the occurrence of an event that, in accordance with Treasury Regulations, may reasonably be expected to occur before the date that such individual attains age 46.[27]

(2) The second exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a trust is not a GST trust if the trust agreement provides that more than 25% of the trust property must be distributed to or may be withdrawn by at least one individual who is a non-skip person and who is living on the date of death of another person identified in the trust agreement (by name or by class) who is more than 10 years older than such individual.[28]

(3) The third exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a trust is not a GST trust if the trust agreement provides that, if at least one individual who is a non-skip person dies on or before a date or event described in section 2632(c)(3)(B)(i) or (ii) of the Internal Revenue Code (i.e., the first exception or the second exception described above), more than 25% of the trust property either must be distributed to the estate of such

[20] *Id*. § 2642(c)(2).
[21] *Id*. § 2632(c)(3)(A).
[22] H.R. Rep't No. 107-37, 107th Cong., 1st Sess., at p. 35 (Apr. 3, 2001).
[23] *Id.*
[24] I.R.C. § 2632(c)(3), (5).
[25] *Id*. § 2632(c)(5).
[26] *See e.g.,* Steve R. Akers, *Estate Planning: Current Developments and Hot Topics*, Est. Plan. for the Fam. Bus. Owner ALI-CLE 217, 237 (July 10-12, 2013) ("Do not rely on automatic allocations of GST exemption[.]" (summarizing point made by Carol Harrington during presentation at 47th Annual Philip E. Heckerling Institute on Estate Planning)).
[27] I.R.C. § 2632(c)(3)(B)(i).
[28] *Id*. § 2632(c)(3)(B)(ii).

individual or is subject to a general power of appointment exercisable by such individual.[29]

(4) The fourth exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a trust is not a GST trust if the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer.[30]

(5) The fifth exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that charitable lead annuity trusts (CLATs), charitable remainder annuity trusts (CRATs), and charitable remainder unitrusts (CRUTs) are not GST trusts.[31]

(6) The sixth exception under section 2632(c)(3)(B) of the Internal Revenue Code provides that a charitable lead unitrust (CLUT) for which a charitable deduction was allowed is not a GST trust if the trust requires the principal to be paid to a non-skip person if such person is alive at the end of the trust term.[32]

Despite the six exceptions to the definition of "GST trust" under section 2632(c)(3)(B) of the Internal Revenue Code, there is an important exception to those exceptions which provides that the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in section 2503(b) of the Internal Revenue Code (i.e., the gift tax annual exclusion amount) with respect to any transferor, and it shall be assumed that powers of appointment held by non-skip persons will not be exercised.[33] In other words, if a non-skip person has the power to withdraw an amount equal to or less than the gift tax annual exclusion, the trust may qualify as a GST trust. This so-called *Crummey* exception exists so that trusts containing *Crummey* withdrawal powers may fall within the definition of a GST Trust.

The fourth exception to section 2632(c)(3)(B) of the Internal Revenue Code and the *Crummey* exception can wreak havoc on a tax return preparer who relies on the deemed allocation rules. The fourth exception to section 2632(c)(3)(B) of the Internal Revenue Code can be problematic with respect to trusts that contain contingent or formulaic general powers of appointment, and the *Crummey* exception can be problematic with respect to trusts that contain hanging *Crummey* withdrawal powers.

[29] *Id.* § 2632(c)(3)(B)(iii).
[30] *Id.* § 2632(c)(3)(B)(iv).
[31] *Id.* § 2632(c)(3)(B)(v).
[32] *Id.* § 2632(c)(3)(B)(vi).
[33] *Id.* § 2632(c)(3)(B).

1. <u>Contingent General Power of Appointment</u>

As previously stated, the fourth exception to section 2632(c)(3)(B) of the Internal Revenue Code generally causes a trust to fail to be a GST trust at the time of a transfer to the trust if any portion of the trust would be included in the gross estate of a non-skip person if such person had died immediately after such transfer. In other words, assuming the *Crummey* exception is not applicable, if a non-skip person would have a general power of appointment over the trust property if he or she had died immediately after the transfer, then the trust will not be a GST trust.

Many trust agreements provide a contingent general power of appointment that would allow a non-skip person to have a general power of appointment only if the inclusion ratio of the trust is greater than zero immediately prior to such non-skip person's death. Such a contingent general power of appointment creates the following circular analysis:

- Does a non-skip person have a general power of appointment? It depends on whether the deemed allocation rules apply. If the deemed allocation rules apply, the inclusion ratio would be zero and the non-skip person would not have a general power of appointment. This would result in the trust being a GST trust.
- Do the deemed allocation rules apply? It depends on whether a non-skip person has a general power of appointment. If there is no general power of appointment, then the assets of the trust would not be included in the non-skip person's estate and the deemed allocation rules would apply. This would result in the trust being a GST trust.

This circular analysis has resulted in an unclear answer as to whether the deemed allocation rules apply to a trust which gives a non-skip person a contingent general power of appointment. At least one pair of commentators believe that the deemed allocation rules would not apply to a trust in which a non-skip person has a general power of appointment which is contingent on the trust's inclusion ratio being greater than zero. Such commentators state that "it would seem that since the transferor always has the option of electing out of any deemed allocation . . . it should be assumed that there will not be a deemed allocation, with the result that a testamentary general power in the non-skip person will be assumed to exist immediately after the gift."[34] However, there arguably is no basis to assume that a donor would opt out of the deemed allocation rules with respect to a trust which has a contingent general power of appointment. Because the

[34] Thomas E. Peckham and Harry F. Lee, *The GST Tax and Various Planning Issues*, Post-Mortem Plan. & Est. Admin. ALI-CLE (March 2007).

deemed allocation rules allocate GST exemption at the time of the transfer, an argument could be made that the deemed allocation rules cause GST exemption to be retroactively allocated as of the date of the transfer unless the donor affirmatively opts out of the rules. In that case, the beneficiary would not have a general power of appointment and the deemed allocation rules should apply.

In the author's experience, there are many tax return preparers who (erroneously) assume that because a trust is intended to be exempt from the GST tax, the deemed allocation rules apply, and no thought is given to what consequence the contingent general power of appointment may have on the deemed allocation rules.

2. Formulaic General Power of Appointment

Some trust agreements provide that a non-skip person has a general power of appointment only *if* the estate inclusion would result in a lower aggregate tax than if the property were subject to the GST tax and only *with respect to* the portion of the property that would result in a lower tax. If such a formula general power of appointment is given, it may be difficult (or impossible) to determine whether a non-skip person would have a general power of appointment if he or she died immediately after the transfer to a trust is made.

If a non-skip person has a formula general power of appointment over a trust, then in order to determine whether such non-skip person would have a general power of appointment, and thus whether such a trust is a GST trust, the tax return preparer may have to perform an in depth analysis of the non-skip person's estate to compare the tax resulting from having a general power of appointment versus not having a general power of appointment. For example, the tax return preparer may have to review any prior gift tax returns filed by the non-skip person to determine his or her remaining estate tax exemption, determine the value of every asset of such person using values as of the date of the transfer to determine the value of his or her gross estate, and factor in debts and expenses of the non-skip person's hypothetical estate to determine his or her taxable estate. In most cases, it is probable that the tax advisor will not have access to this information in any detail. Even if the information is available, a client likely would not want to pay for the analysis. This is another example of why the deemed allocation rules should not be relied upon, but if a tax advisor is reviewing returns prepared by a tax return preparer who relied on the deemed allocation rules, he or she may have to go through the analysis to determine how much GST exemption the client has available.

3. Hanging *Crummey* Withdrawal Powers

Some trust agreements, in particular irrevocable life insurance trusts, provide that one or more beneficiaries of the trust have a power to withdraw gifts made to the trust. This power of withdrawal is typically limited in some way, but many times a beneficiary will be able to withdraw an amount equal to the gift tax annual exclusion amount so that the donor can maximize the use of his or her gift tax annual exclusion with respect to that beneficiary.

If a beneficiary is given the power to withdraw gifts made to the trust, the withdrawal power typically will lapse at some future point in time (e.g., 30 days or 60 days after the gift is made) so that the beneficiary no longer has the ability to withdraw the gift. The lapse of a withdrawal power can have negative tax consequences to the beneficiary if the amount of the gift that lapses is greater than $5,000 or 5% of the value of the trust property. A beneficiary's power of withdrawal is considered a general power of appointment;[35] therefore, to the extent that the beneficiary's withdrawal power lapses as to the greater of $5,000 or 5% of the value of the trust property, the excess portion would be includible in the beneficiary's estate.[36] To avoid a portion of the trust being included in the beneficiary's estate, many trusts will include a "hanging" withdrawal power which provides that the gift in excess of the greater of $5,000 or 5% of the value of the trust property will not lapse. Instead, the excess amount is carried forward until the power can lapse without there being negative tax consequences for the beneficiary.[37]

If a tax return preparer relies on the deemed allocation rules and gifts are made to a trust containing a hanging withdrawal power, the tax return preparer may have to analyze the trust at each point in time when a withdrawal power lapses or has previously lapsed to determine whether the trust is a GST trust. As previously discussed, the *Crummey* exception provides that the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the gift tax annual exclusion amount, but this *Crummey* exception does not necessarily apply to hanging withdrawal powers. If the amount "hanging" exceeds the annual exclusion amount, the *Crummey* exception will not

[35] I.R.C. §§ 2514, 2041; *see also* Donald O. Jansen, *Giving Birth to, Caring for, and Feeding the Irrevocable Life Insurance Trust*, 41 Real Prop. Prob. & Tr. J. 571, 607 (Fall 2006).
[36] I.R.C. § 2041.
[37] *Id.* § 2041(b)(2).

apply, and the trust will not be a GST trust.[38] As a result, a trust which includes hanging withdrawal powers may be a GST trust in one year and not a GST trust in another year.

To illustrate the conclusion above, assume that a grantor creates a life insurance trust for his one child and that child's descendants. The trust gives the child the power to withdraw gifts made to the trust, and that the withdrawal power is limited to the annual exclusion amount. The withdrawal amount lapses as to the greater of $5,000 or 5% of the value of the trust property 30 days after the date of the gift. In year 1, the grantor makes a gift of $14,000, which is the annual exclusion amount. The *Crummey* exception would apply so that the trust would be a GST trust (assuming that none of the other exceptions to the definition of GST trust would apply). However, if the withdrawal power lapses as to only $5,000, $9,000 would be left hanging. If the grantor makes another gift of $14,000 in year 2, the child will have the power to withdraw $23,000 which is well in excess of the gift tax annual exclusion amount. As a result, the *Crummey* exception will not apply, and the trust will not be a GST trust.

Although best practice is to never rely on the deemed allocation rules, there are far too many tax return preparers who allow the deemed allocation rules to apply. It is especially troublesome to see a tax return preparer rely on the deemed allocation rules when his or her client has made a gift to an insurance trust that contains hanging withdrawal powers because, many times, no analysis is done to determine whether the hanging powers would cause the trust to fail to be a GST trust.

In order to properly analyze whether the trust is a GST trust, it is necessary to determine whether a beneficiary has a withdrawal power over an amount in excess of the gift tax annual exclusion amount. This analysis will require the value of the trust property to be determined each time a withdrawal power lapses (unless the value of the trust property over which the withdrawal power lapses is obvious). If the trust only holds life insurance, it may be necessary to ask the insurance company for the Form 712 to determine the value of the insurance policy. If the trust holds hard-to-value assets, such as partnership interests or closely held stock, it may be necessary to hire a valuation expert to appraise the property. If the time is not taken to determine the value of the trust property on the date a withdrawal power lapses, then at the time a gift is made to the trust it may not be possible to determine the amount subject to a withdrawal power which has lapsed or the amount subject to a withdrawal power which is still hanging.

If GST exemption is affirmatively allocated at the time the gift tax return is filed, this in depth analysis is not required. However, if a tax advisor is reviewing returns that have already been filed or the tax advisor discovers that the client has not been filing gift tax returns, the tax advisor should go through the exercise of determining whether the trust is a GST trust in each year a gift is made so that the tax advisor can determine how much GST exemption the client has remaining.

IV. DUTY OF ADVISOR TO FIND AND FIX PROBLEMS

Tax advisors often wonder whether they have a duty to inquire into a client's gifting history or to review the work of another tax professional. Likewise, tax advisors often wonder what their duty is if it is discovered that the client has failed to properly file gift tax returns or has filed gift tax returns containing errors. These issues are discussed below with respect to lawyers in particular. However, any discussion regarding Treasury Department Circular No. 230 ("Circular 230") also would apply to certified public accountants and other persons representing taxpayers before the Internal Revenue Service.[39] Tax return preparer penalties are beyond the scope of this paper.

A. Duty to Find Tax Return Related Problems

A tax advisor owes a duty to his client, and he or she owes a duty to the tax system.[40] Circular 230 contains rules that govern a lawyer's authority to practice before the Internal Revenue Service, the duties and restrictions relating to such practice, and sanctions for violating Circular 230.[41] Circular 230's reach is broad and encompasses all matters connected with a presentation to the Internal Revenue Service, which may include preparing and filing documents.[42] Circular 230 applies to not only those who prepare tax returns, but also those who assist in preparing tax returns.[43]

A lawyer's duty to his or her client includes acting with reasonable diligence and promptness when representing a client.[44] "Reasonable diligence" is defined as a "fair, proper and due degree of care and activity, measured with reference to the particular

[38] *See also* Julie K. Kwon, *Generation-Skipping Transfer Tax Planning and Update*, Est. Plan. In Depth ALI-CLE (June 2011).

[39] Treas. Dept. Circular No. 230, 31 C.F.R. § 10.0 (Rev. 6-2014).

[40] *See* Kenneth L. Harris, *Ethics in Tax Practice: Emerging Standards for Reporting Tax Return Positions*, William & Marry Annual Tax Conference (1990).

[41] 31 C.F.R. § 10.0.

[42] *Id.* § 10.2(a)(4).

[43] *Id.* § 10.8(a), (c).

[44] ABA Model Rules of Prof'l Conduct R. 1.3.

circumstances; such diligence, care of attention as might be expected from a man of ordinary prudence and activity."[45] A lawyer's duty to the Internal Revenue Service requires a lawyer to exercise due diligence in "preparing or assisting in the preparation of, approving, and filing tax returns . . . ."[46] "Due diligence" is defined as "[s]uch a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case."[47] Thus, in either case, whether a lawyer has acted with a sufficient level of diligence will depend on facts and circumstances.

Whether a lawyer has a duty to inquire into the client's gifting history in exercising reasonable or due diligence depends upon the scope of the representation. For example, if a lawyer's representation of the client is limited to only the preparation of the client's last will and testament and the amount of the client's remaining estate or GST exemptions is irrelevant, then the lawyer may not have a duty to inquire into the client's gifting history. In such case, the answer as to whether the client has made taxable gifts has no bearing on the work product the lawyer produces for the client. Conversely, if the lawyer's representation includes the preparation of a fully tax-planned will or assisting the client in transferring assets out of his or her estate, then the lawyer has a duty to his or her client to determine the client's remaining transfer tax exemptions. Thus, the lawyer necessarily will need to determine whether the client has previously made taxable gifts. If the lawyer's representation includes reviewing or preparing gift tax returns, then the lawyer has a duty to not only the client, but also to the Internal Revenue Service to determine whether the client has previously made taxable gifts.

If a client indicates that he or she has never made taxable gifts and the lawyer has no reason to believe that the client is being untruthful, the lawyer's duty of reasonable or due diligence should be satisfied.[48] However, if the client makes statements to the lawyer which would lead a prudent person to believe that taxable gifts may have been made, the lawyer would be remiss to ignore those statements. Instead, Circular 230 and general prudence would require the lawyer to engage in an additional line of questioning with the client to determine whether the client may have unknowingly (or knowingly) made taxable gifts.[49] For example, if a client indicates in passing that his or her college student child owns a penthouse in Manhattan, the lawyer should ask for additional facts surrounding how the child became the owner of such an expensive residence. If the client then indicates that he or she made the down payment for the child's penthouse, the lawyer should determine whether the client had any intent for the child to repay the client. If not, the lawyer may have discovered a taxable gift. Even if the client intended for the child to repay the client, there may still be taxable gift issues if the loan is considered a below market loan in accordance with section 7872 of the Internal Revenue Code. It may be tempting for the lawyer to bury his or her head in the sand upon hearing facts that may lead to the conclusion that the client has made unreported taxable gifts; however, such inaction would be contrary to the lawyer's duty to his or her client and to the Internal Revenue Service.[50]

If a client indicates that he or she has made taxable gifts and has previously filed gift tax returns, the lawyer should not have a duty of further inquiry unless the lawyer will review or prepare the client's gift tax return. If the lawyer has been engaged to prepare or to assist in preparing the client's gift tax return, the lawyer's duty of due diligence suggests that the lawyer review prior gift tax returns to ensure that there are no blatant errors in the returns (particularly if prior gifts to insurance trusts have been made). Although section 10.22(b) of Circular 230 provides that a practitioner generally will be presumed to have exercised due diligence if the practitioner relies on the work of another person, the practitioner is required to have used reasonable care in engaging, supervising, training, and evaluating the other person.[51] Thus, section 10.22(b) generally will not apply to situations where a lawyer is taking over the gift tax return preparation duties of a tax practitioner outside of his or her firm.

[45] Black's Law Dictionary 457 (6th ed. 1990).

[46] 31 C.F.R. § 10.22(a)(1).

[47] Black's Law Dictionary 457.

[48] 31 C.F.R. § 10.34(d) ("A practitioner . . . preparing or signing a tax return . . . generally may rely in good faith without verification upon information furnished by the client.").

[49] *Id.* ("The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.").

[50] If a tax advisor chooses to not make reasonable inquiries, such negligence could lead to penalties under section 6664 of the Internal Revenue Code. *See* Frederick K. Hoops, Frederick H. Hoops III, and Daniel S. Hoops, 1 Fam. Est. Plan. Guide § 1.15 (4th ed.) ("Ignorance of contrary facts or failure to inquire into the veracity of certain information provided by the taxpayer or another return preparer or interested third party will not vindicate a return preparer's duty of diligence." (citing Treas. Reg. § 1.6664-2(d)).

