The Texas Tax Lawyer

Fall 2011
Vol. 39, No. 1
www.texastaxsection.org

STATE BAR OF TEXAS ANNUAL MEETING, JUNE 24, 2011 AND OTHER BAR MATERIALS:

Practical Ethical Considerations of Administering a Tax Law Practice in the New iWorld – Part I of II

State Bar of Texas Section of Taxation

Annual Meeting

Prepared and Presented by:

Christina A. Mondrik, CPA, Esq.

Board Certified in Tax Law - Texas Board of Legal Specialization
Mondrik & Associates
515 Congress Avenue, Suite 1850
Austin, Texas 78701
(512) 542-9300; Fax: (512) 542-9301
cmondrik@mondriklaw.com
www.mondriklaw.com

Catherine C. Scheid, Esq.

Board Certified in Tax Law - Texas Board of Legal Specialization
Law Offices of Catherine C. Scheid
4301 Yoakum Boulevard
Houston, Texas 77006
(713) 840-1840; Fax: (713) 840-1820
ccs@scheidlaw.com
www.scheidlaw.com

Practical Ethical Considerations of Administering a Tax Law Practice in the New iWorld

The paper discusses various practical, legal, financial and ethical considerations of managing a tax law practice and its employees in the age of iPads, smart phones, and cloud computing. We start with a discussion of worker and employment issues and proceed on to computer and network issues.

This is not intended to be a comprehensive discussion to necessarily answer all questions, and certainly cannot take the place of hiring a qualified employment attorney and IT professional, but our aim is to start the reader thinking about the various issues that may need to be addressed, whether a practice is small or large, longstanding or just starting out.

Hiring and Firing Workers / Employees

Let's start with the happy side of the equation – hiring workers and employees. Hiring the first employee for a new small firm is definitely a big decision, affecting not only taxes and payroll, but also affecting other aspects of the business, such as policies, procedures, and management issues.

Job Description

The first step of hiring a new worker should be a detailed analysis of what you are seeking from that worker. Start with the job description. What will the work entail? What tasks will it include? What skills are required? Desired? What hours are essential? What additional work might be required outside standard hours?

Even if you had someone in the position previously, think about what skills of theirs were most valuable? What additional skills would be nice to have?

Worker Classification Issues

Once you've determined the hours, the level of direction, and the other aspects of the job, it's important to make a decision up front, whether to hire an independent contractor to perform the work, or whether to go through the process of hiring an employee. Consider the worker classification factors published by the IRS (Exhibit A). The IRS has been very active, particularly in recent years, in challenging contractor relationships where the employee factors appear to be present.

Worker classification decisions are very important, as they directly impact an employer's responsibilities for payroll tax, unemployment tax, worker compensation, unemployment compensation, and compliance with various laws. Consequences of improper classification could result in massive assessments of tax, penalties and interest. If your firm intends to treat someone as a contractor, be sure to be consistent. The

worker should truly be a contractor, and should meet the various factors. When in doubt, treat a worker as an employee, or work through a temp help agency instead.

Advertising (?)

Once you have the job description determined, consider your target audience for marketing the job opening. You may want to start small and expand your search as needed. Especially in today's economy, word about job openings travels fast. Large employers may be more restricted regarding their interviewing procedures, and may be required to follow certain procedures in making the job available to the public. However, smaller employers, which include most law firms, have more flexibility in advertising an open job position.

Think about who you've hired in the past. Many times, after sifting through piles of resumes and fielding numerous phone inquiries, you've ended up hiring a worker with whom you made some connection in the interview. Either they knew someone you knew, or worked with someone you respected, or went to the same school or participated in some of the same organizations you did. Why not start with your personal network and potentially expedite the candidate search process?

Limited Circulation. The easiest way to let your circle of contacts know you are seeking to fill a position is by simply telling them. Let it be known what you are seeking. Talk about it at meetings, at lunches, at events. Let your friends, neighbors and colleagues know. Send around the job description by e-mail to a few trusted colleagues and ask them to let you know if they run across someone who might fill the position well.

Social Media. With the expansion of social media, something as simple as posting a status on Linked In or Facebook may actually provide valuable leads to prospective workers. Let them know the job position and the most important characteristics you're seeking.

Campus Resources. Easy methods of advertising include on campus interviewing programs for local universities, review of resume books, etc. If the on campus interview process isn't detailed enough, there's always the option of inviting a student back to the office for a more extensive interview. Also remember student programs for graduate student, undergraduate student, or law school interns who may be available to work for free or at a reduced rate, depending upon your firm's needs. Hiring a student on a temporary basis is less likely to be challenged than hiring others for a short duration.

The Interviewing Process

The interviewing process is a challenge. The interview has a very limited duration to determine whether a prospective employee may be a good fit for the organization. During the interview process, remember to focus not only on technical questions or work experience questions that may provide insight into a particular

candidate's behavior, such as how well he/she may deal with stress, communicate with co-workers, or work with clients.