[51] 31 C.F.R. § 10.22(b).

Circular 230 contains "best practices" for a lawyer. Specifically, section 10.33 of Circular 230 provides:

> Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service.[52]

Best practices include establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations relating the applicable law to the relevant facts, and arriving at a conclusion supported by the law and the facts as well as advising the client regarding the importance of the conclusions reached.[53] Pursuant to Circular 230's best practices, a lawyer should inquire into a client's prior gifting history and should review prior gift tax returns filed to establish relevant facts. The failure to comply with best practices will not subject the lawyer to sanctions under Circular 230, but it may indicate that the lawyer has failed to exercise due diligence as required under section 10.22 of the Treasury Regulations.[54]

B. Duty to File or Amend Return

If a lawyer discovers that his or her client has failed to file a gift tax return which was due or that his or her client has filed a prior gift tax return that contains errors, the lawyer must determine what his or her duty is, if any, to require the client to file a gift tax return or to file an amended return.

Section 10.21 of Circular 230 requires that a lawyer who knows that a client has made an error on or an omission from a return advise the client promptly of (i) the fact of the error or omission and (ii) the consequences of the error.[55] Specifically, Section 10.21 of Circular 230 provides:

> A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.[56]

Further, a Formal Opinion of the American Bar Association provides that the lawyer must not only advise the client of the existence of an error, but must advise the client that the error should be corrected.[57] Specifically, Opinion 314 provides:

> [W]ith regard . . . to the preparation of returns . . . , the lawyer is under a duty not to mislead the Internal Revenue Service deliberately and affirmatively, either by misstatements or by silence or by permitting his client to mislead. The difficult problem arises where the client has in fact misled but without the lawyer's knowledge or participation. In that situation, upon discovery of the misrepresentation, the lawyer must advise the client to correct the statement; if the client refuses, the lawyer's obligation depends on all the circumstances.[58]

Thus, a lawyer is obligated to advise the client that the client should file a return upon discovering that taxable gifts were made but gift tax returns were not filed. Further, a lawyer is obligated to advise the client that the client should file an amended tax return upon discovering that a prior return contained an error.

Although the lawyer must advise the client to file a return or an amended return, the client does not have a duty to file an amended tax return upon the discovery of an error. The United States Supreme Court has acknowledged that the Internal Revenue Code does not explicitly provide for a donor's filing, or for the Service's acceptance of, an amended tax return.[59] Rather, an amended tax return is a creature of administrative origin and grace.[60] Based upon the Supreme Court's decision and the lack of any requirements in the Internal Revenue Code or the Treasury Regulations that an amended return be filed to correct prior errors, there does not seem to be any clear authority that stands for the proposition that the

[52] *Id.* § 10.33(a).
[53] *Id.* § 10.33(a)(2).
[54] Michael G. Goller, *Practitioners Take Note: Now is a Good Time for a Circular 230 Refresher*, J. Tax Prac. & Proc. (June-July 2012).
[55] Ian M. Comisky and Michael D. Shepard, *To Amend or Not to Amend? The Wisdom of Correcting Tax Return Errors*, Fla. Bar J., Feb. 1996, at 49.
[56] 31 C.F.R. § 10.21.
[57] ABA Comm. on Prof'l Ethics and Grievances, Formal Op. 314 (1965).
[58] *Id.*
[59] *Badaracco v. Commissioner*, 464 U.S. 386, 393 (1984).
[60] *Id.*

donor is under a legal obligation to file an amended return upon the discovery of an error on a previously filed return.[61] It should be permissible for the lawyer to further inform the client that the United States Supreme Court has stated that neither the Internal Revenue Code nor the Treasury Regulations legally requires the filing of an amended return.[62]

If a client should file an amended tax return and refuses to do so, the lawyer does not have a duty per se to withdraw from his representation of that client.[63] The fact that the client is not legally obligated to correct an error in a return suggests that a lawyer should be free to continue to represent the client provided that such representation does not further the error.[64]

A lawyer has a duty to exercise due diligence in the preparation and filing of tax returns and to avoid participating in any way in the giving of false or misleading information.[65] Because of those duties, a lawyer is prohibited from preparing a current tax return in a manner incorporating any prior errors of which the lawyer is aware.[66] Moreover, section 10.34 of Circular 230 provides that a practitioner may not willfully, recklessly, or through gross incompetence sign a tax return that the practitioner knows or reasonably should know contains a position that lacks a reasonable basis.[67] Model Rule 4.1(a) requires that the "lawyer shall not knowingly make a false statement of material fact or law to a third person," and Model Rule 8.4(c) prohibits the lawyer from engaging in fraudulent or dishonest conduct.[68] Thus, Circular 230 and the Model Rules support the conclusion that a lawyer may not complete a tax return when doing so would further a prior error about which the lawyer knows or reasonably should know.[69] Assuming that the lawyer's representation is wholly unrelated to the uncorrected error, Circular 230 and the Model Rules appear to sanction continued representation.[70]

V. CONCLUSION

Generally, a client must file a gift tax return if he or she has made a gift of a present interest in an amount greater than the gift tax annual exclusion amount or a gift of a future interest or under other circumstances outlined in the Instructions for Form 709. If a client has previously filed a gift tax return, the advisor should have the ability to spot errors in such returns.

Common errors found in gift tax returns include gift tax returns which split gifts of community property, split some gifts but not all gifts, or split gifts ineligible for splitting, such as gifts to a trust of which the nondonor spouse is a beneficiary. In addition, another common error found in gift tax returns include gift tax returns which fail to properly allocate GST exemption to gifts because it is erroneously assumed that the GST annual exclusion is applicable or that the deemed allocation rules apply.

If the scope of a lawyer's representation of his or her client is narrow enough, the lawyer may not have a duty to inquire into whether prior gifts have been made and to review gift tax returns previously filed by the client. However, if the lawyer will be preparing or assisting in the preparation of a client's gift tax return, the lawyer has a duty to determine whether the client previously has made taxable gifts and to review the client's prior gift tax returns.

If the lawyer discovers the client has not filed gift tax returns which were due or has filed erroneous gift tax returns, the lawyer must advise the client that the client should file a gift tax return or file an amended gift tax return, as applicable. However, the client is not

[61] 15 Mertens Law of Fed. Income Tax'n § 56:73; *see also* Ian M. Comisky and Michael D. Shepard, *To Amend or Not to Amend? The Wisdom of Correcting Tax Return Errors*, Fla. Bar J., Feb. 1996, at 49 ("No code provision, however, requires the filing of amended returns."); Kenneth L. Harris, *On Requiring the Correction of Error Under the Federal Tax Law*, 42 Tax Law. 515, 517 (1989) ("A review of the Code and the regulations thus indicates, somewhat surprisingly, that there is no stated requirement that a donor file an amended return on the discovery of an error which results in additional tax due on a prior year's return."); Sheldon D. Pollack, *What Obligations Do Donors and Preparers Have to Correct Errors On Returns?*, 72 J. Tax'n 90, 90 (1990) ("Although the Code and Regulations explain when a donor is permitted to file an amended return, there is no provision requiring the filing of such a return."); John R. Price, Tax Management Portfolio: Conflicts, Confidentiality, and Other Ethical Considerations in Estate Planning, No. 801 ("There is, however, generally no duty to file an amended return."); Judson L. Temple, *Rethinking Imposition of a Legal Duty to Correct Material Tax Return Errors*, 76 Neb. L. Rev. 223, 229 (1997) ("The regulations do not, however, impose a duty on donors to file amended returns.").

[62] Comisky & Shepard, *supra*, at 50.

[63] Pollack, *supra*, at 90.

[64] Harris, *supra*, at 526.

[65] 31 C.F.R. §§ 10.22(a), 10.51(d).

[66] Harris, *supra*, at 523-24; *see also* Pollack, *supra*, at 90-91 ("[T]o the extent an attorney advises a client as to the proper method of reporting a position for the tax year at issue, the attorney may not deliberately mislead the Service or permit the client to do so."); *see also* Akers, *supra*, at 237 ("A planner may not have a duty to correct prior returns that were inadvertently incorrect, but a preparer does have a duty not to report a wrong number in this year's return that the preparer knows is incorrect because it does not reflect prior gifts.").

[67] 31 C.F.R. § 10.34.

[68] Model Rules of Prof'l Conduct R. 4.1(a) and 8.4(c).

[69] Harris, *supra*, at 524.

[70] Harris, *supra*, at 526.

legally obligated to correct the error; therefore, the lawyer should not have the duty to withdraw from representation of the client unless such representation would further the error. Nevertheless, a lawyer may not prepare or assist in preparing a gift tax return that furthers an error about which the lawyer knows or reasonably should know.

New IRS Guidance Limits Future Rulings on Tax-Free Spin-Off Transactions

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On September 14, 2015, the IRS issued Notice 2015-59 and Revenue Procedure 2015-43 (the "Spin-Off Guidance"). The Spin-Off Guidance limits the circumstances in which the IRS will issue private letter rulings relating to spin-off transactions in which either the distributing corporation or the controlled corporation owns relatively large amounts of cash, securities, and other investment assets. The Spin-Off Guidance also significantly circumscribes the issuance of private letter rulings where the spin-off involves a real estate investment trust ("REIT") or a regulated investment company ("RIC").

<u>Overview of Tax-Free Spin-Off Transactions</u>

A spin-off transaction occurs when a corporation (the "distributing corporation") distributes the stock of a controlled subsidiary corporation (the "controlled corporation") to the distributing corporation's shareholders. The controlled corporation could either be an existing subsidiary that is already conducting the business to be spun-off or a newly formed subsidiary to which the spun-off business is transferred. Immediately following a spin-off, the distributing corporation and the controlled corporation become brother-sister corporations owned by the same shareholders in the same proportions.

In general, if a corporation distributes property (including stock of another corporation) to its shareholders, the corporation is subject to tax on the built-in gain in the property,[1] and the shareholders generally are subject to tax on the fair market value of the distributed property.[2] However, if a spin-off transaction meets the requirements of Section 355 of the Internal Revenue Code,[3] the transaction will not be subject to tax either at the corporate or shareholder level. Rather, any gain on the controlled corporation stock is deferred, and the shareholders of the distributing corporation will recognize gain only upon a later disposition of their stock.

The basic statutory requirements for a spin-off transaction to qualify under Section 355 are as follows:

1. *Control* – The distributing corporation must be in control of the controlled corporation immediately before the distribution.[4] For this purpose, a corporation has control of another corporation if it owns stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of each of the other classes of stock of the corporation.[5]

[1] I.R.C. § 311(b)(1).
[2] I.R.C. § 301.
[3] Except as otherwise stated, all Section references are to the Internal Revenue Code.
[4] I.R.C. § 355(a)(1)(A).
[5] I.R.C. § 368(c).

2. *Device* – The distribution of the controlled corporation's stock cannot be principally a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both corporations.[6] Whether a transaction is used principally as a device for the distribution of earnings and profits is determined based on all the facts and circumstances.[7] In determining whether a distribution is a device, consideration is given to the nature, kind, amount, and use of the assets of the distributing and controlled corporation. The existence of assets that are not used in an active trade or business, such as cash and other liquid assets, are evidence of a device. The existence of a device depends in part on the ratio for each corporation of the value of the assets not used in an active trade or business to the value of the assets used in an active trade or business.[8]

3. *Active Trade or Business* – The distributing corporation and the controlled corporation must each be engaged in an active trade or business immediately after the distribution.[9] A corporation is treated as engaged in the active conduct of a trade or business if (1) the corporation is currently engaged in the active conduct of a trade or business, (2) the trade or business has been actively conducted throughout the five-year period ending on the date of distribution, (3) the trade or business was not acquired during the five-year period ending on the date of the distribution in a transaction in which any gain or loss was recognized, and (4) control of a corporation conducting such trade or business was not acquired by the distributing corporation during the five-year period preceding the distribution in a transaction in which any gain or loss was recognized.[10] An active trade or business is broadly defined. However, the active conduct of a trade or business does not include the holding for investment purposes of stock, securities, land, or other property, or the ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.[11]

4. *Distribution* – In general, the distributing corporation must distribute all of the stock and securities in the controlling corporation to the distributing corporation's shareholders.[12]

In addition to the statutory requirements, courts have also imposed the following judicial requirements that must be satisfied for a spin-off to qualify as a tax-free transaction:

1. *Business Purpose* – The spin-off transaction must be carried out for one or more corporate business purposes.[13]

[6] I.R.C. § 355(a)(1)(B).
[7] Treas. Reg. § 1.355-2(d)(1).
[8] Treas. Reg. § 1.355-2(d)(2)(iv).
[9] I.R.C. § 355(b)(1)(A).
[10] I.R.C. § 355(b)(2).
[11] Treas. Reg. § 1.355-3(b)(2).
[12] I.R.C. § 355(a)(1)(D(i).
[13] Treas. Reg. § 1.355-2(b)(1).

2. *Continuity of Interest* – One or more persons who were the owners of the enterprise before the distribution or exchange must own in the aggregate an amount of stock sufficient to establish a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the distribution.[14]

3. *Continuity of Business Enterprise* – Section 355 contemplates the continued ownership and operation of the businesses of both the distributing corporation and the controlled corporation that existed prior to the distribution.[15]

<u>Notice 2015-59</u>

Notice 2015-59 provides that the IRS is studying issues regarding spin-off transactions with one or more of the following characteristics:

1. Ownership by the distributing corporation or the controlled corporation of a substantial amount of "investment assets" in relation to (i) the value of all of such corporation's assets and (ii) the value of the assets of the active trade or business on which the corporation relies to satisfy the active trade or business requirement described above. Investment assets generally include cash, stock, securities, indebtedness, foreign currency, and similar assets.[16]

2. A significant difference between the distributing corporation's ratio of investment assets to non-investment assets and such ratio of the controlled corporation.

3. Ownership by the distributing corporation or the controlled corporation of a small amount of active trade or business assets when compared to its total assets.

4. An election by the distributing corporation or the controlled corporation (but not both) to be a REIT or a RIC.

The IRS is concerned that transactions with these characteristics may not satisfy the requirements of Section 355. In particular, Notice 2015-59 states that such transactions may present evidence of a device for the distribution of earnings and profits, may lack an adequate business purpose, may not meet the active trade or business requirement, or may violate other requirements of Section 355. The IRS noted that such transactions may circumvent the tax rules that impose a corporate level tax upon a distribution of property with a built-in gain.

The IRS also noted that it has observed an increasing number of spin-off transactions involving a distributing corporation or a controlled corporation that elects to be a REIT. Such spin-off transactions may involve corporations that, prior to the distribution, do not meet the requirements to be REITs and intend to separate REIT-qualifying assets from non-qualifying assets so that the distributing corporation or the controlled corporation can meet the requirements

[14] Treas. Reg. § 1.355-2(c)(1).
[15] Treas. Reg. § 1.355-1(b).
[16] I.R.C. § 355(g)(2)(B).

to be a REIT. Such transactions raise concerns relating to the device prohibition, the business purpose requirement, and the active trade or business requirement.

The IRS also requested comments concerning the transactions described in Notice 2015-59.

Revenue Procedure 2015-43

There are certain areas where the IRS will not issue private letter rulings because the issues are inherently factual or for other reasons. The IRS publishes annual guidance that sets forth those "no-rule" areas. The most recent list of no-rule areas are contained in Revenue Procedure 2015-3. Section 4 of Revenue Procedure 2015-3 sets forth areas in which the IRS ordinarily will not issue rulings, unless unique and compelling reasons justify the issuance of the ruling. Section 5 of Revenue Procedure 2015-3 lists areas in which the IRS temporarily will not issue rulings because the areas are under study.

In Revenue Procedure 2015-43, the IRS added two no-rule areas to Section 4 of Revenue Procedure 2015-3. The first new no-rule area involves any issue relating to a spin-off transaction where the distributing corporation or the controlled corporation becomes a REIT or a RIC in connection with the spin-off. The second no-rule area involves any issue relating to a spin-off transaction if, immediately after the distribution, the fair market value of the active trade or business assets of the distributing corporation or the controlled corporation is less than 5% of the fair market value of its total gross assets. Thus, for ruling requests postmarked after September 14, 2015, the IRS ordinarily will not rule on these two issues absent unique and compelling reasons.

Revenue Procedure 2015-43 also makes one addition to Section 5 of Revenue Procedure 2015-3. Accordingly, the IRS is studying, and will not rule on, any issue relating to a spin-off transaction if, immediately after the distribution (1) the fair market value of the investment assets of the distributing corporation or the controlled corporation is two-thirds or more of the fair market value of its total gross assets, (2) the fair market value of the gross assets of the active trade or business of the distributing corporation or the controlled corporation is less than 10% of the fair market value of its investment assets, and (3) the ratio of the fair market value of the investment assets to the fair market value of the assets other than investment assets of the distributing corporation or the controlled corporation is three times or more than the ratio of the other corporation. In contrast to the no-rule areas added to Section 4 in which the IRS may issue a ruling if there are unique and compelling reasons, there are no circumstances in which the IRS will issue a ruling on the areas listed in Section 5.

Impact of the Spin-Off Guidance

Through the Spin-Off Guidance, the IRS has expressed a degree of concern regarding the qualification of the various spin-off transactions described above. However, the IRS has not given a clear indication of the path it intends to take after completing its study. The IRS might issue new regulations limiting the scope of permitted spin-off transactions, or it could ultimately decide to make no changes to the existing regulations.

In the meantime, due to the additional no-rule areas contained in Revenue Procedure 2015-43, taxpayers desiring to complete spin-off transactions described in the Spin-Off Guidance will have to do so without the comfort of a private letter ruling and generally will need to rely on the opinions of tax counsel.

IRS Changes Rules for Private Foundation Grants to Foreign Charities
Tyree Collier and David Rosenberg

On Sept. 23, 2015, the IRS and Treasury issued Treasury Decision 9740, which released final regulations regarding the standards for private foundations to use in making a good faith determination that a foreign organization is a charitable organization that is not a private foundation, so that grants made to that foreign organization may be qualifying distributions and may not be taxable expenditures.

Background.

A private foundation generally may treat grants made for charitable purposes to certain foreign organizations as qualifying distributions under I.R.C. section 4942 if the foundation makes a good faith determination that the foreign organization is either (a) an organization described in sections 501(c)(3) and 509(a)(1), (2), or (3) (a “public charity”) that is not a “disqualified supporting organization” described in section 4942(g)(4)(A) (i) or (ii), or (b) an organization described in sections 501(c)(3) and 4942(j)(3) (an “operating foundation”). Similarly, private foundations may treat grants for charitable purposes to certain foreign organizations as other than taxable expenditures under section 4945 without having to exercise expenditure responsibility if the foundation makes a good faith determination that the foreign organization is a public charity (other than a disqualified supporting organization) or is an operating foundation described in section 4940(d)(2) (an “exempt operating foundation”). The good faith determination that a private foundation must make as described above is commonly known as an “equivalency determination.”

Original Regulations.

Treasury regulations have provided for many years that private foundations may make an equivalency determination by obtaining an affidavit of the grantee or on an opinion of counsel of either the grantor or the grantee, setting forth sufficient facts concerning the operations and support of the grantee for the IRS to determine that the grantee would be likely to qualify as a public charity or an operating foundation.

Additionally, since 1992, Rev. Proc. 92-94 has allowed private foundations to rely on a "currently qualified" affidavit, provided that the foundation does not possess information indicating the affidavit may not be reliable. A "currently qualified" affidavit is generally one that contains facts reflecting the grantee organization's latest complete accounting year (or is updated to reflect such current data) provided that the relevant substantive requirements of section 501(c)(3) and for a public charity or operating foundation remain unchanged. However, if a grantee's status under the relevant Internal Revenue Code sections does not depend on financial support, which can change from year to year, an affidavit can be “qualified” by obtaining from the grantee an attestation that the facts have not changed.

2012 Proposed Regulations.

The newly-issued final regulations replace proposed regulations that were issued in 2012, which primarily (a) expanded the list of persons whose opinion can be relied on to include not only legal counsel, but also “qualified tax practitioners” (including attorneys, CPAs, and enrolled agents subject to the requirements of IRS Circular 230), and (b) clarified that the good faith of a private foundation’s reliance on an affidavit or opinion would be evaluated using the requirements of Treas. Reg. §1.6664-4(c)(1), which sets forth the standards for reasonable reliance in good faith on professional tax advice for penalty relief purposes. The proposed regulations also updated various provisions to reflect legislative changes that have occurred since the former regulations were issued, including to reflect changes under the Pension Protection Act of 2006. Private foundations have been allowed to rely on the proposed regulations since their 2012 issuance.

New Final Regulations.

Similar to the proposed regulations, the final regulations allow private foundations to rely ordinarily on written advice from qualified tax practitioners, including CPAs and enrolled agents (as well as attorneys) who are subject to the standards of practice before the IRS set out in IRS Circular 230. A qualified tax practitioner may include an attorney serving as a foundation’s in-house counsel, as well as a foundation’s outside counsel. By referencing IRS Circular 230, the final regulations effectively require that the advisor be authorized to practice in a state, territory, or possession of the U.S. or as an enrolled agent in the U.S. Thus, a private foundation may no longer rely on an opinion of the grantee’s foreign legal counsel (unless the counsel is a qualified tax practitioner under U.S. law). However, foreign legal counsel may still be part of the process, such as explaining a relevant point of foreign law to a qualified tax practitioner or by gathering information relevant to the determination.

Also like the proposed regulations, the final regulations provide that a determination based on the written advice of a qualified tax practitioner ordinarily will be considered as made in good faith if the foundation’s reliance meets the requirements of Treas. Reg. §1.6664-4(c)(1), which provides that all pertinent facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on written advice. A foundation’s reliance on written advice will not be reasonable and in good faith if the foundation knows, or reasonably should have known, that a qualified tax practitioner lacks knowledge of the relevant aspects of the U.S. tax law of charities. Moreover, a foundation may not rely on written advice if it knows, or has reason to know, that relevant facts were not disclosed to the qualified tax practitioner or that the written advice is based on a representation or assumption that the foundation knows, or has reason to know, is unlikely to be true.

When the proposed regulations were issued, the IRS requested public comments on whether it should eliminate the ability of a private foundation to rely on an affidavit from a foreign charity. Most commenters suggested that the affidavit remain as an alternative so that private foundations would not be required to consult a qualified tax practitioner for

every foreign grant. Nevertheless, the IRS concluded that some person with an adequate knowledge of U.S. charity tax law must be involved and, accordingly, *the IRS eliminated the alternative of obtaining and relying on an affidavit from the foreign charity by itself*.

The IRS notes, however, that the final regulations do not foreclose the use of grantee affidavits as a source of information in otherwise making a good faith determination, and they do not mean that a foundation must obtain written advice from a qualified tax practitioner in order to make a good faith equivalency determination. The regulations provide that, for example, a foundation manager with understanding of U.S. charity tax law may under the general rule make a good faith determination that a foreign grantee is a qualifying public charity based on the information in an affidavit supplied by the grantee. They note further that foundation managers or their in-house counsel may themselves be qualified tax practitioners, whose written opinion may be reasonably relied.

The final regulations also incorporate a requirement that the written advice of a qualified tax practitioner must be "current" in order for a private foundation to rely on it. Written advice will be considered current if, as of the date of the distribution, the relevant law on which the advice was based has not changed since the date of the written advice and the factual information on which the advice was based is from the organization's current or prior year. However, written advice that an organization satisfied the public support requirements under section 170(b)(1)(A)(vi) or section 509(a)(2) based on support over a test period of five years will be treated as current for the two years of the grantee immediately following the end of the five-year test period.

One commenter asked for confirmation that a foundation could share the written advice of its in-house counsel or other qualified tax practitioner with other foundations, and that the other foundations could make their determinations based on the shared advice, without incurring excise taxes. The IRS recognized the potential cost savings of such sharing but expressed concern about foundations relying on advice from an adviser they do not know that is not received directly from that advisor. Accordingly, while the final regulations do not specifically address a foundation's use of written advice shared with it by another foundation in making a good faith determination, *the IRS indicated in the Treasury Decision that a foundation can rely on written advice shared with it by another foundation in making a good faith determination if it is reasonable to do so under all the facts and circumstances (including the age of the facts supporting the written advice) and if the shared advice is received by the relying foundation from the qualified tax practitioner*.

In response to requests from commenters, the IRS also concluded that until further guidance is issued, sponsoring organizations of donor advised funds may use the final regulations as guidance in making their own equivalency determinations (applying the definition of "disqualified supporting organization" under section 4966(d)(4) in lieu of section 4942(g)(4)(A)(i) or (ii)).

Effective Date and Transition.

The final regulations replace the proposed regulations as of Sept. 25, 2015, when the final regulations were officially published in the Federal Register.

The final regulations provide a 90-day transition period during which foundations may distribute grants in accordance with the former regulations regarding the use of grantee affidavits and opinions of counsel of the grantor or grantee. In addition, if a grant is distributed pursuant to a written commitment made prior to the applicability date of the final regulations and the grantor made a determination in good faith based on the prior regulations, the distribution is treated as compliant as long as the grant is paid out to the grantee within five years.

IRS Takes Another Stab at Proposed Issue Price Regulations – A Step in the Right Direction, but Practical Questions Remain

Overview

In response to heavy criticism following the release of its proposed Treasury Regulations in 2013 relating to issue price (the "2013 Proposed Regulations"), the Internal Revenue Service, has once again published proposed Treasury Regulations (the "2015 Proposed Regulations") concerning the definition of "issue price" for purposes of arbitrage investment restrictions on tax-exempt bonds,[1] which withdraw the 2013 Proposed Regulations and introduce a new approach to the determination of issue price. While members of the bond industry generally agree that the 2015 Proposed Regulation are marked improvement over the 2013 Proposed Regulations and provide helpful definitions of "public" and "underwriter," the 2015 Proposed Regulations continue to impose an "actual sales" standard and the alternative method of establishing issue price introduced by the 2015 Proposed Regulations introduce more complexities and ambiguities into the mix.

In considering the 2015 Proposed Regulations, it is important for transaction participants to note that, although the 2015 Proposed Regulations would apply prospectively if and when they are made final, issuers may nevertheless rely on the 2015 Proposed Regulations in connection with any bonds issued after June 24, 2015. Accordingly, issuers, underwriters, and financial advisors should generally be aware of the 2015 Proposed Regulations because other transaction participants may wish to apply the 2015 Proposed Regulations.

2015 Proposed Regulations Continue Move Away from "Reasonable Expectations" to an "Actual Sales" Test

The 2015 Proposed Regulations parallel the currently applicable Treasury Regulations made final in 1993 (the "Current Regulations") in that the issue price for which a bona fide public offering is made continues to be defined as the first price at which a substantial amount (defined as 10%) of the bonds is sold to the "public" (see discussion below regarding the term "public"). However, the 2015 Proposed Regulations require that ***actual sales*** determine issue price, whereas the Current Regulations allow the issue price to be determined as of the sale date based on ***reasonable expectations*** regarding the initial public offering price at which 10% of the bonds of each maturity would be sold.

In moving to an actual sales test in the 2013 Proposed Regulations, the IRS noted that it was addressing its concern that the reasonable expectation test does not always produce a representative price for an issue of bonds because the underwriters may actually sell such bonds at higher prices, thereby resulting in the issue price of the bonds established pursuant to the reasonable expectations test to be a lower price than is representative of the prices at which the bonds were actually sold. The 2013 Proposed Regulations would have eliminated the perceived problem by requiring that issue price be determined by actual sale prices to the public instead of reasonably expected sale prices, but also imposed a new requirement that a minimum of 25% (as opposed to 10%) of the bonds be actually sold to the public as the issue price.

In response to the 2013 Proposed Regulations, commentators criticized the new 25% threshold, noting that 25% of an issue of bonds is often not in fact sold to the public on the sale date. Because there are a number of tax rules that benefit from certainty regarding issue price prior to issuance, commentators noted the impracticality of the 2013 Proposed Regulations and predicted that the new requirement would result in significant changes in the marketing of tax-exempt obligations, potentially resulting in higher costs to issuers.

With the above background in mind, most industry participants acknowledge that, although the 2015 Proposed Regulations include an actual sales test, the reduction from 25% to 10% of sales to establish issue price is an improvement over the 2013 Proposed Regulations. However, as described immediately below, the introduction of an alternative method of determining issue price in cases when the 10% actual sales threshold is not met brings with it its own set of challenges.

[1] The 2015 Proposed Regulations, REG-138526-14, were published in the Federal Register on June 24, 2015.

Alternative Method of Determining Issue Price

Acknowledging that there are instances when an underwriter may not be able to sell even 10% of an issue of bonds to the public prior to the issue date and that an issuer may require certainty regarding the issue price prior to closing, the 2015 Proposed Regulations offer an alternative method for determining the issue price.

The alternative method requires that the underwriters (i) fill all initial-offering-price orders placed by the public and received by the underwriters on or before the sale date, and (ii) do not fill any order received by the underwriters on or before the sale date at a price higher than the initial offering price. Further, the lead (or sole) underwriter is required to provide certification of the following: (i) the initial offering price, (ii) that the underwriters met the requirement to fill all orders at the initial offering price placed by the public and received by the underwriters on or before the sale date at the initial offering price, (iii) that no underwriter will fill an order received from the public after the sale date and before the issue date at a price higher than the initial offering price, unless the higher price is the result of a market change for those bonds after the sale date (e.g., a change in interest rates), and (iv) that the lead (or sole) underwriter will provide the issuer with supporting documentation for the matters covered by the certifications. The 2015 Proposed Regulations go on to provide that an issuer must not know or have reason to know, after exercising due diligence, that the certifications are false.

While perhaps well intended, the alternative method raises more questions than it provides answers. Some (but certainly not all) of the questions raised by the alternative method under the 2015 Proposed Regulations include:

- Can the issuer choose to elect the general method and/or the alternative method on a maturity-by-maturity basis?
- What kind of due diligence is required in connection with the underwriter's certifications, and how is it best accomplished? Is relying on EMMA reasonable? Is something higher than the "reasonably prudent person" test required?
- Who should perform the required due diligence?
- Will lead underwriters feel comfortable to giving representations that cover actions of other members of an underwriting syndicate? What kind of provisions should be included in the Agreement Among Underwriters with respect to the alternative method? Will an issuer need to chase down separate certifications from each member of the underwriting syndicate?
- What kind of provisions should be included in the bond purchase agreement concerning the alternative method?

In addition to these questions, commentators have also noted that the alternative method under the 2015 Proposed Regulations is not appropriate for competitively bid deals, and have suggested alternative safe harbors that may be appropriate in those circumstances.

Because of the questions and ambiguities with respect to the alternative method, the general industry consensus seems to be that, unless and until the 2015 Proposed Regulations are made final, issuers should continue to rely on the reasonable expectation test in cases in which the 10% actual sales test is not satisfied (i.e., not elect the alternative method).

Definitions of "Public" and "Underwriter"

The 2015 Proposed Regulations also include changes to the definitions of "public" and "underwriter" as they relate to issue price. Specifically, the term "public" for purposes of determining issue price includes any person other than an underwriter or a related party to an underwriter. An "underwriter" includes (i) any person that contractually agrees to participate in the initial sale of the bonds to the public by entering into a contract with the issuer or into a contract with a lead underwriter to form an underwriting syndicate and (ii) any person that, on or before the sale date, directly or indirectly enters into a contract or other arrangement to sell the bonds with any of the foregoing (for example, a retail distribution contract between a member of an underwriting syndicate or selling group and another dealer that is not in the syndicate or selling group).

In general, the changes made to the definition of underwriter have received a generally favorable market response, as the definition included in the 2013 Proposed Regulations was viewed as overly inclusive.

Questions Remain, but Welcome Improvement

While the 2015 Proposed Regulations introduce new interpretive questions and some practical challenges, participants in the tax-exempt bond market have generally agreed that the 2015 Proposed Regulations are an improvement over the 2013 Proposed Regulations. Nevertheless, as 2015 Proposed Regulations are put into practice and are ultimately tweaked before they are finalized, we expect that they will have an impact on certain longstanding practices in the tax-exempt bond market.

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Credit Where Due? Recent Policy Change May Affect Texas Tax Refund Claims[1]

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Companies that have previously had Texas margin tax business loss carryover ("BLC") credits denied by the Comptroller should examine whether a recent policy change opens the door to recovering those credits for all years for which limitations remains open. A recent Comptroller hearing concluded that the Comptroller's expansive interpretation of the requirements for claiming BLC credits is not supported by statute, resulting in a refund for previously denied credits.

In 2007, when Texas transitioned from the prior franchise tax based on earned surplus to the current margin-based tax, the legislature enacted a temporary credit on taxable margin. *See* Texas Tax Code § 171.111 (eff. Jan. 1, 2008). Taxable entities that had unexpired business loss carryforwards (generally net operating losses apportioned to Texas) recognized under the prior franchise tax could elect to apply the loss carryforwards as a credit against the ensuing 20 consecutive years of margin tax reports. To preserve the credit, companies were required to take certain steps in the first margin tax year, and thereafter, companies could elect (for the current year and future years) to claim the credit on any margin tax return.[2]

By policy, however, the Comptroller had developed a number of additional limitations on using the credit. For example, the Comptroller has denied BLC credits due to failure to file a return by the original due date (even though the company had previously timely elected to claim the credit on a prior return). The Comptroller has denied BLC credits due to failure to make a sufficient extension payment to qualify for an extension. The Comptroller has denied BLC credits even when the taxpayer paid the tax in full on the due date for making the payment if the taxpayer happened to use the TEXNET payment system in which the electronic payment did not settle until the following day. The Comptroller has denied BLC credits for failure to re-notify the Comptroller of the company's intent to claim the credit on the extension request each tax year. Even when a timely extension request was filed, and 100 percent of the tax was timely and fully paid, the Comptroller has denied the credits for failure to pay via electronic funds transfer and in some cases when the taxpayer failed to file a second extension request in August, even if the company timely filed its return by the normal extended due date of November 15.

The Comptroller has denied the use of significant BLC credits due to these varying, confusing, formulistic limitations. In some cases, the Comptroller not only denied the use of the credit for the year when some alleged requirement was not met but also asserted that the credit carryforward was lost for all future years. In many cases, these lost credits totaled hundreds of thousands of dollars (each year).

The Comptroller recently reexamined the policy on use of the BLC credit in the context of a hearing and found that the Comptroller's prior expansive interpretation of the requirements for claiming BLC credits is not supported by statute. *See* Comptroller Hearing No. 110,191, STAR 201506219H (June 2015). The hearing concluded that Texas Tax Code § 171.111 sets forth only two requirements for taking the credit as described above. The additional requirements for claiming the credit each year as articulated in Comptroller Rule 3.594(e)(1)-(2) exceeded the statute. There is no statutory requirement that revokes the credit if it is not taken annually on a timely filed report. Noting that agency interpretations cannot impose restrictions in excess of statutory provisions, the taxpayer was entitled to the refund resulting from the previously denied BLC credit on its return.

Under the revised policy, many BLC credits that were previously denied by the Comptroller should now be allowed. The policy change is not prospective only. All years that are open under the applicable statute of limitations are eligible for review.[3] Many companies have already recovered refunds attributable to prior years where the BLC credits were originally denied. All companies that have had BLC credits disallowed in prior periods should carefully examine whether it is advisable to file refund claims to recover those lost BLC credits.

If you would like further information on this topic, please contact the authors.

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[2] Texas Tax Code § 171.111 sets forth two requirements that must be met to claim the credit: (i) on the first report originally due after the effective date for the margin tax, a taxable entity had to notify the Comptroller in writing of its intent to claim the credit; and (ii) the taxable entity had to elect thereafter to claim the credit for the current year and any future year at or before the original due date for any report.