Questions to Consider Asking in an Interview

- How did you get where you are today?
- What is the most rewarding / challenging experience you've had? What did you learn from that experience?
- Recount a time you disagreed with your supervisor (or a coworker). How did you address the issue? Did you provide research/reasoning to support your position? What was the result? What did you learn from that experience?
- Describe a time a project didn't go as well as planned. What would you do differently?
- Recount a time you were unable to persuade someone. What did you learn from that? What would you do differently?
- Would you rather have a job you love and make less money or a job you hate and make more money?
- In what ways will this role help you stretch your professional capabilities?[1]
- What have been your greatest areas of improvement in your career?[2]
- What's the toughest feedback you've ever received and how did you learn from it?[3]
- What are people likely to misunderstand about you?[4]
- If you were giving your new staff a "user's manual" to you, to accelerate their "getting to know you" process, what would you include in it?[5]
- What are you doing for the community?

[1] "Five Must-Ask Interview Questions," WALL STREET JOURNAL, by Willa Plank.
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*

Consider a Working Interview

A working interview is a good chance for both the employer and prospective employee. The prospective employee can find out more about what it would be like to work in the office and more about the type of work the position entails. The employer can observe the prospective employee's interactions with clients, with co-workers and with others, and determine whether the person is a good fit for the office.

Cautions: If you pay the worker during the working interview, you may be responsible for unemployment compensation if the prospective employee is not offered the position. The law generally does not allow exceptions to unemployment compensation chargebacks to an employer's account for temporary help workers, unless the temporary help was a student internship for a semester, or a similar situation. If you decide not to keep the temporary worker, you may be liable for unemployment, even if it is just short term. Be sure to check with your employment lawyer.

Also, you may be tempted to treat a temporary help worker as a contractor in order to prevent unemployment issues. Doing so could be like jumping from the frying pan into the fire. Particularly with the recent IRS focus on worker classification issues, if the worker more closely fits into the employee category, the worker should be compensated as an employee.[6]

Terminating the Employment Relationship

One of the most difficult parts of being an employer is terminating an employment relationship. In cases where there is documented fraud, malfeasance, or embezzlement, the decision is easier and the documentation issues are not as difficult to manage. A police report or other formal documentation will go a long way in showing that the employee was fired for cause. In such cases, the termination of employment should occur as soon as is practicable following the discovery of the event.

More difficult situations arise when an employee works wells some of the time but is destructive at other times. Or, if there is an employee who historically presents what could be described as "attitude problems," it may be very difficult to ascertain when an employer should terminate the employment relationship or seek to rehabilitate the employee into a productive worker.

At some point, preferably sooner than later, it may become evident that the employment relationship needs to be terminated. Unemployment compensation claim hearings tend to focus on the "last straw" event that led to the termination of the employment relationship. Regardless of whether the Texas Workforce Commission deems the "last straw" event to constitute a termination for cause that makes the former employee ineligible for unemployment compensation, bear in mind your workplace is always better off without a toxic employee who reduces productivity and poisons overall

[6] See "Independent Contractor (Self-Employed) or Employee?" *available online at:* http://www.irs.gov/businesses/small/article/0,,id=99921,00.html.

morale in the organization. The following excerpt is from an article published in the Winter 2011 edition of Texas Business Today.

> In general, it is best to avoid accusing the claimant of having a "bad attitude." Rather, be specific about behavior or conduct that violated a rule or interfered with the work of others. Document the warnings that were given. Present firsthand testimony from those who were affected by the claimant's attitude problems. Their testimony should clearly explain how the claimant's poor attitude made it harder for them to do their jobs, adversely affected customer relations, or otherwise hurt the company. Specifics are extremely important. Depending upon the facts, if the employer explains the circumstances well, the TWC decisionmaker can independently arrive at the conclusion that the claimant had a bad attitude.[7]

The article provides the following advice for employers regarding common workplace issues, which the TWC hearing officers frequently couch as "attitude problems" or "personality conflicts":[8]

- **Persistent rule violations**:
  - Document the problems
  - Make notes of available evidence
  - Identify potential witnesses
  - Give appropriate counseling, warnings, or other forms of corrective action consistent with your company's policy.
  - Prior to discharge, give the employee a clear written final warning letting the person know that he or she is at the last step of the process, that no further chances will be given, and that if the complained-of conduct occurs again, the employee will be subject to immediate discharge.
  - Do not give a final warning until and unless the company is truly ready to act in the event of a verified and provable final incident.
- **"I hope you/they fire me so that I can claim unemployment."**
  - Benefits are about half or less than half of regular employment earnings
  - Benefits last for 10 to 26 weeks
  - Extensions under federal law are not at all a sure thing
  - Claimants must prove eligibility a weekly
  - Many claimants would be eager to take the job
  - It is much easier to find a new job while currently employed
  - Any hope of improving career chances requires good references.

[7] "Taking Steps to Deal with Poor Attitudes," by William T. Simmons, TEXAS BUSINESS TODAY, Winter 2011, available online at: http://www.twc.state.tx.us/news/tbt/tbt0211.pdf.
[8] *Id.* (paraphrased).

- **"This company is so unfair and/or the boss is so bad – I wish they would just fire me."**
  - Can affect other employees and lead to unnecessary morale problems.
  - Prepare a list of the bad effects you have noticed.
  - Discuss them with the employee.
  - Ask if he understands how and why such things are wrong.
  - Conclude by asking him for confirmation that he understands that unless he ends such conduct, he will lose his job.
  - Give him a copy of a formal written warning to that effect.
  - The employee is not required to sign warnings – what is important is that you can explain that he was given a copy of it.
  - Present the document in front of a witness if needed.
- **"Monday/Friday disease"**
  - Employees who habitually calls in "sick."
  - More three- or four-day weekends than anyone else.
  - If pressed, such employees can usually manage to submit a doctor's note.
  - Counsel the employee.
  - If counseling fails, it is possible the layoff could be deemed a medical work separation, resulting in chargeback protection for the company.[9]

Upon deciding termination is necessary, consider what steps might help ease the former employee's transition from working to searching for a job. This may include researching public libraries with Internet access, providing forms for transitioning addresses for notary public registration or other licenses, etc.

Think about what resources you would want available to you if you were in the situation of the former employee. Anticipate what types of questions might be asked or what types of information may be desired. Information regarding potential job search resources or available openings may be helpful. If you feel comfortable doing so, you may offer to assist the former employee with revising his/her resume, or even offer resources to allow him/her to do so.

Since Texas is a "right to work" state, the employer is generally not required to provide notice to the worker prior to termination of the employment. In fact, it is generally better – for obvious internal control reasons – to prevent too much advance warning of an employment termination. Some larger employers fall within regulatory requirements to provide pay in lieu of notice. Therefore, you will want to check with your employment lawyer regarding the applicable requirements for your organization.

If you make a payment to a former employee at the termination of his/her employment, and the payment does not constitute consideration for any sort of agreement from the former employee, the worker will not be entitled for unemployment benefits for the period of time the payment covered.

---

[9] See "Medical Absence Warnings" in the book *Especially for Texas Employers* online at http://www.twc.state.tx.us/news/efte/medical_absence_warnings.html.

Regardless of whether fraud was involved in the decision to terminate the employment relationship, internal controls are important. Schedule the termination conference early enough in the day to allow locks and passwords to be changed before the close of business. Remember not only computer passwords and network passwords, but also account passwords for office supplies, etc., to which the former employee may have had access. Prepare a checklist of items to obtain from the former employee before any last paycheck is provided. This may include building access cards, firm credit cards, keys, identification badges, etc. Cancel any credit cards to which the former employee had access and have the credit card reissue the card with a different account number. Closely monitor accounts to ensure that no unauthorized activity is taking place.

You'll also want to ensure the former employee's safety and security as they leave the premises. This is particularly important if the former employee had a parking garage transponder or other items in his/her car, which must be returned to the employer. Especially if the former employee is in an agitated or emotional state, it's important to have building security escort the former employee to his/her vehicle to help prevent slips, falls, or other accidents that could occur along the way.

Termination Conference Checklist

- Check with guard morning before
  - Arrange for escort to car, assistance with transponder, assistance with gate
  - Arrange for locks to be changed and new keys for remaining employees and replacement employee
- Items to Return
  - Passkey to building
  - Mailbox key
  - Debit card
  - Office key
  - Desk key
  - Any office equipment or resources
  - Garage Access Card or Transponder
  - Obtain a list of passwords for any accounts the employee may have controlled
- Items for Former Employee to Take
  - Personal items
  - Verify contents before departure
- List of Usernames and Passwords to Change
  - Include vendor account usernames and passwords
  - Credit and debit card accounts (get new account numbers)
- Revise website, voice mail messages, voice mail system
- List of contacts and phone numbers that may be needed
- List of people to contact after former employee's departure

Policies and Procedures

One of the best defenses against employment issues is having a strong policy and procedures manual. The manual should include not only procedures for processing various types of documents, such as certified mail, scanned documents, hand deliveries Federal Express packages, etc., but also timesheet policies, smoke break policies, tardy policies, disciplinary policies, etc. Include maps to the nearest facilities, along with their hours. The manual can help busy attorneys working on evenings or weekends who forget how to process certain types of deliveries in addition to doubling as a manual for administrative staff. The timekeeping and disciplinary policies can help to define what procedures are being violated. If you already have a policy and procedures manual, consider updating those policies on a periodic basis to incorporate new issues arising as a result of societal and technological changes.

A good resource for general policies and procedures is available on the Texas Workforce Commission's website: "Especially for Texas Employers" (see http://www.twc.state.tx.us/news/efte/tocmain.html). The manual includes easy-to-customize policies and procedures for Internet use, devices allowed and disallowed in the office, etc. It should be made clear that employees should not have any expectation of privacy regarding personal items left in the office, either physically or on digital storage (i.e. desktop computer, disk or network). Internet usage, downloads and software should be limited in order to prevent viruses and malware. Particularly with the variety of cameras and other digital devices available, it's also important to preserve your employees' privacy (and your own) regarding what is and is not permissible use in the workplace.

Remember, you may be held responsible for your employees' behavior. Under the State Bar Rules, over both lawyers and nonlawyers shall make reasonable efforts to ensure that their conduct is compatible with the lawyer's own professional obligations.[10] Ensure that your employees and any contractors who may work for you, clearly understand the attorneys' and law firms' requirements to maintain confidential client information. Make sure they know that includes, in many cases, the identification of who your clients are.