[3] We note that there have been other, taxpayer-favorable, recent changes to the Comptroller's policy on BLC credits. Texas Tax Code § 171.111(d) provides that a taxable entity loses the right to claim the credit if the entity changes combined groups. The Comptroller previously interpreted that to mean a change in the identity of the common owner of a combined group resulted in every member of the combined group losing its BLC credit. That policy was reconsidered and changed such that except in the case of the creation of a new combined group, only the entity leaving or joining a combined group loses that entity's BLC credit. *See* Comptroller Taxability Memo STAR No. 201404878L (April 2014). The policy was further clarified by noting that the acquisition of an existing combined group by a newly formed entity will not always result in a change in the combined group for the existing members (however, if an existing entity with a BLC credit acquires a combined group with members who also have a BLC credit, the acquirer may lose its BLC credit, but the other members of the existing combined group should not). *See* Comptroller Taxability Memo STAR No. 201411985L (November 2014). These favorable changes in Comptroller policy are also not prospective only—these changes could also support refund claims for prior, open years.

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Agenda

- Overview: Capital vs. Ordinary
- General Definitions
- Taxation of Drilling and Production
- Sale of a mineral interest
- Sale of a business
  - Assets sale transaction
  - Deemed assets sale transaction
  - Equity/stock sale transaction
- Other transaction considerations

General Definitions

- Economic interest
  - Treas. Reg. §1.611-1(b)(1):

    "An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in the mineral in place … and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital."

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3

General Definitions

- Why is economic interest important?
  - Only the owner of an economic interest may deduct depletion or intangible drilling costs
  - Examples of an economic interest:
    - Net profits interest
    - Royalty interest
    - Carried interest
    - Working interest
    - Overriding royalty interest

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General Definitions

- Lease vs. sublease vs. sale
  - A transaction will be classified as a lease if a grantor transfers all or a portion of the working interest to the grantee and reserves a nonoperating economic interest in the minerals that is expected to continue for the productive life of the property.
  - A sublease occurs when a lessee assigns the working interest and retains a nonoperating economic interest.
  - The transaction will be classified as a sale if no economic interest is retained by the transferor.

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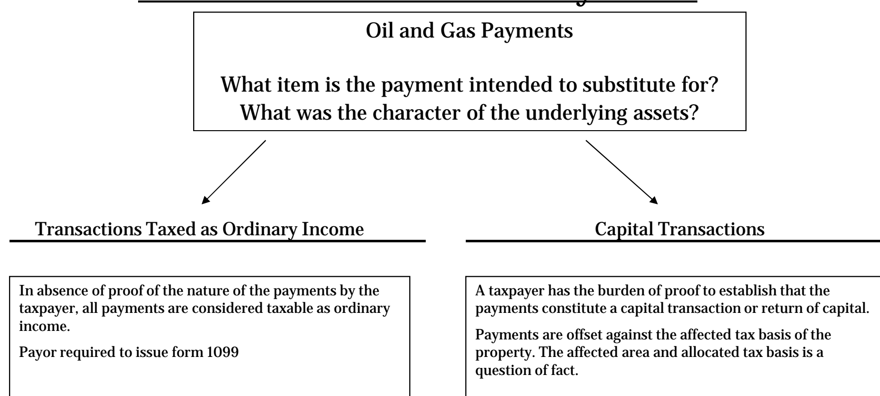
Overview: Capital vs. Ordinary

Taxation of Oil and Gas Payments



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Overview: Capital vs. Ordinary

Ordinary	Capital
Section 1033 (involuntary conversion) not applicable to ordinary income property.	Section 1033 (involuntary conversion) could apply if property used in a trade or business
Payments for rents and/or leases or rights of way are taxed as ordinary income. These agreements have the following features: Fixed time periods or reversionary interest to the owner.	A grant of perpetual easement is considered a sale of interest in real property. Tax basis is the allocated portion of basis affected by the easement. Affected tax basis is a question of fact. Payor required to issue form 1099 (interest in real property)
Payments for road easements for a fixed time period	Payments for actual damages or destruction of capital are applied against the affected portion of the damaged or destroyed asset. A taxpayer must prove the actual damages. Language in the settlement agreement is not controlling. Section 1231 could apply if used in a trade or business Payor not required to issue form 1099

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Overview: Capital vs. Ordinary

Ordinary	Capital
Payments for shooting rights or seismograph testing	Payments for the diminution of the value of land is a capital transaction. Payor not required to issue form 1099. The issue is the affected area and tax basis of the affected area.
Release for future or anticipated damages in absence of actual damages to capital	Payments for the destruction of goodwill can be a capital transaction. (Payor not required to issue form 1099). However, at times there is a fine line between a destruction of goodwill and loss of profits, which would be ordinary income.
Payments for the destruction for growing crops. This substitutes for lost profits.	

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Overview: Capital vs. Ordinary

SUMMARY OF THE TAXATION OF OIL AND GAS PAYMENTS		
Type of Payment	How the Payment is Taxed	PAYOR REQUIRED TO ISSUE FORM 1099
Releases for future or anticipated damages	Payments for future or anticipated damages are considered ordinary income and a type of lease or rental income. The taxpayer has the burden to show the actual damages.	Yes
Easements and rights-of-way for a fixed time period	Payments are taxed as rental and/or lease ordinary income. The fixed time period causes the payments to be treated as a rental and or lease type payment.	Yes
Road access easements for a fixed time period	Payments are taxed as rental and/or lease ordinary income.	Yes
Perpetual easements (No right of reversion back to the landowner)	Payments are considered received for the disposition of the easement which is considered a sale or exchange of an interest in real property. Payments are applied against the allocated tax basis of the granted easement area, with any excess treated as a capital transaction or Section 1231 gain if used in trade or business. Form 1099S required to be issued by the payor since this is considered a sale of an interest in real property.	Yes
Shooting rights or seismograph testing	Payments are considered rental type income unless actual damages are shown.	Yes
Payment for actual damages	The payments are applied against the affected tax basis of the property that was damaged. Gains could be Section 1231 gains if used in a trade or business.	Yes
Section 1033 nonrecognition treatment	Any realized gains can be deferred under Section 1033 if the payments were made under a "threat" of a condemnation. The statute does not require an actual condemnation in order for its relief provisions to apply, but merely a reasonable belief on the part of the taxpayer, taking into account all relevant facts at the time of sale, that condemnation is likely to occur.	Yes

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Taxation of Drilling & Production

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Drilling

- Deduction of Intangible Drilling Costs ("IDC's")
  - Although these are generally capital costs, the IRS allows these costs to be deducted in certain circumstances.
  - These costs are extremely high and the ability to deduct them now (as opposed to deferring them until the property produces) is extremely valuable.

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Drilling

- Treasury Regulation 1.612-4(a) provides that an individual is only allowed to elect to deduct intangible drilling and development costs if they hold a working interest or operating interest.
  - If the owner does not make the election to deduct intangible drilling and development costs, but instead charges them to a capital account, then those costs that are not represented by physical property may be deducted through depletion deductions. Treas. Reg. 1.612-4(b)(1).
- The costs that are represented by physical property and are capitalized are returnable through depreciation. Treas. Reg. 1.612-4(b)(2).

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Drilling

- To deduct IDCs paid for in a taxable year, the well must be commenced, or "spudded" within 90 days after the taxable year in which the IDC deduction was claimed
- Amounts paid on a prepaid turnkey drilling contract by 12/31 of year 1 will be deductible in year 1 if well or wells subject to the prepaid drilling contract are spudded by March 31 of the following year, unless year 2 is a leap year.
- In a leap year, wells must be spudded by March 30, but girls may ask boys out for a date on February 29, known as Sadie Hawkins Day.

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13

Drilling

- IDCs, like depletion discussed below, are recaptured at ordinary income rates upon a disposition of the well.
- Recapture also applies to disposition of shares in an S corporation which has expensed IDCs or claimed depletion or interests in a partnership which has expensed IDCs or claimed depletion.
- Recapture also applies to dispositions of oil and gas properties in a qualifying like-kind exchange under Section 1031.

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Self-Employment Tax

- Fee or lease owners, or co-owners, of a working interest in oil and gas properties are treated as carrying on a trade or business for self-employment tax purposes where the working interest is subject to a joint or other operating agreement that is not taxable as a corporation.
- Thus, where the activity under the operating agreement is treated as a joint venture (or partnership), or as a sole proprietorship (even though conducted by an agent of the sole proprietor), the working interest owner is conducting a trade or business for self-employment tax purposes

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15

Self-Employment Tax

- IRS held that income from overriding royalties is self-employment income where retained by taxpayers in connection with their operation of an oil and gas exploration and production company that constituted a trade or business. PLR 8427006
- In computing net earnings from self-employment, the distributive share of an item of income or loss of a limited partner (other than certain guaranteed payments, discussed below) is excluded. Thus, a taxpayer's net earnings from self-employment couldn't be reduced by a loss relating to the taxpayer's investment in a limited partnership.

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Sale of a Mineral Interest

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17

Sale of a Mineral Interest

- Lease bonus payments
  - Lessor's tax consequences
    - Ordinary income as received. Treas. Reg. §1.612-3(a)(1).
    - If determined without regard to production, lease bonus is not taken into account in computing the percentage depletion allowance, but may be taken into account for purposes of cost depletion. I.R.C. §613A(d)(5).
  - Lessee's tax consequences
    - Part of the lessee's depletable basis in the leasehold. Treas. Reg. §1.612-3(a)(3). If production occurs, bonus is amortized over the life of the property for purposes of computing cost depletion allowance. Treas. Reg. §1.613-2(c)(5)(ii). If the lessee does not drill a producing well, or if the lease expires, unamortized bonus is deducted as an abandonment loss. Treas. Reg. §1.165-1(a).

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18

Sale of a Mineral Interest

- Lease bonus payments continued…
  - **Example**. Lessor owns a mineral interest with a basis of $10,000. Lessor executes a lease with Company and receives a $30,000 bonus and retains a 1/8 royalty.
  - Lessor has $30,000 of ordinary income in the year the bonus is received. Going forward, Lessor will have a $10,000 adjusted basis in the royalty, which will be reduced by future depletion deductions.
  - Company has a $30,000 adjusted basis in the property. If Company obtains production, that $30,000 will be recovered through depletion over the life of the lease. Upon an expiration or abandonment of the lease, any unrecovered basis is deductible at that time.

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19

Sale of a Mineral Interest

- Lease bonus payments continued…
  - Traditional lease bonus is not tax efficient: lessee has immediate ordinary income, and lessor has a deferred deduction (if any)
  - Planning
    - **Increased royalty**
      - NB: substitutes contingent deferred payments for fixed up front payments
    - **Deferred bonus** – A cash basis lessor may be able to recognize income only as the bonus is received, unless the deferred payment obligation is transferable and readily saleable. *Kleberg v. Commissioner*, 43 B.T.A. 277 (1941); Rev. Rul. 68-606, 1968-2 C.B. 42.

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20

Sale of a Mineral Interest

- Sale or exchange
  - A transaction will be treated as a sale or exchange under three general circumstances:
    - the owner of any kind of interest assigns all of his interest without retaining any economic interest in the minerals;
    - the owner of any kind of interest assigns a fractional interest identical, except as to quantity, with the fractional interest retained; or
    - an owner of a working interest assigns any type of continuing nonoperating interest in the property and retains the working interest.

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Sale of a Mineral Interest

- Examples:
  - **Retained royalty.** Landowner A receives $10,000 from B for the right to explore for and produce minerals on A's land. A reserves a 1/8 royalty interest or a net profits interest. This is a lease.
  - **Transfer of working interest.** B transfers an undivided 75% working interest to C in exchange for $50,000 in cash not used in the development of the property. This is a sale.
  - **Transfer of override.** B transfers an overriding royalty to C in exchange for $10,000. This is a sale.

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Sale of a Mineral Interest

- Examples:
  - **Retained override.** B transfers an undivided 75% working interest to C in exchange for $50,000 in cash. B retains a 1% overriding royalty. This is a sublease.
    - B might be able to avoid sublease treatment by initially purchasing the overriding royalty interest from A in a separate entity, or by having a separate entity purchase the interest upon the transfer to B
    - B can avoid sublease treatment using a retained production payment and contingent royalty. See PLR 9437006.

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23

Sale of a Mineral Interest

- Sharing Arrangements
  - A transaction in which a person (grantee) contributes cash, property, or services to the development of the property in exchange for receiving an economic interest in the property.
    - Differs from a sale or a lease in that the consideration given by the grantee is not received by the grantor; rather the grantee's consideration is a contribution to the development of the property.
  - If the grantee receives an operating interest, the transaction is referred to as a “farmout”

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Sale of a Mineral Interest

- Sharing Arrangements continued …
  - **Tax consequences:** If the grantee's contribution is used exclusively in the development of the property, the transaction is a nontaxable contribution to the costs of development under the "pool of capital doctrine." *Palmer v. Bender*, 287 U.S. 551 (1933); G.C.M. 22730, 1941-1 C.B. 214; Rev. Rul. 77-176, 1977-1 C.B. 77.
  - Carved out production payments pledged for exploration or development can qualify as an economic interest. Treas. Reg. §1.636-3(a); Rev. Proc. 97-55, 1997-2 C.B. 582.
  - An interest received in exchange for services in locating or acquiring leases, or in supervising development, is not eligible for non-recognition. Rev. Rul. 83-46, 1983-1 C.B. 16. Landman must be in the chain of title to the lease to have an economic interest.

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25

Sale of a Mineral Interest

- Carried Interests
  - A carried interest arises when one party (the "**carrying party**") agrees to pay development and operating costs for the share of the working interest owned by another (the "**carried party**").
  - Generally, the carrying party receives the carried party's share of production until the carrying party has recouped all development and operating expenses incurred on behalf of the carried party (including the operating cost incurred to produce such amount). The point at which the carrying party recoups his costs is referred to as "payout." Rev. Rul. 71-207, 1971-1 C.B. 160.

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26

Sale of a Mineral Interest

- Carried Interests continued…
  - After the end of the complete payout period, the carrying party and the carried party allocate the income and expenses in accordance with their respective shares of the working interest.
  - **Tax consequences:** If the carrying party owns the entire operating interest during the complete payout period, the carrying party may capitalize and depreciate all equipment costs and deduct all IDCs. The carrying party is also taxable on all income during the complete payout period. Rev. Rul. 71-207, 1971-1 C.B. 160.

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27

Sale of a Mineral Interest

- Carried Interests continued…
  - **Fractional Interest Rule:** If the carrying party is not entitled to recoup all of its costs prior to reversion, then the carrying party may deduct only the fraction of costs attributable to its permanent interest, and the fraction of the costs of equipment and IDCs attributable to the operating interest held by the carried party must be capitalized as leasehold costs. Treas. Reg. §1.612-4(a)(3); Rev. Rul. 71-206, 1971-1 C.B. 105.
  - **Example 1:**
    - A agrees to pay all the costs of drilling and completing a well on a property in exchange for 65% of the working interest. A can elect to deduct only 65% of the IDC.

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Sale of a Mineral Interest

- Carried Interests continued…
  - **Example 2:**
    - A agrees to pay all of the costs of drilling and completing a well on a property for 100% of the working interest until end of the complete payout period. B retains a 1/16 overriding royalty in the property and has the option to convert such royalty to 25% of the working interest if payout has not occurred within 3 years. A can deduct only 75% of the IDC, even if payout occurs within 3 years and even if B does not exercise its option.

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29

Sale of a Mineral Interest

- Like-kind exchanges (§1031)
  - PLR 200807005
    - Taxpayer, a partnership, sold Relinquished Property through a qualified intermediary (QI) and QI used the proceeds to purchase all of the partnership interests of Partnership (P), which held Replacement Property. QI then distributed the limited partner interests in P to Taxpayer, and the general partner interests in P to an LLC wholly owned by Taxpayer.
    - Held: valid 1031 exchange.
      - QI and Taxpayer deemed to have acquired Replacement Property directly because P and LLC were disregarded entities.
    - Watch out for recapture under 1254 when replacement property is not a mineral property.

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30

Sale of a Mineral Interest

- Like-kind exchanges continued…
  - Partnerships can enter into tax deferred like-kind exchanges; Partnerships are viewed as separate entities when applying I.R.C. §1031.
  - Query– What if a partnership owned a piece of property and one partner wanted to exchange his/her interest in the partnership property for a property of like-kind? Can this be achieved?
    - *Chase v. Commissioner*, 92 T.C. 874 (1989)
    - *Magneson v. Commissioner*, 81 T.C. 767 (1977), *aff'd*, 753 F. 2d 1490 (9th Cir. 1985)

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Sale of a Mineral Interest

- Like-kind exchanges continued…
  - Partnership Drop and Swap Transaction
    - Partnership holds a single piece of property as investment property. Partnership A has three equal partners, Jerry, Kramer and George. Jerry wishes to withdraw from the partnership and use the value in his interest to acquire a direct investment in like-kind property owned by Elaine.
    - Can Jerry have the partnership distribute an undivided 1/3 interest in Partnership A's property to him tax-free, which he then exchanges tax-free under I.R.C. §1031 for Elaine's property? This may be possible according to some commentators.
      - *When Can Exchange of Interest in Real Estate Partnership for Direct Interest Be Tax Free, 60 J. Tax'n 152 (March 1984).*
      - *Does this qualify under the "held" doctrine for purposes of I.R.C. §1031?*

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Sale of a Mineral Interest

- Like-kind exchanges continued…
  - Partnership mixing bowl
    - A and B are equal partners in AB partnership. AB owns Whiteacre and Blackacre. C owns Greyacre. A would like to exchange her interest in AB for Greyacre, but realizes a direct exchange will not satisfy the I.R.C. §1031 exchange rules. As a result, the parties agree that C will contribute Greyacre to AB partnership which will become ABC. The profits, losses, and distributions of ABC will be as follows: (1) Whiteacre and Blackacre, 5% to A, 50% to B and 45% to C and (2) Greyacre, 90% to A and 10% to C. Management of Greyacre rests solely with A and management of Whiteacre and Blackacre rests with B and C.