When a new employee starts, have the new employee review the policy manual. Prepare a memo for each new employee to sign, confirming that they've reviewed all of the policies and procedures in the manual.

As you continue in business, remember to periodically update your policies and procedures. Make it a living document that changes as your business changes. Circulate new policies with a memo for employees to sign off on as policies change, to ensure you've documented their review of the policies.

---

[10] *See* Appendix B.

Exhibit A

Independent Contractor (Self-Employed) or Employee?

It is critical that business owners correctly determine whether the individuals providing services are employees or independent contractors.

Generally, you must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. You do not generally have to withhold or pay any taxes on payments to independent contractors.

Select the Scenario that Applies to You:

- **I am an independent contractor or in business for myself**
  If you are a business owner or contractor who provides services to other businesses, then you are generally considered self-employed. For more information on your tax obligations if you are self-employed (an independent contractor), see our Self-Employed Tax Center.
- **I hire or contract with individuals to provide services to my business**
  If you are a business owner hiring or contracting with other individuals to provide services, you must determine whether the individuals providing services are employees or independent contractors. Follow the rest of this page to find out more about this topic and what your responsibilities are.

Determining Whether the Individuals Providing Services are Employees or Independent Contractors

Before you can determine how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be -

- An independent contractor
- An employee (common-law employee)
- A statutory employee
- A statutory nonemployee

In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

Common Law Rules

Facts that provide evidence of the degree of control and independence fall into three categories:

1. Behavioral: Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. Financial: Are the business aspects of the worker's job controlled by the payer? (these include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
3. Type of Relationship: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no "magic" or set number of factors that "makes" the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another.

The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination.

Form SS-8

If, after reviewing the three categories of evidence, it is still unclear whether a worker is an employee or an independent contractor, Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding (PDF) can be filed with the IRS. The form may be filed by either the business or the worker. The IRS will review the facts and circumstances and officially determine the worker's status.

Be aware that it can take at least six months to get a determination, but a business that continually hires the same types of workers to perform particular services may want to consider filing the Form SS-8 (PDF).

Employment Tax Obligations

Once a determination is made (whether by the business or by the IRS), the next step is filing the appropriate forms and paying the associated taxes.

- Forms and associated taxes for independent contractors

- Forms and associated taxes for employees

Misclassification of Employees

Consequences of Treating an Employee as an Independent Contractor
If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you may be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply). See Internal Revenue Code section 3509 for more information.

Relief Provisions
If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required federal information returns on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977. See Publication 1976, Section 530 Employment Tax Relief Requirements (PDF) for more information.

Misclassified Workers Can File Social Security Tax Form
Workers who believe they have been improperly classified as independent contractors by an employer can use Form 8919, Uncollected Social Security and Medicare Tax on Wages to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation. See the full article Misclassified Workers to File New Social Security Tax Form for more information.

References/Related Topics

- Proper Worker Classification Audio
- Virtual Small Business Tax Workshop - Lesson 6
  The Virtual Small Business Tax Workshop is composed of nine interactive lessons designed to help new small business owners learn their tax rights and responsibilities. See Lesson 6 for information on how to identify an employee versus an independent contractor.
- IRS Internal Training: Employee/Independent Contractor (PDF)
  This manual provides you with the tools to make correct determinations of worker classifications. It discusses facts that may indicate the existence of an independent contractor or an employer-employee relationship. This training manual is a guide and is not legally binding.
- Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding (PDF)
- Publication 15-A, The Employer's Supplemental Tax Guide (PDF) has detailed guidance including information for specific industries.
- Publication 15-B, The Employer's Tax Guide to Fringe Benefits supplements Circular E (Pub. 15), Employer's Tax Guide, and Publication 15-A,

Employer's Supplemental Tax Guide. It contains specialized and detailed information on the employment tax treatment of fringe benefits.

- Businesses with Employees
- Hiring Employees
- Know Who You're Hiring - Independent Contractor (Self-employed) vs. Employee

Note: *This page contains one or more references to the Internal Revenue Code (IRC), Treasury Regulations, court cases, or other official tax guidance. References to these legal authorities are included for the convenience of those who would like to read the technical reference material. To access the applicable IRC sections, Treasury Regulations, or other official tax guidance, visit the Tax Code, Regulations, and Official Guidance page. To access any Tax Court case opinions issued after September 24, 1995, visit the Opinions Search page of the United States Tax Court.*

Page Last Reviewed or Updated: February 18, 2011

Available online at: http://www.irs.gov/businesses/small/article/0,,id=99921,00.html

Exhibit B

Rule 5.01 Responsibilities of a Partner or Supervisory Lawyer

A lawyer shall be subject to discipline because of another lawyer's violation of these rules of professional conduct if:

(a) The lawyer is a partner or supervising lawyer and orders, encourages, or knowingly permits the conduct involved; or
(b) The lawyer is a partner in the law firm in which the other lawyer practices, is the general counsel of a government agency's legal department in which the other lawyer is employed, or has direct supervisory authority over the other lawyer, and with knowledge of the other lawyer's violation of these rules knowingly fails to take reasonable remedial action to avoid or mitigate the consequences of the other lawyer's violation.

Comment:
1. Rule 5.01 conforms to the general principle that a lawyer is not vicariously subjected to discipline for the misconduct of another person. Under Rule 8.04, a lawyer is subject to discipline if the lawyer knowingly assists or induces another to violate these rules. Rule 5.01(a) additionally provides that a partner or supervising lawyer is subject to discipline for ordering or encouraging another lawyer's violation of these rules. Moreover, a partner or supervising lawyer is in a position of authority over the work of other lawyers and the partner or supervising lawyer may be disciplined for permitting another lawyer to violate these rules.
2. Rule 5.01(b) likewise is concerned with the lawyer who is in a position of authority over another lawyer and who knows that the other lawyer has committed a violation of a rule of professional conduct. A partner in a law firm, the general counsel of a government agency's legal department, or a lawyer having direct supervisory authority over specific legal work by another lawyer, occupies the position of authority contemplated by Rule 5.01(b).
3. Whether a lawyer has direct supervisory authority over the other lawyer in particular circumstances is a question of fact. In some instances, a senior associate may be a supervising attorney.
4. The duty imposed upon the partner or other authoritative lawyer by Rule 5.01(b) is to take reasonable remedial action to avoid or mitigate the consequences of the other lawyer's known violation. Appropriate remedial action by a partner or other supervisory lawyer would depend on many factors, such as the immediacy of the partner's or supervisory lawyer's knowledge and involvement, the nature of the action that can reasonably be expected to avoid or mitigate injurious consequences, and the seriousness of the anticipated consequences. In some circumstances, it may be sufficient for a junior partner to refer the ethical problem directly to a designated senior partner or a management committee. A lawyer supervising a specific legal matter may be required to intervene more directly. For example, if a supervising lawyer knows that a supervised lawyer misrepresented a matter to an opposing party in negotiation, the supervisor as well as the other lawyer may be required by Rule 5.01(b) to correct the resulting misapprehension.

5. Thus, neither Rule 5.01(a) nor Rule 5.01(b) visits vicarious disciplinary liability upon the lawyer in a position of authority. Rather, the lawyer in such authoritative position is exposed to discipline only for his or her own knowing actions or failures to act. Whether a lawyer may be liable civilly or criminally for another lawyer's conduct is a question of law beyond the scope of these rules.
6. Wholly aside from the dictates of these rules for discipline, a lawyer in a position of authority in a firm or government agency or over another lawyer should feel a moral compunction to make reasonable efforts to ensure that the office, firm, or agency has in effect appropriate procedural measures giving reasonable assurance that all lawyers in the office conform to these rules. This moral obligation, although not required by these rules, should fall also upon lawyers who have intermediate managerial responsibilities in the law department of an organization or government agency.
7. The measures that should be undertaken to give such reasonable assurance may depend on the structure of the firm or organization and upon the nature of the legal work performed. In a small firm, informal supervision and an occasional admonition ordinarily will suffice. In a large firm, or in practice situations where intensely difficult ethical problems frequently arise, more elaborate procedures may be called for in order to give such assurance. Obviously, the ethical atmosphere of a firm influences the conduct of all of its lawyers. Lawyers may rely also on continuing legal education in professional ethics to guard against unintentional misconduct by members of their firm or organization.

Rule 5.02 Responsibilities of a Supervised Lawyer

A lawyer is bound by these rules notwithstanding that the lawyer acted under the supervision of another person, except that a supervised lawyer does not violate these rules if that lawyer acts in accordance with a supervisory lawyer's reasonable resolution of an arguable question of professional conduct.

Comment:
1. Rule 5.02 embodies the fundamental concept that every lawyer is a trained, mature, licensed professional who has sworn to uphold ethical standards and who is responsible for the lawyer's own conduct. Accordingly, a lawyer is not relieved from compliance with these rules because the lawyer acted under the supervision of an employer or other person. In some situations, the fact that a lawyer acted at the direction or order of another person may be relevant in determining whether the lawyer had the knowledge required to render the conduct a violation of these rules. The fact of supervision may also, of course, be a circumstance to be considered by a grievance committee or court in mitigation of the penalty to be imposed for violation of a rule.
2. In many law firms and organizations, the relatively inexperienced lawyer works as an assistant to a more experienced lawyer or is directed, supervised or given guidance by an experienced lawyer in the firm. In the normal course of practice the senior lawyer has the responsibility for making the decisions involving professional judgment as to procedures to be taken, the status of the law, and the propriety of actions to be taken by the lawyers. Otherwise a consistent course of action could not be taken on behalf of clients. The junior lawyer reasonably can be expected to acquiesce in the decisions made by the senior lawyer unless the decision is clearly wrong.