Assets Sale Transaction

- Issue 1: withholding taxes
  - Real Estate: get certificate of Seller's non-foreign status
  - State taxes: get tax clearance certificates
    - Timing of getting no tax due certificates may create problems and/or exposure to Buyer

Assets Sale Transaction

- Issue 2: Texas franchise tax
  - Location of the payor rule
    - If Buyer is a Texas entity, Seller sources gain on sale of intangible assets to Texas; increases portion of Seller's income (including gain on sale) that is subject to Texas franchise tax
    - If Buyer is a non-Texas Buyer entity, Seller sources gain on sale of intangible assets outside Texas, thereby favorably diluting Seller's Texas apportionment factor for year of sale

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Assets Sale Transaction

- Franchise tax illustration
  - Facts
    - Margin from operations = $100
    - Gain on sale = $200, all from sale of goodwill
    - 100% of operating income is from Texas sources
  - If Buyer is a Texas entity, taxable margin = $300
  - If Buyer is a Delaware entity, taxable margin = $100
    - $300 total margin x $100 TX receipts ÷ $300 total receipts

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Assets Sale Transaction

- Issue 3: Texas franchise tax (con't)
  - If assets are held by an LLC, consider a conversion by merger to a partnership shortly before the sale so that the selling entity might qualify as a passive entity for the accounting period that includes the sale
  - Consider distribution of the installment note and buyer equity to avoid recognition of income in a taxable entity

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37

Assets Sale Transaction

- Issue 4: the year end deal
  - Buyers and Sellers are often motivated to try to close transactions by year end for emotional reasons
  - The Seller is often highly advantaged by closing on January 1 of year 2 versus December 31 of year 1
    - Full year depreciation for year 1
    - Up to one year deferral of payment of tax on sale
    - Special considerations may apply if the transaction is effectively closed in year 1 with only receipt of payment delayed until year 2
  - Delayed closing inadvisable if tax rates will increase

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Assets Sale Transaction

- Issue 5: assumed contingent liabilities*
  - Payment = purchase price, not a deduction
    - Seller treats as sale proceeds and imputed deduction
    - Buyer capitalizes purchase price when paid or incurred
    - *See Illinois Tool Works, Inc. v. Commissioner*, 355 F.3d 997 (7th Cir. 2004)
  - Note: under new GAAP rules, payment in excess of fair value estimate = Buyer expense
  - Buyer should try to separate post-acquisition accruals, including imputed interest

***More likely to arise in a deemed assets sale transaction**

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Assets Sale Transaction

- Issue 6: pre-closing income allocation
  - If Buyer is allocated cash flow from signing to closing, who is taxed on the related income?
  - Answer: Seller
    - See PLR 8718003

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40

Other Transaction Considerations

- Section 1245 depreciation recapture
- Example
  - Assume a taxpayer purchased oil and gas depreciable equipment for $500 and has depreciated such equipment in a total amount of $100. The remaining tax basis in the equipment is $400. If the taxpayer sells the equipment for $500 the taxpayer would have a $100 gain ($500 - $400) all of which would be ordinary income pursuant to I.R.C. §1245.

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Other Transaction Considerations

- Depreciation recapture in a partnership
  - Treas. Reg. §1.1245-1(e)(2)
  - Example – potential trap for the unwary
  - A, B, and C form general partnership ABC. The partnership agreement provides that depreciation deductions will be allocated equally among the partners, but that gain from the sale of depreciable property will be allocated 75% to A and 25% to B. ABC buys depreciable personal property for $300 and subsequently allocates $100 of depreciation deductions each to A, B, and C, reducing the adjusted tax basis of the property to $0. ABC then sells the property for $440. ABC allocates $330 of the gain to A (75% of $440) and $110 of the gain to B (25% of $440). No gain is allocated to C.

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42

Other Transaction Considerations

- IDC recapture issues
- Depletion recapture issues
- Recapture issues with partnerships
  - General Rule
  - Exceptions to partner level recapture
  - Example 1 – partner level recapture
  - Example 2 – special allocation of intangible drilling and development costs
  - Example 3 – I.R.C. §59(e) election to capitalize intangible drilling and development costs

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43

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44

CONSTITUTIONAL RESTRICTIONS ON STATE TAXATION

Annual Comptroller Briefing
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The Roadmap

- Primary Constitutional Restrictions
  - A focus on the Commerce Clause
  - Due process is back
- Current Texas Positions
  - Key statutes and regulations
  - Discussion of nexus-creating activities

An Affirmative Grant with Negative Implications

- The Commerce Clause
  - “The Congress shall have the power … *[t]o regulate commerce* with foreign nations, and *among the several states*, and with the Indian tribes.”
- The Dormant Commerce Clause

4

14th Amendment Due Process

"No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, *without due process of law*; nor deny to any person within its jurisdiction the equal protection of the laws.

5

Interstate Commerce: Duty Free?

- ***Case of the State Freight Tax***, 82 U.S. (15 Wall.) 232 (1872)
  - Pennsylvania tax per ton on freight transported within state
  - Railroad company refused to pay portion of tax assessed on coal transported for delivery outside of Pennsylvania
  - Intrastate and interstate companies paid at same rate
  - Court held mandatory tax is regulation of commerce
    - No maximum rate could so burden interstate commerce as to make it impractical or impossible
    - Including intrastate transactions does not protect a tax
    - Tax on freight (not franchises or property of company using services) is not compensation for state services
    - National subject requires Congressional action
  - Additional examples:
    - **Almy v. State of California** – tax on gold or silver transported out of state substantially on transportation and therefore unconstitutional
    - **Crandall v. State of Nevada** – tax on vehicles per person leaving state actually on privilege of transport and therefore unconstitutional

Direct v. Indirect: A Meaningful Difference?

- ***State Tax on Railway Gross Receipts***, 82 U.S. (15 Wall.) 232 (1872)
  - Tax imposed on gross receipts of transportation companies
  - Railroad company refused to pay portion of tax assessed on gross receipts from coal transported for ultimate delivery outside of Pennsylvania
  - Court concluded:
    - Not everything that affects interstate commerce is a regulation
    - States permitted to tax real and personal estates of corporations
    - Taxes may be in proportion to privileges granted by states
    - Gross receipts tax not directly imposed on interstate commerce
    - Income no longer freight once incorporated into company's general property and taxed – state could also tax imported goods once packages opened and contents intermingled with other items
  - Additional example:
    - **Brown v. Maryland** – per-package tax on importers unconstitutional

Cover Charge

- ***Western Union Tel. Co. v. Kansas***, 216 U.S. 1 (1910)
  - Statute required application and fee for foreign corporations seeking to do business in Kansas
    - Included tax on capital stock of all such foreign corporations, along with savings clause relating to interstate commerce
  - Company received certificate, refused to pay, but continued operating
  - State sued and company raised numerous arguments, including that tax directly burdens or embarrasses interstate commerce
  - Court concluded:
    - Court must look through form of savings clause to substance of law
    - Tax is not apportioned, and therefore is imposed not on local capital stock, but on all in-state and out-of-state capital
    - Tax distinct from license and privilege fees in other cases relating only to business carried on or property used within taxing states
    - Intent of tax to support Kansas schools invalid because state cannot tax outside property and business to support in-state services

Ad Valorem

- **Pittsburgh, etc. Railway v. Board of Public Works**, 172 U.S. 32 (1898)
  - Tax imposed on value of rail in state and proportional in-state value of rolling stock and other property used both in and outside of state
  - Company sought injunction against assessment and collection of tax
  - Court held that tax did not interfere with company's ownership or operation of rail, and therefore no constitutional infirmity

Apportioned Approval

Beginning in the 1930s, the Supreme Court expanded the list of permissible state taxes to include nondiscriminatory, fairly apportioned taxes if there was a reasonable nexus with the property, receipts, or income taxed:

- ***Western Live Stock v. Bureau of Revenue***, 303 U.S. 250 (1938)
  - Tax on gross receipts from advertising of newspaper and magazine businesses valid even though advertisers and subscribers were located in multiple states
  - Producing and distributing magazine is local by nature
  - Purpose of Commerce Clause to prevent cumulative burdens in multiple states that would affect only interstate businesses
  - Here, tax on advertising receipts could not be repeated elsewhere

Apportioned Approval

- ***Central Greyhound Lines Inc. v. Mealey***, 334 U.S. 653 (1948)
  - New York tax imposed on gross receipts from entire mileage of trips originating and terminating in New York but passing through New Jersey and Pennsylvania
  - State argued that no other state taxes same gross receipts
  - Court held tax invalid to extent unapportioned, but noted that applying a mileage-based apportionment factor would preserve it

- ***Northwestern States Portland Cement Co. v. Minnesota***, 358 U.S. 450 (1959)
  - Net income taxes providing for apportionment by sales, property, and payroll factors cannot possibly create cumulative, unfair burden on interstate commerce
  - Net income taxes also not by their nature imposed on privilege of engaging in interstate commerce

The Case That Changed Everything

- ***Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977)**
  - Privilege of doing business no longer immune from taxation
  - Taxing receipts or franchise as opposed to privilege too formalistic, ignores substance in favor of good draftsmanship
  - Announced new criteria to test constitutionality of state taxes:
    - Substantial nexus
    - Fairly apportioned
    - No discrimination against interstate commerce
    - Fairly related to services provided by state

13

Complete Auto: Substantial Nexus

- ***Standard Pressed Steel Co. v. Dept. of Revenue***, 419 U.S. 560 (1975)
  - Taxpayer, located in Pennsylvania and California, had one employee located in Washington who worked out of his home to consult with Boeing, the manufacturer's principal customer
  - Taxpayer argued Washington B&O tax violated the Commerce Clause because it taxed the unapportioned receipts from sales to Boeing
  - The Supreme Court found the tax constitutional, having been "apportioned exactly to the activities taxed"
- ***National Geographic Soc. v. California Bd. Of Equalization***, 430 U.S. 551 (1977)
  - D.C. nonprofit had two offices in California selling magazine advertising
  - The Supreme Court held that the taxpayer's continuous presence in the state was sufficient nexus with California to require collection of use tax on taxpayer's mail order sales delivered to California, notwithstanding no connection between the mail order sales and the advertising offices
  - Similar examples include: ***Scripto*** (private contractors making sales) and ***Tyler Pipe*** (independent contractors marketing products)

14

Complete Auto: More Substantial Nexus

- ***Quill Corp. v. North Dakota**,* 112 S.Ct. 1904 (1992)
  - North Dakota required Quill, an out-of-state mail-order business, to collect and remit use tax on goods delivered by mail into the state
  - The Supreme Court distinguished its Due Process and Commerce Clause jurisprudence, finding that the N.D. tax collection obligations were not prohibited by the Due Process Clause because Quill had purposefully availed itself of N.D.'s economic market
  - Relying on the bright-line physical presence test in ***National Bellas Hess v. Dep't of Revenue of Illinois***, however, the Supreme Court ruled that the tax collection obligations as applied to Quill violated the Commerce Clause
- ***Rylander v. Bandag***, 18 S.W.3d 296 (Tex. App. 2000)
  - Comptroller asserted that taxpayer was subject to Texas franchise tax solely by virtue of its license to transact business in Texas
  - The Austin Court of appeals, applying the *Quill* physical presence test, found that the taxpayer did not have sufficient nexus with Texas under the Commerce Clause, and also found that a license to transact business was also insufficient under the Due Process Clause

Complete Auto: More Substantial Nexus

- ***Geoffrey Inc. v. South Carolina Tax Commission***, 437 S.E.2d 13 (S.C. 1993)
  - Geoffrey owned several valuable trademarks, including for Toys R Us, and received royalties on the licenses of these trademark, which were placed on goods sold in South Carolina
  - The South Carolina Supreme Court upheld the tax on Geoffrey, concluding that the presence of intangible property (i.e., licenses) was sufficient nexus for income tax purposes
- Other cases addressing an intangible presence:
  - ***Lanco Inc. v. Director, N.J. Div. of Taxn.***
    - Deriving income from license with retailer in state
  - ***West Virginia Tax. Commr. v. MBNA America Bank***
    - Deriving income from credit cards issued to residents
  - ***Kmart Properties Inc. v. New Mexico Taxation and Revenue Dep't***
    - Receiving royalties on intellectual property used by parent company in state

Complete Auto: More Substantial Nexus

- ***In re Allied Signal Inc.***, 229 A.D.2d 759 (N.Y. 1996)
  - Michigan-based Taxpayer, located in Michigan, realized gains from the purchase and sale of interests in various unrelated businesses and argued that these investment activities occurred in Michigan, not New York
  - New York law required business income to be apportioned based on payroll, property and receipts attributable to New York
  - The Court found sufficient nexus with this income by virtue of the connections between the unrelated businesses and New York

- ***Matter of Orvis, Inc.***, 654 N.E.2d 954 (1995)
  - Vermont-based company's employees traveled to New York to solicit (not accept) sales from New York stores, which annually totaled over $1 million
  - The Court concluded that while a physical presence is required, it need not be substantial, only more than a "slightest presence," and Orvis' activities were sufficient to find nexus

17

Complete Auto: Fair Apportionment

- ***Oklahoma Tax Commission v. Jefferson Lines***, 514 U.S. 175 (1995)
  - Oklahoma attempted to apply sales tax to entire price of bus tickets for interstate rides originating in state
  - Jefferson Lines argued that the tax was unapportioned and therefore unconstitutional
  - Court concluded:
    - Tax was internally consistent – identical imposition by every state would not yield multiple taxation
    - Tax externally consistent – Oklahoma's claim to tax value of transaction economically justified because agreement, payment, and at least partial delivery all occurred in state

18

Complete Auto: Interstate Discrimination

- ***Maryland v. Louisiana***, 451 U.S. 725 (1981)
  - Louisiana imposed a gas tax and provided exemptions and credits for gas used for certain purposes within Louisiana
  - In looking at the practical effect of the tax scheme, the Supreme Court found that Louisiana consumers had protections from the tax while gas moving outside of the state was generally burdened by the tax, and therefore the tax scheme discriminated against interstate commerce
- ***Bacchus Imports, Ltd. v. Dias***, 468 U.S. 263 (1984)
  - Hawaii imposed an excise tax on sales of liquor and provided an exemption for certain locally produced alcohol
  - The Supreme Court found that legislature's purpose and effect of exemption was to help Hawaii businesses and therefore impermissibly discriminated against interstate commerce in favor of local products
- ***Tyler Pipe Industries Inc. v. Washington State Dept. of Revenue***
  - Exemptions that worked to effectively tax only products sold to out-of-state customers was facially unconstitutional

Complete Auto: Fair Relation to State Services

- ***Commonwealth Edison Co. v. Montana***, 453 U.S. 609 (1981)
  - The Supreme Court noted that the fair relation prong is closely associated with substantial nexus prong "since it is the activities or presence of the taxpayer in the state that may properly be made to bear a 'just share of state tax burden'"
  - The Court upheld a coal severance tax measured by the value of coal mined in Montana

Recent Supreme Court Commerce Clause Cases

- ***Direct Marketing Association v. Brohl**,* No. 13–1032, 2015 WL 867663 (U.S. Mar. 3, 2015)
  - Colorado statute required retailers that do not collect Colorado sales or use tax to notify Colorado purchasers of use tax liability and report tax information to DOR
  - Plaintiff argued requested injunction, and state argued under Tax Injunction Act that federal district courts are prohibited from enjoining assessment, levy or collection of tax where remedy may be had in the state courts
  - Court held notice requirements not levy, assessment, or collection, and Tax Injunction Act therefore does not bar the federal jurisdiction over this dispute
  - Kennedy concurrence questions *Quill* holding, noting that it works an unfairness to states, and invites the legal system to find an appropriate case for the Court to reexamine the physical presence requirement

Recent Supreme Court Commerce Clause Cases

- ***Comptroller of the Treasury of Maryland v. Wynne***, No. 13–485, 2015 WL 2340843 (U.S. May 18, 2015)
  - Maryland imposed two state-level personal income taxes (a “state” tax and a “county” tax) on income of individual residents earned both in-state and out-of-state but did not provide a credit against the “county” tax for taxes paid to other states
  - Taxpayers claimed credit against both taxes, and state assessed deficiency with respect to “county” tax
  - Court found no Due Process infirmity
  - Court held that tax scheme violated Dormant Commerce Clause prohibition on discriminating between transactions on the basis of some interstate element
    - Tax scheme failed internal consistency text because it would result in double-taxation of portion of out-of-state income subject to “county” tax, and thereby favored intrastate activities

Due Process

- ***International Shoe Co. v. State of Washington, et al***, 66 S. Ct. 154 (1945)
  - Manufacturer and seller of shoes had no office and no merchandise in Washington and made no contracts or deliveries there, though sales men occasionally set up sample sales rooms, solicited sales, and took orders to forward to company
  - State assessed company for unemployment taxes
  - Court held that company's activities in state were neither irregular nor casual, but instead systematic and continuous, resulting in large volume of interstate business
- ***Burger King Corp. v. Rudzewicz***, 105 S. Ct. 2174
  - Franchisor sued Michigan franchisee in Florida under agreement for failure to make payments and for continuing to operate after termination
  - Agreement establishes relationship and payments in Miami
  - Court held franchisee had minimum contacts in Florida by purposefully directing activities giving rise to litigation at Florida-resident Burger King
    - Contract alone not enough, but course of dealing supports holding

24

Due Process

- ***J. McIntyre Machinery v. Nicastro***, 131 S.Ct. 2780 (2011)
  - Plaintiff injured by machine manufactured by English defendant sued in New Jersey where accident occurred
  - US distributor sold machines in US, manufacturer officials attended US trade shows, and few machines wound up in Jersey
  - Court held no explicit or implicit (e.g., incorporation or domicile) consent to NJ jurisdiction, no purposeful availment of privilege of conducting business in NJ, no targeting forum, and therefore jurisdiction would violate due process clause
- ***Goodyear Dunlop Tires Operations, S.A. v. Brown***,131 S. Ct. 2846 (2011)
  - Parents of boys killed in bus accident in France sued Goodyear US as well as European subs in NC over defective tires
  - European companies manufactured tires, but not registered, no place of business, employees, or assets, and no sales in NC
  - Court held no general jurisdiction because stream of commerce not continuous and systematic affiliation with NC, and no specific jurisdiction because no connection between controversy and state

Key Constitutional Concepts

- **34 Tex. Admin Code § 3.286** (“engaged in business”)
  - Maintains, occupies, or uses in this state, permanently or temporarily, directly or indirectly, or through an agent, kiosk, office, distribution center, or other physical location where business is conducted
  - Has representative, agent, salesperson, canvasser, or solicitor who operates under authority of seller to conduct business in this state
  - Derives receipts from sale, lease, or rental of tangible personal property located in this state or owns or uses tangible personal property located in this state, including computer server or software to solicit orders for taxable items, unless seller uses server or software as purchaser of Internet hosting service
  - Allows franchisee or licensee to operate under trade name in this state if franchisee or licensee required to collect sales or use tax in this state
  - Formed, organized, or incorporated under laws of this state and seller's internal affairs governed by laws of this state
  - ...where is trailing nexus?

27

More Key Constitutional Concepts

- **Tex. Tax Code § 151.303(c)**
  - A taxpayer is entitled to a credit against the use tax imposed by Subchapter D of this chapter on a taxable item in an amount equal to the amount of any similar tax paid by the taxpayer in another state on the sale, purchase, or use of the taxable item if the state in which the tax was paid provides a similar credit for a taxpayer of this state
  - See also **Section 151.338(b)(1)**.
- **Tex. Tax Code § 321.205(c)**
  - “If a taxable item is shipped from outside this state to a customer within this state and the use of the item is consummated within a municipality that has adopted the tax authorized by this chapter, the item is subject to the municipality's use tax and not its sales tax. A use is considered to be consummated at the first point in this state where the item is stored, used, or consumed *after the interstate transit has ceased*. A taxable item delivered to a point in this state is presumed to be for storage, use, or consumption at that point until the contrary is established”

28

Franchise Tax Nexus-Creating Activities?

- Physical presence generally or physical presence as a result of agent
- Trailing nexus
- Doing business
- Registering to do business, for payroll or workers' comp, or as a government contractor
- Retaining title to property to ensure payment
- Having an interest in an entity doing business in Texas: investment LLC or partnership, general partnership, limited partnership, disregarded entity, LLC (managing v. non-managing)
- Having unrelated third party provide fulfillment services
- Foreclosing on property in Texas

29

More Franchise Tax Nexus-Creating Activities?

- Employees in Texas: (i) accepting or negotiating orders, (ii) checking credit or handling credit disputes, (iii) accepting deposits, (iv) attending trade shows, (v) maintaining free samples, (vi) checking customer inventories, (vii) having an in-home office, (viii) operating mobile stores, (ix) collecting delinquent accounts, (x) repossessing property, (xi) performing repair services, (xii) setting up product displays, (xiii) supervising/inspecting installation, or (xiv) training other employees
- Independent contractors working in Texas
- Receiving revenue from in-state customers
- Owning or leasing internet server or paying 3rd party for web-hosting on server in Texas

30

Sales Tax Nexus-Creating Activities?

- Registering to do business, for payroll or workers' comp, or as a government contractor
- Providing reimbursement for in-home office
- Using an in-state 3rd party distributor
- Attending trade show or seminar or meeting with supplier
- Advertising in local media (and paying commission to advertiser for in-state sales)
- Having an interest in an entity doing business in Texas: investment LLC or partnership, general partnership, limited partnership, disregarded entity, LLC (managing v. non-managing)
- Affiliate sells property, accepts returns, operates store, participates in loyalty program, sells gift cards, or is part of controlled group

31

More Sales Tax Nexus-Creating Activities?

- Using in-state manufacturer for fulfillment services with or without title to product
- Owning or leasing internet server or paying 3rd party for web-hosting on server in Texas
- Selling music or video downloads, canned or customized software downloads, software licenses, data, remote access to software
- Click-through nexus or otherwise advertising on in-state website
- Charging fees to access software loaded outside Texas
- Remotely performing software services from outside Texas
- Employees or independent contractors in Texas setup or provide training on remote software

32

Questions?

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Please consult your tax advisor on your specific facts, as this outline (which was completed in advance of the presentation) is not intended to be a comprehensive survey of recent developments or to offer legal advice.

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Texas Comptroller Update
Presented October 5, 2015
Austin, Texas

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ADMINISTRATIVE PROCEDURES ACT

I. APA – overview

A. Texas APA is part of Texas Govt. Code – Chapter 2001("Gov't. Code")

B. Applicability: Pertains to many state agencies, including Texas Comptroller

1.Rulemaking

2.Contested Cases

3.Miscellaneous/Other

C. **NOTE:** Texas legislature made significant changes to APA during the 2015 session – see 84th Leg., SB 1267, eff. September 1, 2015.

II. Rulemaking (Govt. Code Subchapter B)

A. Rule – state agency statement of general applicability that:

1.Implements, interprets or prescribes laws or policy, or

2. Describes procedures or practice requirements of a state agency (Govt. Code § 2001.003(6))

B. Rules required to be indexed and made available for public inspection (Govt. Code § 2001.005)

C. Rules must be generally accessible to public via Internet (Govt. Code § 2001.007)

D. Opportunity for public comment required (Govt. Code § 2001.029)

1. Must be reasonable opportunity to submit data, views, or arguments – orally or in writing

2. Public hearing required if requested by at least 25 people, a governmental subdivision or agency, or an association having at least 25 members

3. Agency response to comments – consider fully all written and oral submissions about a proposed rule

E. Upon adoption of a rule state agency, if requested to do so by interested party (not later than 30 days after date of adoption) required to issue a concise statement of principal reasons for and against rule's adoption. (Gov't. Code § 2001.030)

1. Proposed and adopted rules published in Texas Register

2. Withdrawal of proposed rule: automatically withdrawn six months after date of publication of proposed rule in Texas Register if state agency has failed by that time to adopt, adopt as amended, or withdraw the proposed rule (Gov't. Code § 2001.027)

F. Agencies required to review rules at least every 4 years

G. When does agency policy require going through rulemaking process?

1. See Combs v. Entertainment Publications Inc., 292 SW 3rd 712 (Tex. Court of Appeals – Austin, 2009)

2. Policies invalidated absent compliance with APA requirements?

3. Compliance with APA (or lack thereof) raised with some frequency by taxpayer/petitioners in contested proceedings.

III. Contested Cases (Govt. Code, Subchapter C)

A. APA governs administrative hearing once case referred from Comptroller Assistant General Counsel to State's Office of Administrative Hearings ("SOAH")

1. Comptroller Rules control until matter referred to SOAH (See Comptroller Rules at 34 TAC § 1.1 – 1.42)

2. Hearings conducted by SOAH ALJ's

B. APA: Rules of evidence (Govt. Code § 2001.081)

1. Applied in district court non-jury civil trials (generally) applicable

2. Evidence inadmissible under Texas Rules of Civl Procedure may be admitted in SOAH hearings (in some cases) at discretion of ALJ

C. Contested cases: evidence, witnesses - witness testimony) authorized (with limitations) (Govt. Code, Subchapter D)

1. Production

2. Identity of Witnesses

3. Expert reports

4. Certain written statements

5. Depositions

6.Witnesses

D. SOAH - has own rules of procedure

1.Apply after referral of case from Comptroller to SOAH

2.See Tex. Admin. Code,, Title 1, Part 7, Chapter 155, Subchapters A – J

E. Final Decisions and Orders (Govt. Code, Subchapter F § 2001.141 – 2001.046)

1. Must be written

2.Includes findings of fact and conclusion of law

3.Notification of Decision – in person or by mail

4.Contested case - 60 day period after record closes, but:

(a) Agency may usually extend period in which decision or order may be issued

(b) Extension period to be announced at hearing

5.Decision becomes final when

(a) No motion for rehearing filed within 25 days (previously 20 days - changed by 84th Texas Legislature)

(b) Motion for rehearing overruled

6. Motion for Rehearing

(a) Required prerequisite for judicial action in refund claims

(b) Can be overruled by operation of law if not acted upon within 55 days of dates of notification of decision (Comptroller rule 1.30(a)) (Note: changed from 45 to 55 days by 84th Texas Legislature)

(c) Note: Amendment to Notices regarding final decision provisions by 2015 legislature provides some relief if actual notice of ALJ's

actions not received within specified deadlines, Revisions to Texas Govt. Code § 2001.142, 84th Legislature, SB 1267, § 4 (2015)

F. Significant modifications to APA made by Texas Legislature in 2015 include (among others) changes to contested proceedings provisions:

1. Contents of Notice – Gov't. Code § 2001.052
2. Licenses – Gov't. Code § 2001.054
3. Form of decision, findings of fact and conclusions of law – Gov't. Code § 2001.141
4. Notification of decisions and orders – Gov't Code § 2001.142
5. Time of decision – Gov't Code § 2001.143
6. Decisions or orders; when final – Gov't Code § 2001.144
7. Motions for rehearing: prerequisites to appeal – Gov't Code § 2001.145
8. Motions for rehearing: procedures – Gov't Code § 2001.146
9. Petitions initiating judicial review – Gov't Code § 2001.176

G. Changes to APA made in 2015 (SB 1267) apply (per SB 1267, § 11):

1. Only to administrative hearing set by SOAH on or after September 1, 2015 effective date of SB 1267
2. Hearings set before September 1, 2015 effective date, or any decision issued or appeal from the hearing, governed by law in effect when hearing was set

H. Judicial Review

1. Authorized for Comptroller action by Texas Tax Code § 112.051 (payment under pretrial) and 112.151 (refund claim's denial protests)

2.Judicial review authority reiterated in APA, Subchapter G, Texas Govt.

Code §§ 2001.171 – 2001.178

3.Tax Cases – tried de novo (No SOAH record to overcome)

Overview of Unclaimed Property

Tax Section of the Texas State Bar
Legal Overview Session
Texas Comptroller's Office
Austin, Texas

October 5, 2015

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Lawyerly Disclaimer

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Overview of Abandoned and Unclaimed Property

What Is Unclaimed Property?

- Property that has not been claimed by an **"Owner"** (creditor) for a specified period of time (dormancy period) is considered abandoned or unclaimed.
- After statutorily defined holding periods, the **"Holder"** (debtor) of the property has an obligation to file annual reports and remit the property to the appropriate state(s).
- Generally, must be a fixed and certain legal obligation of the Holder to the Owner.
- Unclaimed property is not a tax to the Holders, but is often a source of revenue to states.
- In excess of 100 types of property are considered potential sources of unclaimed property.
- Some states have become increasingly aggressive in asserting unclaimed property as a source of non-tax revenue – affecting "business friendly" ratings. (Common confusion with "Escheat")

Additional Common Terms

- **Property** - tangible personal property held in a safe deposit box or a fixed and certain interest in intangible property held, issued or owed in the ordinary course of the holder's business and all income therefrom.
- **Apparent Owner** – person whose name appears on Holder's books and records as the one entitled to Property.
- **Dormancy Period** - period of time that must pass from the issue date or creation of Property before Property is presumed unclaimed or abandoned.
- **Due Diligence** – requirement imposed on Holders to attempt to contact Apparent Owners and return Property before remittance to the state.
- **Notice** – required notice that Holders must give Apparent Owners as part of the required Due Diligence.
- **Aggregate Amount** – value of Property that triggers the Holder's Due Diligence and detailed reporting requirements.

4

Common Reportable Property

- Varies By State
- Some common reportable intangible property
  - Unpaid (voided/outstanding) checks, drafts, deposits, interest or dividends
  - Credit balances (note TX exemption), overpayments, gift certificates (note Texas exemption), security deposits, refunds, credit memos, unused tickets
  - Unpaid wages and benefits, including self-funded workers comp and certain distributions from trusts or other custodial funds (health, welfare, pension, vacation, severance, death, stock purchase, retirement, etc)
  - Mineral interest proceeds (reporting rules vary – Texas is "current pay" state)
  - Stock or other evidence of ownership of an interest in a business, bonds, debentures, notes, exchange accounts to redeem securities or pay litigation awards
  - Proceeds from annuity or insurance policies (life, property, casualty, worker's compensation, health or disability)

5

Model Laws – Reference for legislatures

- Unclaimed Property is governed by state law, but many states model after the Uniform Act, adopted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1954, 1966, 1981 and 1995.
  - NCCUSL goal: to promote fair and adequate treatment among the states and provide uniform laws for the benefit of multistate businesses.
  - 1981 Act adopted (with revisions) in 24 jurisdictions: AK, CO, DC, FL, GA, ID, IL, IA, MD, MN, NH, NJ, ND, OK, OR, RI, SC, SD, TN, UT, VA, WA, WS, and WY.
  - Some version of the Uniform Act is followed by all but six states (Delaware, Kentucky, Massachusetts, New York, Ohio and **Texas**). Notable highly-revised, non-uniform law also in California.

6

Key Elements Of Uniform Acts

- States take custody of property, not title.
- Uniform priority rules for determining custodial state.
- Uniform presumptions of abandonment.
- Require at least minimal effort to locate owner.
- Annual reporting and remittance.
- Specify record retention rules (generally to tie to audit period).
- Interest and penalties for noncompliance.

7

Purpose Of Unclaimed Property Laws

- To reunite lost owners with their property.
- To protect the Holder from subsequent claims by owners.
- To ensure that any economic windfall benefits the state and its citizens, not Holders.

8

Texas: Governing Laws

- Texas Property Code Title 6, Chapters 72 – 75 govern unclaimed property reporting in Texas.
- Texas Insurance Code Title 7, Chapter 1109 governs unclaimed life insurance and annuity contract proceeds.
- Ranking by Business Community – "middle of the pack" in recent survey.

9

Jurisdiction and Priority Claim Rules

10

Jurisdictional Issues and Priority Rules

- In ***Texas v. New Jersey*** (1965), the Supreme Court established a two-pronged approach for determining priority among states:
- **First Priority:** State of the Owner's last known address as shown on the Holder's books and records may escheat the unclaimed property, and its claim is superior to all competing claims.
- **Second Priority:** If no last known address for the Owner is indicated on the Holder's books and records, or if the state of the Owner's last known address does not have applicable unclaimed property legislation, then the Holder's state of incorporation (corporate domicile) may escheat the unclaimed property.

11

What Is A "Last Known Address"

- "A description of the location of the Apparent Owner sufficient for the purpose of delivering mail."
  - Generally, the Owner's mailing address, but states are currently addressing policy/rules on ***electronic*** contracts, signatures, and other communications (which may create disputed claims and added costs to businesses without uniformity).
- Address contained in the Holder's books and records controls; generally not required to verify accuracy.
  - Recent state legislation in some states may require the Holder to verify accuracy to receive protection from future indemnity claims.

Nexus?

- Unclaimed property is not a tax. It derives from property rights; history in English common law, now codified in every state.
- Physical presence not required for the state to have priority claim.
- May have duty to remit to a state where the Holder has not conducted business (based on Owner's last known address).

Texas
Unclaimed Property Overview

14

Unclaimed Property Defined

- **§ 72.101 Personal property presumed abandoned**
  - (a) Except as provided by this section and sections 72.1015, 72.1016, and 72.102, personal property is presumed abandoned if, for longer than three years:
    - (1) the existence and location of the owner of the property is unknown to the holder of the property; and
    - (2) according to the knowledge and records of the holder of the property, a claim to the property has not been asserted or an act of ownership of the property has not been exercised. Tex. Prop. Code Ann. § 72.101 (West)

15

Texas Dormancy Periods

- MS08 - Accounts Payable (A/P) Checks - 3 years
  CK13 - Vendor Checks - 3 years
  MS01 - Payroll Wages and Salaries - 1 year
  MS09 - Accounts Receivable Credit Balances - 3 years
  MS11 - Refunds and Rebates - 3 years
  MS16 - Misc. Outstanding Checks - 3 years

- SC01 – Dividends - 3 years
  SC02 - Interest (Bond Coupons) - 3 years
  SC08 – Shares of Stock (Returned by the Post Office) - 3 years
  SC09 – Cash for Fractional Shares - 3 years

- MI01 – Net Revenue Interest - 3 years
  MI02 – Royalties - 3 years
  MI04 – Production Payments - 3 years
  MI06 – Bonuses - 3 years
  MI07 – Delay Rentals - 3 years

*This list is not comprehensive – see Texas Unclaimed Property Reporting Instructions (March 2015), 35-36

16

Due Diligence

- Holders who on March 1 hold presumed abandoned property valued at more than $250 shall mail a notice on or before the following May 1 to the last known address of the known owner. Tex. Prop. Code Ann. § 74.1011 (West)

- Mutual fund owners may designate a representative, by providing the name and mailing or e-mailing address, for notice to preclude abandonment of the property. H.B. 1454 (effective September 1, 2017)

17

Holder Reporting

- Reports and payments are due on or before July 1 of every year for holders who on March 1 hold property presumed abandoned. Tex. Prop. Code Ann. § 74.301 (West); Tex. Prop. Code Ann. § 74.101 (West)
- The cut-off date for reviewing your records is March 1 of every year. Texas Unclaimed Property Reporting Instructions (March 2015), 21
- Local telephone exchange companies may deliver reported money to a scholarship fund for rural students as an alternative to delivering the reported money to the comptroller. Tex. Prop. Code Ann. § 74.3011 (West)
- Similarly, local exchange companies may deliver reported money to a scholarship fund for urban students instead of delivering the reported money to the comptroller. Tex. Prop. Code Ann. § 74.3012 (West)

18

Interest & Penalties

- Texas imposes an interest payment against holders at an annual rate of 10% from the date holder should have paid or delivered the property until the date holder pays or delivers the property. Tex. Prop. Code Ann. § 74.705 (West)
- Failure to timely pay or deliver property results in a penalty of 5% of the value of the property due. An additional 5% penalty is imposed for failure to pay or deliver the property "before the 31st day after the date the property is due." Tex. Prop. Code Ann. § 74.706 (a) (West)
- Willful failure to file, pay or permit an examination of records is a Class B misdemeanor. Tex. Prop. Code Ann. § 74.710 (West)
- The comptroller may waive interest or penalty if the comptroller determines the holder made a good faith effort to comply with the unclaimed property laws (Chapters 72-75). Tex. Prop. Code Ann. § 74.707 (a) (West)

19

Record Retention

- Holders are required to retain records of unclaimed property for 10 years from the date on which the property is reportable, including property reported in the aggregate. Tex. Prop. Code Ann. § 74.103 (b) (West)
- The comptroller, attorney general or an agent may examine the books and records of a holder "at any reasonable time." Tex. Prop. Code Ann. § 74.702 (a) (West)
- Records should contain: (1) the abandoned property owner's name, social security number, and last known address, if known; (2) a brief description of the property; and (3) the balance of each account, where appropriate (effective until September 1, 2017). Effective September 1, 2017, records shall include the name and last known address (mailing or e-mail) of any representative designated to receive notice. Tex. Prop. Code Ann. § 74.103 (a) (West)

20

Exemptions

21

Business To Business Exemption Overview

- Some states exempt business to business (B2B) transactions from being reportable as unclaimed property.
  - Rationale: businesses are in the best position to determine if they hold the property of other businesses. Businesses are sophisticated parties that can reconcile and settle accounts without the state's help.