3. Rule 5.02 takes a realistic attitude toward those prevailing modes of practice by lawyers not engaged in solo practice. Accordingly, Rule 5.02 provides the supervised lawyer with a special defense in a disciplinary proceeding in which the lawyer is charged with having violated a rule of professional conduct. The supervised lawyer is entitled to this defense only if it appears that an arguable question of professional conduct was resolved by a supervising lawyer and that a resolution made by the supervising lawyer was a reasonable resolution. The resolution is a reasonable one, even if it is ultimately found to be officially unacceptable, provided it would have appeared reasonable to a disinterested, competent lawyer based on the information reasonably available to the supervising lawyer at the time the resolution was made. Supervisory lawyer as used in Rule 5.02 should be construed in conformity with prevailing modes of practice in firms and other groups and, therefore, should include a senior lawyer who undertakes to resolve the question of professional propriety as well as a lawyer who more directly supervises the supervised lawyer.
4. By providing such a defense to the supervised lawyer, Rule 5.02 recognizes that the inexperienced lawyer working under the direction or supervision of an employer or senior attorney is not in a favorable position to disagree with reasonable decisions made by the experienced lawyer. Often, the only choices available to the supervised lawyer would be to accept the decision made by the senior lawyer or to resign or otherwise lose the employment. This provision of Rule 5.02 also recognizes that it is not necessarily improper for the inexperienced lawyer to rely, reasonably and in good faith, upon decisions made in unclear matters by senior lawyers in the organization.
5. The defense provided by this Rule is available without regard to whether the conduct in question was originally proposed by the supervised lawyer or another person. Nevertheless, the supervised lawyer is not permitted to accept an unreasonable decision as to the propriety of professional conduct. The Rule obviously provides no defense to the supervised lawyer who participates in clearly wrongful conduct. Reliance can be placed only upon a reasonable resolution made by the supervisory lawyer.
6. The protection afforded by Rule 5.02 to a supervised lawyer relates only to professional disciplinary proceedings. Whether a similar defense may exist in actions in tort or for breach of contract is a question beyond the scope of the Texas Disciplinary Rules of Professional Conduct.

Rule 5.03 Responsibilities Regarding Nonlawyer Assistants

With respect to a non-lawyer employed or retained by or associated with a lawyer:

(a) a lawyer having direct supervisory authority over the nonlawyer shall make reasonable efforts to ensure that the persons conduct is compatible with the professional obligations of the lawyer; and
(b) a lawyer shall be subject to discipline for the conduct of such a person that would be a violation of these rules if engaged in by a lawyer if:
(1) the lawyer orders, encourages, or permits the conduct involved; or
(2) the lawyer:
(i) is a partner in the law firm in which the person is employed, retained by, or

associated with; or is the general counsel of a government agency's legal department in which the person is employed, retained by or associated with; or has direct supervisory authority over such person; and
(ii) with knowledge of such misconduct by the nonlawyer knowingly fails to take reasonable remedial action to avoid or mitigate the consequences of that person's misconduct.

Comment:
1. Lawyers generally employ assistants in their practice, including secretaries, investigators, law student interns, and paraprofessionals. Such assistants act for the lawyer in rendition of the lawyer's professional services. A lawyer should give such assistants appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to representation of the client, and should be responsible for their work product. The measures employed in supervising non-lawyers should take account of the fact that they do not have legal training and are not subject to professional discipline.
2. Each lawyer in a position of authority in a law firm or in a government agency should make reasonable efforts to ensure that the organization has in effect measures giving reasonable assurance that the conduct of nonlawyers employed or retained by or associated with the firm or legal department is compatible with the professional obligations of the lawyer. This ethical obligation includes lawyers having supervisory authority or intermediate managerial responsibilities in the law department of any enterprise or government agency.

Rule 5.04 Professional Independence of a Lawyer
(a) A lawyer or law firm shall not share or promise to share legal fees with a non-lawyer, except that:
(1) an agreement by a lawyer with the lawyer's firm, partner, or associate, or a lawful court order, may provide for the payment of money, over a reasonable period of time, to the lawyer's estate to or for the benefit of the lawyer's heirs or personal representatives, beneficiaries, or former spouse, after the lawyer's death or as otherwise provided by law or court order.
(2) a lawyer who undertakes to complete unfinished legal business of a deceased lawyer may pay to the estate of the deceased lawyer that proportion of the total compensation which fairly represents the services rendered by the deceased lawyer; and
(3) a lawyer or law firm may include non-lawyer employees in a retirement plan, even though the plan is based in whole or in part on a profit-sharing arrangement.
(b) A lawyer shall not form a partnership with a non-lawyer if any of the activities of the partnership consist of the practice of law.
(c) A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.
(d) A lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for a profit, if:
(1) a nonlawyer owns any interest therein, except that a fiduciary representative of the estate of a lawyer may hold the stock or interest of the lawyer for a reasonable time

during administration;
(2) a nonlawyer is a corporate director or officer thereof; or
(3) a nonlawyer has the right to direct or control the professional judgment of a lawyer.

Comment:
1. The provisions of Rule 5.04(a) express traditional limitations on sharing legal fees with nonlawyers. The principal reasons for these limitations are to prevent solicitation by lay persons of clients for lawyers and to avoid encouraging or assisting nonlawyers in the practice of law. See Rules 5.04(d), 5.05 and 7.03. The same reasons support Rule 5.04(b).
2. The exceptions stated in Rule 5.04(a) involve situations where the sharing of legal fees with a nonlawyer is not likely to encourage improper solicitation or unauthorized practice of law. For example, it is appropriate for a law firm agreement to provide for the payment of money after the death of a lawyer, or after the establishment of a guardianship for an incapacitated lawyer, to the estate of or to a trust created by the lawyer. A court order, such as a divorce decree, may provide, when appropriate, for the division of legal fees with a nonlawyer. Likewise, the inclusion of a secretary or nonlawyer office administrator in a retirement plan to which the law firm contributes a portion of its profits or legal fees is proper because this division of legal fees is unlikely to encourage improper solicitation or unauthorized practice of law.
3. Rule 5.04(a) forbids only the sharing of legal fees with a nonlawyer and does not necessarily mandate that employees be paid only on the basis of a fixed salary. Thus, the payment of an annual or other bonus does not constitute the sharing of legal fees if the bonus is neither based on a percentage of the law firms profits or on a percentage of particular legal fees nor is given as a reward for conduct forbidden to lawyers. Similarly, the division between lawyer and client of the proceeds of a settlement judgment or other award in which both damages and attorney fees have been included does not constitute an improper sharing of legal fees with a nonlawyer. Reimbursement by a lawyer made to a bona fide or pro bono legal services entity for its reasonable expenses in connection with the matter referred to or being handled by the lawyer does not constitute a division of legal fees within the meaning of Rule 5.04.
4. Because the lawyer-client relationship is a personal relationship in which the client generally must trust the lawyer to exercise appropriate professional judgment on the client's behalf, Rule 5.04(c) provides that a lawyer shall not permit improper interference with the exercise of the lawyers professional judgment solely on behalf of the client. The lawyer's professional judgment should be exercised only for the benefit of the client free of compromising influences and loyalties. Therefore, under Rule 5.04(c) a person who recommends, employs, or pays the lawyer to render legal services for another cannot be permitted to interfere with the lawyer's professional relationship with that client. Similarly, neither the lawyers personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute the lawyer's loyalty to the client.
5. Because a lawyer must always be free to exercise professional judgment without regard to the interests or motives of a third person, the lawyer who is employed or paid by one to represent another should guard constantly against erosion of the lawyers professional judgment. The lawyer should recognize that a person or organization that pays or furnishes lawyers to represent others possesses a potential power to exert strong pressures against the independent judgment of the lawyer. The lawyer should be watchful

that such persons or organizations are not seeking to further their own economic, political, or social goals without regard to the lawyer's responsibility to the client. Moreover, a lawyer employed by an organization is required by Rule 5.04(c) to decline to accept direction of the lawyer's professional judgment from any nonlawyer in the organization.
6. Rule 5.04(d) forbids a lawyer to practice with or in the form of a professional corporation or association in certain specific situations where erosion of the lawyer's professional independence may be threatened. The danger of erosion of the lawyer's professional independence sometimes may exist when a lawyer practices with associations or organizations not covered by Rule 5.04(d). For example, various types of legal aid offices are administered by boards of directors composed of lawyers and nonlawyers, and a lawyer should not accept or continue employment with such an organization unless the board sets only broad policies and does not interfere in the relationship of the lawyer and the individual client that the lawyer serves. See Rule 1.13. Whenever a lawyer is employed by an organization, a written agreement that defines the relationship between the lawyer and the organization and that provides for the lawyers professional independence is desirable since it may serve to prevent misunderstanding as to their respective roles.

Rule 5.05 Unauthorized Practice of Law

A lawyer shall not:

(a) practice law in a jurisdiction where doing so violates the regulation of the legal profession in that jurisdiction; or
(b) assist a person who is not a member of the bar in the performance of activity that constitutes the unauthorized practice of law.

Comment:
1. Courts generally have prohibited the unauthorized practice of law because of a perceived need to protect individuals and the public from the mistakes of the untrained and the schemes of the unscrupulous, who are not subject to the judicially imposed disciplinary standards of competence, responsibility and accountability.
2. Neither statutory nor judicial definitions offer clear guidelines as to what constitutes the practice of law or the unauthorized practice of law. All too frequently, the definitions are so broad as to be meaningless and amount to little more than the statement that the practice of law is merely whatever lawyers do or are traditionally understood to do. The definition of the practice of law is established by law and varies from one jurisdiction to another. Whatever the definition, limiting the practice of law to members of the bar protects the public against rendition of legal services by unqualified persons.
3. Rule 5.05 does not attempt to define what constitutes the unauthorized practice of law but leaves the definition to judicial development. Judicial development of the concept of law practice should emphasize that the concept is broad enough but only broad enough to cover all situations where there is rendition of services for others that call for the professional judgment of a lawyer and where the one receiving the services generally will be unable to judge whether adequate services are being rendered and is, therefore, in need