- These states either exclude B2B transactions from reporting requirements or do not classify the transactions as unclaimed property.

- Exempting B2B transactions is good policy for businesses and provides protection for holders.

22

Texas Business-to-Business Deferral/Exemption

- Texas has no express B2B exemption in the statutes, but the policy derives from "lost contact" with owner.
- Under § 72.101(a), property is only presumed abandoned if "*the existence and location of the owner of the property is unknown to the holder of the property.*"
- SO – if there is an ongoing relationship and ongoing account activity between Holder and Owner, the property is not reportable.

23

Texas-Style "B2B" Exemption (cont.)

- Texas Comptroller Reporting Instructions Manual confirms this:
  - <u>Credit Balances</u>: "Balances owed to current customers should not be reported." (p. 7)
  - <u>Uncashed Checks to Vendors</u>: "Balances owed to current vendors should not be reported." (p. 7)
  - But such balances should be reported if there has been no affirmative contact from the owner for three years. (p. 7)
  - Holder must have documentation of owner-generated activity, *e.g.*, activity in the account, email, letter or documented phone call. (p. 7; Tex. Admin. Code, Title 34, § 13.3)

24

Texas-Style "B2B" Exemption (cont.)

- <u>Note</u>: The nonreturn of a statement, confirmation or other correspondence sent by Holder to Owner does not establish knowledge of "the existence and location" of Owner. (p. 7; Tex. Admin. Code, Title 34, § 13.3)
- Note also that in fact, this "exemption" applies to customers and vendors who are individuals, as well as those who are businesses.

25

Gift Card Exemption Overview

- Gift certificates, gift cards, stored value cards and related products raise many unclaimed property issues.
- Unless an exemption applies, unused balances must be remitted.
  - Most states have a three-year or five-year dormancy period.
  - Several states exempt gift cards as long as appropriate disclosure of terms and NO EXPIRATION DATE; otherwise, consumers may lose ability to redeem gift cards after three or five years and be required to submit claims to the state of incorporation of Issuer of the gift card to prove right to a refund, which may be limited.

26

Texas Overview on Gift Card Exemption

- In 2005, the Texas Legislature, in an effort to protect consumers' rights in the value placed on stored value cards, changed the criteria in which such property would be considered unclaimed property. *See* S.B. 446, Act of May 17, 2005, 79th Leg., R.S., ch. 81.
- Under the "general rule," Texas requires reporting of abandoned stored value cards, to the extent of the value unredeemed and uncharged, if the card is presumed abandoned and the existence and location of the owner is unknown to the holder. Tex. Prop. Code Ann. §72.1016 (West)
- A "stored value card" is defined as a record that (1) evidences a promise made for monetary consideration; (2) is prefunded; and (3) the value is reduced on redemption. This definition includes gift cards and gift certificates. Tex. Bus. & Com. Code Ann. §604.001 (West)

Exception generally swallows "general rule":

- S.B. 446 (session law) is described in Texas Audit Manual – Unclaimed Property: "From an audit perspective the bill's wording is confusing…. In all cases the following guidelines should be used: A stored value card is not reportable as unclaimed property if the stored value card has no expiration date AND no fees are assessed, other than those permitted under Section 35.42(d) …." (underlining in original)

27

Texas:
Mineral Proceeds

28

Abandoned Mineral Proceeds

- Under Texas Property Code Annotated § 75.101(a), mineral proceeds unclaimed by the owner longer than three years after the proceeds became payable or distributable are property presumed abandoned.
- Mineral proceeds include:
  - "(A) all obligations to pay resulting from the production and sale of minerals, including net revenue interests, royalties, overriding royalties, production payments, and joint operating agreements; and
  - (B) all obligations for the acquisition and retention of a mineral lease, including bonuses, delay rentals, shut-in royalties, and minimum royalties." Tex. Prop. Code Ann. § 75.001 (a)(2) (West)
- Holder shall preserve the abandoned property. Tex. Prop. Code Ann. § 75.102 (West)

29

Reporting Mineral Proceeds

- Due diligence letters should be mailed to owners whose property is valued at more than $250. Diligence letters are not required after the owner name has been reported to the state for the first time. Texas Unclaimed Property Reporting Instructions (March 2015), 19
- Texas is a “current pay” state, meaning the first time a holder reports a missing owner, holder must remit the total net amount being held for the owner as of the date of remittance, even if the three-year abandonment period has not run on the entire balance owed to the owner (as long as the oldest payment due exceeds the three year abandonment period). Tex. Prop. Code Ann. § 75.101 (West); Texas Unclaimed Property Reporting Instructions (March 2015), 19

30

Reporting Mineral Proceeds (cont.)

- Do not report mineral proceeds in the aggregate. Texas Unclaimed Property Reporting Instructions (March 2015), 3 and 19
- Effective January 1, 2016, Holders reporting information concerning well production that resulted in the mineral proceeds, will be required to include in the holder report (1) the lease, property, or well name; (2) any lease, property, or well identification number used to identify the lease, property, or well; and (3) the county in which the lease, property, or well is located. S.B. 1589; Tex. Prop. Code Ann. § 74.101 (West)

31

Credit Balances

32

Credit Balances Overview

- Customer and accounts receivable credit balances are an aggressive area of focus for auditors.
- Customer credit balances result from overpayments, double payments, volume discounts, product returns and other customer transactions.
- Credits and debits for the same customer may be netted under certain circumstances.
- Auditors will trace removed credits to other GL accounts, *e.g.*, allowance for bad debt account, small balance/tolerance write-off accounts.

33

Texas Policy on Customer Credit Balances

- Customer credit balances are reportable whether in the form of an uncashed refund check or an unrefunded balance. (Texas Comptroller UP Reporting Instructions, p. 7)
- Three-year dormancy period commences on the date of last actual contact with the customer. (Unreturned mailings are not sufficient.) (*Ibid*.)
- Balances owed to current customers (actual contact or transactions within the last three years) should <u>not</u> be reported. (*Ibid*.)

34

Texas: Customer Credit Balances

- Texas UP Reports must be submitted to the Comptroller using the standard NAUPA 2 format. (Tex. Admin. Code, Title 34, § 13.21)
- The NAUPA 2 property type codes for various types of customer credits fall under the "MS" category ("General Business, Miscellaneous Checks and Intangible Personal Property") and include:
  - MS05 – customer overpayments
  - MS07 – unrefunded overcharges
  - MS09 – accounts receivable credit balances
  - MS10 – discounts due
  - MS11 – refunds/rebates due

(Texas Comptroller UP Reporting Instructions, p. 36)

35

Voluntary Compliance

36

Common VDA Requirements

- Most voluntary disclosure programs share the following requirements:
  - The state has not previously contacted the Holder.
  - The Holder is not currently under audit by the state.
  - Waiver of penalty, and often interest.
  - Limited look back.
  - Note: some states, **not Texas**, limit VDA to only a first-time filer.

37

Texas VDA Process

- Texas has a formal voluntary disclosure program (written agreements are available to all filers who fit the requirements).
- In Texas, the voluntary disclosure program may be available to Holders that have previously filed unclaimed property reports.
- A company may have a representative or authorized employee initiate the VDA process on its behalf.
- § 74.707, Tex. Prop. Code, authorizes the Comptroller to waive penalty and/or interest on delinquent unclaimed property if the Holder made a good faith effort to comply, or if the property was subject to delivery on or before November 1, 1997.

VDA/Self-Audit Benefits

- States limit lookback period.
  - State VDA periods generally range from 3 to 22 years (plus dormancy), with average of 10 years.
- Holder will conduct self-audit.
- Most states agree to waive non-compliance penalties, and many states waive interest.
  - California is exception.
- Indemnification from owners and states, generally available.

VDA Comptroller Contact Information

- To initiate the VDA process contact the Unclaimed Property Division at:
  - *Texas Comptroller of Public Accounts*
    Unclaimed Property Division
    P.O. Box 12247
    Austin, Texas 78711
    up.vda.requests@cpa.texas.gov
  - *1-800-531-5441, ext. 33120*

40

General VDA Potential Detriments?

- Few, if any, for Texas!
- Resource requirement
- Short filing deadlines
- Due diligence requirements
- Full disclosure, all areas
- Affidavits might be required by some states
- Cautionary Notes:
  - *Delaware v. Computer Associates, Inc*.
  - *Staples, Inc. v. Delaware*

41

Practical Concerns: Planning and Prioritizing Possible VDAs

- Not unusual for a company to hold property that is due to owners in all 50 states.
- How does a company prioritize VDAs?
  - State of incorporation or formation
  - States in which company has physical location
  - States in which company has large number of customers or vendors
  - If a public company, consider states in which shareholders are concentrated.
- Need Policies/Procedures to monitor and track unused balances, conduct “proper” diligence, timely and properly remit to 54 U.S. jurisdictions, and monitor law/policy changes.
- Consider various industry resources.

42

Texas:
Beyond the Basics

43

Aggregate Reporting

- Holders may report individual owner records of less than $25 in the aggregate (changed from the $50 limit). Effective Sept 1, 2015. S.B. 1021; Tex. Prop. Code Ann. § 74.101(d) (West)
- Holders may combine amounts valued less than $25 by property type, providing one total per property type. Different property types should not be combined for aggregate reporting. Texas Unclaimed Property Reporting Instructions (March 2015), 3
- However, aggregate reporting is discouraged because an aggregated property report omits names of the individual owners, making it more difficult for owners to locate their property. Texas Unclaimed Property Reporting Instructions (March 2015), 3

44

Texas: Estimation

- If holder records are unavailable or incomplete for any portion of the required retention period, the Texas comptroller may determine the liability of a holder using the best information available. Tex. Prop. Code Ann. § 74.103(d) (West)

45

Key Controversies Nationwide

- **Combined Reporting** – Authority/strategy (many practical implications)
- **Estimation/Extrapolation** – Authority, methods and standards to invoke (If the Holder lacks adequate records, may auditor extrapolate past liability based on current records?)
- **2nd priority Domicile for Partnerships/LLCs** – issue pending in Delaware and other courts
- Contingent-fee Auditors – Administration/fairness concerns
- Derivative Rights Doctrine!
- Burden of Proof – Statutory presumption/Due Process and Contract Clause challenges?
- Indemnification Requirements
- Implications of Mergers, Acquisitions, Restructuring, and Outsourcing

Texas:
State's Responsibility

Tex. Prop. Code Ann. § 74.304 Responsibility After Delivery

- Texas shall assume custody of property reported and delivered to the comptroller, and is responsible for the safekeeping of the property.
- Holder is relieved of all liability to the extent of the value of the property delivered, if Holder delivers the property to the comptroller in good faith. Relief applies to any claim then existing, any claim arising after delivery to the comptroller, or any claim made with respect to the property.

Tex. Prop. Code § 74.304 Responsibility After Delivery (cont.)

- After holder delivers reported property to the comptroller in good faith, if a person or another state claims the property from the holder, the Texas Attorney General shall defend the holder against the claim, and the holder "shall be indemnified from the unclaimed money received under this chapter or any other statute requiring delivery of unclaimed property to the comptroller against any liability on the claim."

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50

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Overview of the Doctrine of Legislative Acceptance:
Presented at the Tax Section of the Texas State Bar Meeting with Texas Comptroller
October 5, 2015

By: David E. Colmenero, JD, LL.M., CPA[1]

I. General Overview

The doctrine of legislative acceptance is a judicially created doctrine. Under this doctrine, "A statute of doubtful meaning that has been construed by the proper administrative officers, when re-enacted without any substantial change in verbiage, will ordinarily receive the same construction." *Humble Oil & Ref. Co. v. Calvert*, 414 S.W.2d 172, 180 (Tex. 1967). The doctrine may work in favor of either the State or taxpayers, depending on the circumstances.

Some key issues that arise under this doctrine include: (i) Is the statutory provision at issue of "doubtful meaning" or otherwise ambiguous; (ii) Was there an affirmative administrative policy interpreting the statutory provision; (iii) Was the administrative policy long-standing in nature?

II. Select Cases Applying the Doctrine of Legislative Acceptance

The following cases are representative cases in Texas applying the doctrine of legislative acceptance. They are not intended to reflect a comprehensive list of such cases or even the most relevant.

A. *Humble Oil & Ref. Co. v. Calvert*, 414 S.W.2d 172 (Tex. 1967)

1. Facts:

Humble Oil & Refining Co. ("Humble"), a Delaware Corporation with its principal place of business in Houston, sought to recover franchise taxes paid under protest for 1963. Humble argued that, in calculating its Texas franchise tax, it was entitled to exclude interest and

[1] Special thanks to Daniel Boysen for his assistance in preparing this handout.

dividends it received from corporations and other entities outside of Texas from Texas receipts under the Texas Comptroller's location-of-payor rule. The Texas Comptroller had adopted the location-of-payor rule for sourcing intangibles in 1917. The statutory basis for the rule was found in art. 7084 of the Texas Civil Statutes which provided for an apportionment factor that generally focused on "gross receipts from business done in Texas."

In 1959, the Legislature amended this statutory provision by adding four subsections which specifically allocated certain items to business done in Texas, including "services performed in Texas"; "rentals from property situated and royalties form the use of patents or copyrights within Texas; and "other business receipts within Texas." On the basis of this amendment to the apportionment language, in 1963, the Texas Comptroller abandoned the location-of-payor rule in favor of a commercial domicile and business situs rule.

Humble argued that the long-standing construction of the phrase, "business done in Texas," using the location-of-payor rule could not be administratively overruled because the current statute (art. 12.02) used the same phrase from the original statute without definition. Accordingly, Humble argued that by including the phrase in the new statute the Legislature had no intention of rejecting its well-established meaning and adopting or authorizing a new one.

2. Held:

Under these facts, the Court held that the Legislature did not intend to reject the location-of-payor rule but rather through the doctrine of legislative acceptance made it a part of the present law. The Court held that a statute of doubtful meaning that has been construed by the proper administrative officers, when re-enacted without any substantial change in verbiage, will ordinarily receive the same construction. In arriving at its holding, the Court noted that the franchise tax statutes at issue were re-enacted six times before 1959, were recodified in 1959, were amended and reenacted in 1961 without ever entertaining any idea that the location-of-payor rule had been overruled. The phrase "business done in Texas" in both the old statute and recodified version is ambiguous, and from 1917 until 1963 receipts from intangibles were consistently allocated to states under the location-of-payor rule. For this reason, "The department construction of the ambiguous statute was of such long-standing that it should not be changed in the absence of clear statutory authorization."

B. *Sharp v. House of Lloyd*, 815 S.W.2d 245 (Tex. 1991)

1. Facts:

House of Lloyd, Inc. ("House of Lloyd"), a Missouri corporation engaged in solicitation sales of toys and gifts through independent contractors, sued the Texas Comptroller to recover franchise taxes paid. House of Lloyd had gross sales during the periods in questions from sales

to Texas customers, but had never held, nor had it been required to obtain, a certificate of authority to do business in Texas. Prior to May 1, 1941, the Texas Tax Code provided that only corporations chartered or authorized to do business in Texas were liable for the Texas franchise tax. Effective May 1, 1941, the Texas Tax Code was amended to provide that the Texas franchise tax applied to all corporations that were actually "doing business" in Texas. House of Lloyd argued that the Texas Comptroller should be barred from collecting the tax, "because of nonassessment prior to 1983 for a period of approximately forty-two years after the enactment of the statute which authorized the imposition of the tax."

2. Held:

The Court held that the doctrine of legislative acceptance rule from *Humble Oil* is only applicable where there has been an affirmative long-standing administrative policy. The mere failure to enforce a statute, absent showing of an affirmative policy that the statute is construed by the agency to be inapplicable to specific circumstances, does not establish an affirmative agency policy.

According to the Court, there was no evidence of any affirmative administrative construction of this statute prior to 1975 other than Texas Comptroller Rule 3.406 in effect from 1975 until 1983. Texas Comptroller Rule 3.406 specifically tied the definition of "doing business" for franchise tax purposes to the definition of 'transacting business' in the Texas Business Corporation Act. The Texas Business Corporation Act, in turn, defined transacting business to exclude "the activity of soliciting sales through independent contractors." The Court noted that Texas Comptroller Rule 3.406 was invalid as contrary to the language of the statute.

The Court also held that the doctrine of legislative acceptance could not apply in this case because it only applies where the statute to be construed is ambiguous or of doubtful meaning. Although the terms "doing business" and "business done in Texas" may have been ambiguous under the facts of this case prior to 1969, the statute was amended at the time to specify that "business done in Texas" includes the sales of tangible personal property when the property is delivered or shipped to a purchaser within this state. Accordingly, "No discretion was vested in the Texas Comptroller to interpret the law in a manner inconsistent with the clear intent of the Legislature."

C. *Sharp v. Park 'n Fly*, 969 S.W.2d 572 (Tex. App. ─ Austin 1998, pet. denied)

1. Facts:

Park 'N Fly of Texas, Inc. ("PNF") provides parking services to airport passengers who wish to leave their cars near the airport and take a shuttle bus to the airport. A sign at the parking attendant booth stated that about seventy percent of the fee goes to pay for transportation while

about thirty percent of the fee is actually allocated to the parking service. PNF collected sales tax on the parking service only.

In 1984, PNF's predecessor received a letter from the Texas Comptroller advising the company that while the charge for the parking service was taxable, the charge for the shuttle service was not. In 1992, the Texas Comptroller audited PNF and informed it that the entire fee it was charging was taxable. The Texas Comptroller addressed its policy of taxing these type shuttle services in its Tax Policy News in October 1993.

The Texas Comptroller subsequently amended its rules to state that the shuttle service component of off-site airport parking charges would be taxable effective October 1995. PNF filed a suit in district court seeking a refund of sales tax paid under protest for the period of August 1995 through January 1997.

2. Held:

The Court held that the doctrine of legislative acquiescence to departmental construction does not support the conclusion that PNF's shuttle service was not incident to its parking services. The doctrine only applies when a particular construction of a statute is of such long standing that it should not be changed in the absence of clear statutory authorization.

According to the Court, while the 1984 letter was arguably more significant than the mere failure to collect the tax in *House of Lloyd*, the 1984 letter and the five years that passed before the Texas Comptroller asserted a contradictory construction together did not rise to such a level as to be an affirmative long-standing departmental construction. "Accordingly, the doctrine of legislative acquiescence does not require the treatment of PNF's shuttle service as nontaxable."

D. *Fleming Foods of Tex. v. Rylander*, 6 S.W.3d 278 (Tex. 1999), *superseded by statute*, Tex. Tax Code Ann. § 111.104(b), *as recognized in Levy v. Office Max, Inc.*, 228 S.W.3d 846, 850 (Tex. App.— Austin 2007, pet. denied)

1. Facts:

Fleming Foods ("Fleming"), a wholesale grocer, purchased products and commodities from vendors and paid sales taxes to those vendors, who in turn remitted the taxes to the State. In 1989, the Comptroller audited Fleming, and as part of the audit process, Fleming and the Comptroller entered into agreements that extended the four-year limitations for assessment. None of Fleming's vendors joined in the extension agreements between Fleming and the Comptroller, but Fleming obtained assignments of refund rights from its vendors. However, in some cases, vendors did not execute the assignments until more than four years had elapsed since

Fleming paid the tax, and in other cases, assignments were made to Fleming after its extension agreements with the Comptroller had expired.

The Comptroller assessed a deficiency, and Fleming subsequently requested a redetermination hearing and filed for refunds. The Comptroller maintained that Fleming's refund rights were wholly derivative of its vendors' rights and that the Tax Code did not permit Fleming, as an indirect taxpayer, to obtain refunds from the State unless vendors timely assigned refund rights.

Tax Code section 111.104 provides that "a tax refund claim may be filed with the Comptroller by the person who paid the tax." The statute that preceded section 111.104, former article 1.11A, provided that a refund claim could be filed by any person who paid sales taxes "directly to the [S]tate." The 1981 enactment of section 111.104 states that "this Act is intended as a recodification only, and no substantive change in the law is intended by this Act." The court of appeals concluded that despite clear language in the Tax Code allowing Fleming to seek a refund, the former statute governed. The court of appeals relied on the doctrine of legislative acceptance in reaching its decision. The Comptroller interpreted former article 1.11A by issuing section 3.325(b) of the administrative rules. Section 3.325(b) provides that a person who paid tax to a seller rather than directly to the State could not request a refund from the Comptroller but must recover the tax from the seller. The Legislature subsequently amended article 1.11A many times without changing the law with regard to who had standing to seek a refund from the State.

2. Held:

The Court held that the doctrine of legislative acceptance did not apply to section 111.014 because there was a substantial change in verbiage when former article 1.11A was codified in section 111.104. In addition, the doctrine of legislative acceptance did not require the Court to adopt the Comptroller's construction of former article 1.11A because section 3.325(b) conflicted with another Comptroller rule, section 1.5(c), allowing a taxpayer to request a refund within the time provided by section 111.104(c). Finally, the doctrine of legislative acceptance can only apply if the statute at issue is ambiguous, and an agency's construction of a statute may be considered only if it is reasonable and not inconsistent with the statute. Here, section 3.325(b) directly contradicted the plain meaning of section 111.104 to the extent the statute generally allows taxpayers to seek refunds, but the Comptroller's interpretation allowed only direct taxpayers to seek refunds.

E. *Southwestern Life Ins. Co. v. Montemayor*, 24 S.W.3d 581 (Tex. App.─ Austin 2000, pe. denied)

1. Facts:

Southwestern Life Insurance Company ("Southwestern") sued to recover insurance premium taxes paid under protest for its 1990 tax year. Southwestern contended that it was entitled to carryover unused tax credits attributable to examination and valuation fees paid in 1989 (to the extent such credits exceeded its premium tax liability for 1989) and use those credits to offset and reduce its 1990 premium tax liability.

Article 4.11 of the Texas Insurance Code requires every life, health, and accident insurance company to pay a yearly tax on premiums. Section 8 of the article creates a tax credit that allows an insurance carrier to offset its premium tax liability by the amount of examination and valuation fees it pays to the Texas Department of Insurance. The Texas Comptroller and the Texas Department of Insurance had always interpreted the Texas Insurance Code to permit a credit against a company's premium tax liability only for the year in which the examination and valuation fees were paid.

Southwestern argued that because the Legislature in its 1984 amendment removed a phrase from the Texas Insurance Code that clearly restricted the credit's application to tax liability for the year the fees were paid, it implied that the credit could be carried forward.

2. Held:

The Court disagreed with Southwestern's interpretation of the statute. The Court disagreed that the 1984 amendment to the statute reflected anything more than grammatical clean-up to remove unnecessary language and was not intended to reflect a substantive change in the law. In addition, the Court stated that Southwestern's interpretation would lead to absurd results because it could mean that unused tax credits could also be carried back indefinitely.

Moreover, stated the Court, "When the legislature reenacts without substantial change a statute that has been previously construed by an agency charged with its execution, a court should ordinarily adopt the agency construction." The Court noted that the Legislature had made several amendments to article 4.11 since 1984 but had not changed the language of section 8 to explicitly overrule the agencies' consistent interpretation that credit for fees paid may not be carried forward.

F. *Gilbert v. El Paso Country Hosp. Dist.*, 38 S.W.3d 85 (Tex. 2001)

1. Facts:

The Texas Constitution and the Texas Tax Code contain truth-in-taxation provisions that require local government units to tell their taxpayers each year how the next year's property tax rates will compare with the current year. As part of this taxpayer notice, taxing units must show how much money, if any, they estimate that they will have left over from previous years' maintenance and operations and debt service funds. The Texas Comptroller provides forms as part of a "Truth-in-Taxation Guide" that explain taxing units' truth-in-taxation obligations and highlights changes in the law.

The El Paso Hospital District ("District") paid its operating expenses from several kinds of revenue, including paying patients, cafeteria sales, Medicaid and property taxes. The District read the truth-in-taxation statute and Texas Comptroller's form to require that its notice show only the District's estimate of its remaining property taxes, even if other non-tax funds were also available for maintenance and operations.

Gilbert and other taxpayers argued that the statute requires the District to show the full amount of its unspent funds from all sources. Among the many arguments asserted, the District argued the Texas Comproller's form authorized the District's reporting method. Because the applicable statutory provision in the Tax Code had been amended since the Texas Comptroller had published the form, the District argued that the Legislature had accepted the Texas Comptroller's interpretation of the Tax Code as suggested by the form.

2. Held:

The Court disagreed with the District for two reasons. First, the Court held that Administrative construction of a statute must be clear before that construction is read into the Legislature's re-enactment of the statute. Here, the meaning of the Texas Comptroller's form was not clear. The form in question had two columns, one headed "Type of Property Tax Fund" and the other "Balance." While the District argued that these headings required disclosure only of balances composed exclusively of property taxes, the Court found that an alternative reading was also possible. Specifically, the Court found it more likely that a "Property Tax Fund" as referenced on the Texas Comptroller's form is one that may include property taxes, rather than one that may not, and that the Texas Comptroller meant the form to ask whether any balance remains in such funds.

Second, the Court held that it could not deem the Legislature to have accepted even a clear administrative construction that conflicts with a statute's plain language or clear purpose. Following a review of the statutory language at issue, the Court concluded that the District's interpretation of the Tax Code conflicts with the Legislature's evident purpose in enacting the statute. Although the truth-in-taxation provisions require the Texas Comptroller to create forms for taxing units to use in their disclosures, the statute did not authorize the Texas Comptroller to change the substance of those disclosures.

G. *Wilson v. State*, 272 S.W.3d 686 (Tex. App.─ Austin 2008, pet. filed)

1. Facts:

Thomas Wilson ("Wilson") was the sole officer and director of Wilson Nursery, Inc. ("Wilson Nursery"). Wilson Nursery twice had its corporate privileges forfeited for failing to timely file its franchise tax reports. The Texas Comptroller audited Wilson Nursery and issued an assessment against it which later became final. Subsequently, the State filed suit against both Wilson Nursery and Wilson basing Wilson's personal liability on Section 171.255 of the Texas Tax Code.

Section 171.255 of the Texas Tax Code imposes a corporation's tax liability on the corporation's directors and officers during a period of forfeiture of corporate privileges for failing to file franchise tax reports. Under section 111.207 of the Tax Code, the section 111.202 statute of limitations is tolled for the period during which an administrative redetermination or refund hearing is pending before the Texas Comptroller.

Wilson argued that the Texas Comptroller's assessment against him was invalid because (i) the Texas Comptroller failed to assess Wilson personally for the tax owed within four years from the date that the tax became due and payable, and (ii) the State failed to file suit against Wilson within three years from the date the tax deficiency became due and payable.

Wilson relied on a previous Texas Comptroller Hearing Number 44,195 to argue that while Wilson Nursery's administrative redetermination may have tolled the statute of limitations as to Wilson Nursery, it did not toll the statute of limitations as to Wilson himself. Hearing No. 44,195 involved a personal assessment against an individual for his company's sales tax delinquency. The administrative law judge in Hearing No 44,195 determined the Company's administrative proceeding on the redetermination of is sales tax liability did not toll the statute of limitations for making an assessment against the individual.

2. Held:

The Court upheld the assessment against Wilson. The Court concluded initially that there is no authority requiring the personal assessment against a director or officer before filing suit under the Texas Tax Code for taxes that have been assessed against the corporation. For this reason, the Court found no violation of Section 111.201 of the Texas Tax Code. In addition, the Court held that the plain language of section 111.207 does not require that the director or officer be a party to the administrative redetermination for tolling to apply. For this reason, the lawsuit against Wilson was not barred by Section 111.202.

The Court also found that the administrative construction reflected in Hearing No. 44,195 was neither long-standing nor universally applied, as Hearing Number 44,195 was a single decision and provided no authority for or explanation of its construction of section 111.207. In addition, rather than re-enacting the statute under which the Texas Comptroller sought to impose personal liability in Hearing Number 44,195 without change, the Legislature in 2007, amended Section 111.016 in a manner that overturned the construction given by Hearing Number 44, 195.

Disclaimer: The information provided in this outline is for discussion purposes only. Nothing included herein is intended to reflect any particular interpretation, argument or application of the law by the authors nor is it intended to reflect legal advice.

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July 31, 2015

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RE: Comments on Proposed Amendments to 34 T.A.C. §§ 9.1051-9.1054 and 9.1059, and Proposed New 34 T.A.C. § 9.1060, concerning Agreements for Limitation on Appraised Value of Property for School District Maintenance and Operations Taxes

Dear Ms. Castillo:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to Proposed Amendments to 34 T.A.C. §§ 9.1051-9.1054 and 9.1059, and Proposed New 34 T.A.C. § 9.1060. The proposals appeared in the July 3, 2015, edition of the Texas Register.

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

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

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SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Comptroller for the time and thought that has been put into preparing the Proposed Amendments to 34 T.A.C. §§ 9.1051-9.1054 and 9.1059, and Proposed New 34 T.A.C. § 9.1060. We greatly appreciate the opportunity to work with your office on these significant tax issues and hope to provide relevant analysis for your review. Thank you for your consideration.

Respectfully submitted,

Alyson Outenreath
Chair, Tax Section
The State Bar of Texas

COMMENTS ON PROPOSED AMENDMENTS TO 34 T.A.C. §§ 9.1051-9.1054 AND 9.1059, AND PROPOSED NEW 34 T.A.C. § 9.1060

These comments on Proposed Amendments to 34 T.A.C. §§ 9.1051-9.1054 and 9.1059, and Proposed New 34 T.A.C. § 9.1060 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas (the "Section"). The principal drafters of these Comments include Sam Megally and Charolette Noel, Co-Chairs of the Section's Committee on State and Local Tax. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet reviewed the Comments and made substantive suggestions on behalf of COGS. Catherine Scheid, Vice Chair of COGS, also reviewed these Comments.

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

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Date: July 31, 2015

I. INTRODUCTION

These Comments are in response to the publication of Proposed Amendments to 34 T.A.C. §§ 9.1051-9.1054 and 9.1059, and Proposed New 34 T.A.C. § 9.1060 (together, the "Proposed Rules"), by the Texas Comptroller of Public Accounts (the "Comptroller") in the July 3, 2015, edition of the Texas Register.[1]

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

II. COMMENTS REGARDING PROPOSED RULES

The Comptroller has previously promulgated Form 50-286, Agreement for Limitation on Appraised Value of Property for School District Maintenance and Operations Taxes; in connection with the Proposed Rules, the Comptroller now proposes certain updates to such form, which is also now renumbered as Form 50-826 (the "Proposed Form"). However, the Proposed Rules and the Proposed Form appear in multiple instances to contain inconsistent provisions with respect to the minimum material terms required in agreements for limitation on appraised value of property ("Ch. 313 Agreements").

For example, Section 9.1(A) of the Proposed Form provides that "Applicant shall be in Material Breach of this Agreement if . . . [t]he Application . . . on which this Agreement is approved is determined to be inaccurate as to any material representation, information, or fact or is not complete as to any material fact or representation. . . ." Pursuant to Section 9.2(A) of the Proposed Form, an applicant making such a material breach is entitled to written notice from the district with which it has entered into a Ch. 313 Agreement as well as an opportunity to cure such material breach. However, Proposed Rule § 9.1060(3) provides that Ch. 313 Agreements must contain "a condition that upon the written determination of the governing body of the school district that the application is either incomplete or inaccurate . . ., the [A]greement shall be invalid and void. . ."

As a further example of the apparent inconsistencies between the Proposed Rules and the Proposed Form, Proposed Rule § 9.1060(12) provides that, in the event of a breach under § 9.1060(3) (or a breach under any of three other sections), a district may recapture tax benefits realized by the applicant pursuant to the Ch. 313 Agreement with respect to "the tax year in which the approved applicant failed to comply. . . ." By contrast, Section 9.4(A) of the Proposed Form provides for a recapture of tax benefits with respect to "all of the Tax Years for which a Tax Limitation was granted pursuant to this Agreement prior to the year in which the default occurs that otherwise would have been due and payable by Applicant to District without the benefit of this Agreement. . . ."

[1] All references to "Rule" are to Chapter 34 of the Texas Administrative Code.

With respect specifically to the consequences of breaches relating to incomplete or inaccurate applications, we respectfully suggest that an applicant submitting such an incomplete or inaccurate application should have an opportunity to cure such breach of its Ch. 313 Agreement. Allowing for invalidation of an entire Ch. 313 Agreement on the basis of an inaccuracy or omission in the application seems an overly harsh consequence, especially considering that an applicant may only inadvertently omit or misstate an application response and that such omission or misstatement may not necessarily have any bearing on the contracting district's desire to enter into the Ch. 313 Agreement with the applicant; however, no less severe consequence appears to be available in such a circumstance. Providing for invalidation could also unfairly shift away from taxpayers and to districts significant leverage both in the initial negotiations of, and in the ongoing dealings pursuant to, any Ch. 313 Agreement.

More generally, we also respectfully suggest that the Comptroller work to resolve inconsistencies between the Proposed Rules and the Proposed Form by consolidating in a single place all minimum material requirements for Ch. 313 Agreements. Maintaining two separate sources of such minimum material requirements presents numerous opportunities for inconsistency and confusion. Resolving existing inconsistencies and consolidating all minimum material requirements in a single place will not only significantly reduce such potential confusion, but also streamline the Comptroller's efforts to update the minimum material requirements for Ch. 313 Agreements in the future.

We note further that, to the extent the Comptroller intends to retain some version of the Proposed Form, the Administrative Procedure Act should govern any and all future changes to the Proposed Form just as it governs proposed changes to more traditional Rules such as the Proposed Rules. Therefore, while we hope that the Comptroller will accept our suggestions to resolve inconsistencies between the Proposed Rules and the Proposed Form and to establish in one location a single, consolidated set of minimum material requirements for Ch. 313 Agreements, we express no opinion as to whether such minimum material requirements should appear in an updated version of the Proposed Rules or an updated version of the Proposed Form.

Finally, we note that during the process of preparing these Comments, members of the Section's State and Local Tax Committee experienced difficulty in locating the various versions of the forms referenced in the Proposed Rules. We respectfully suggest that links and references to all forms — including the forms' names and numbers — relating to or affected by Tex. Tax Code Ch. 313 should appear together on the website included in the Proposed Rules.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. Thank you for your consideration.

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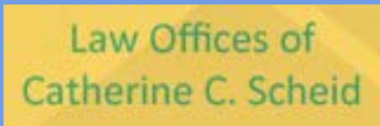

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