of the protection afforded by the regulation of the legal profession. Competent professional judgment is the product of a trained familiarity with law and legal processes, a disciplined, analytical approach to legal problems and a firm ethical commitment; and the essence of the professional judgment of the lawyer is the lawyer's educated ability to relate the general body and philosophy of law to a specific legal problem of a client.
4. Paragraph (b) of Rule 5.05 does not prohibit a lawyer from employing the services of paraprofessionals and delegating functions to them. So long as the lawyer supervises the delegated work, and retains responsibility for the work, and maintains a direct relationship with the client, the paraprofessional cannot reasonably be said to have engaged in activity that constitutes the unauthorized practice of law. See Rule 5.03. Likewise, paragraph (b) does not prohibit lawyers from providing professional advice and instructions to nonlawyers whose employment requires knowledge of law. For example, claims adjusters, employees of financial institutions, social workers, abstractors, police officers, accountants, and persons employed in government agencies are engaged in occupations requiring knowledge of law; and a lawyer who assists them to carry out their proper functions is not assisting the unauthorized practice of law. In addition, a lawyer may counsel nonlawyers who wish to proceed pro se, since a nonlawyer who represents himself or herself is not engaged in the unauthorized practice of law.
5. Authority to engage in the practice of law conferred in any jurisdiction is not necessarily a grant of the right to practice elsewhere, and it is improper for a lawyer to engage in practice where doing so violates the regulation of the practice of law in that jurisdiction. However, the demands of business and the mobility of our society pose distinct problems in the regulation of the practice of law by individual states. In furtherance of the public interest, lawyers should discourage regulations that unreasonably impose territorial limitations upon the right of a lawyer to handle the legal affairs of a client or upon the opportunity of a client to obtain the services of a lawyer of his or her choice.

Rule 5.06 Restrictions on Right to Practice

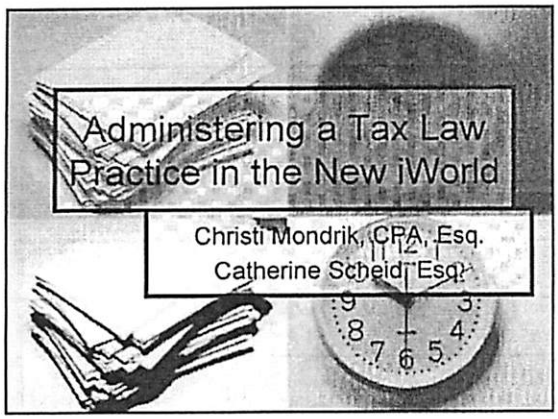
A lawyer shall not participate in offering or making:

(a) a partnership or employment agreement that restricts the rights of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement; or
(b) an agreement in which a restriction on the lawyers right to practice is part of the settlement of a suit or controversy, except that as part of the settlement of a disciplinary proceeding against a lawyer an agreement may be made placing restrictions on the right of that lawyer to practice.

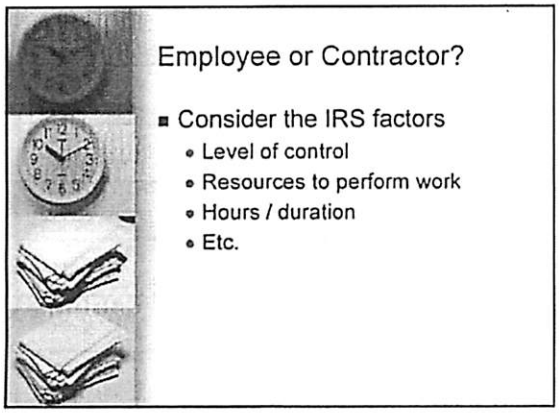
Comment:
1. An agreement restricting the rights of partners or associates to practice after leaving a firm not only limits their professional autonomy but also limits the freedom of clients to choose a lawyer. Paragraph (a) prohibits such agreements except for restrictions incident to provisions concerning retirement benefits for service with the firm.

2. Paragraph (b) prohibits a lawyer from agreeing not to represent other persons in connection with settling a claim on behalf of a client.

Available online at:
http://www.texasbar.com/AM/Template.cfm?Section=The_Grievance_Process&Template=/CM/ContentDisplay.cfm&ContentID=12965


Administering a Tax Law Practice in the New iWorld
Christi Mondrik, CPA, Esq.
Catherine Scheid, Esq.


Hiring New Workers
Start with job description
Make it a wish list
Identify necessary skills
Picture the perfect candidate


Employee or Contractor?
Consider the IRS factors
Level of control
Resources to perform work
Hours / duration
Etc.

Getting the Word Out

- Consider limited distribution
  - Trusted colleagues
  - Family / friends
  - Online networks
- Campus resources
  - On-campus interviews
  - Interview banks
  - Internships

Interviewing Candidates

- Technical questions
- Behavioral questions
- Listen to the answers
  - IF *ANY* RESPONSE GIVES YOU PAUSE IN AN INTERVIEW, *DO NOT HIRE* THE CANDIDATE

Consider a Working Interview

- Good opportunity to "test drive"
- You may be responsible for unemployment compensation
- Consider an assignment through a temp help agency
  - Additional fees may apply

Dealing with Issues

- Decision
  - Counsel and Retain?
  - Terminate relationship?

Immediate Termination

- Fraud
- Malfeasance
- Embezzlement
- Document with Police Report

Chronic Problems

- Persistent rule violations
- "Asking" to be fired
- Inappropriate behavior
- "Monday/Friday" disease

Counseling the Employee

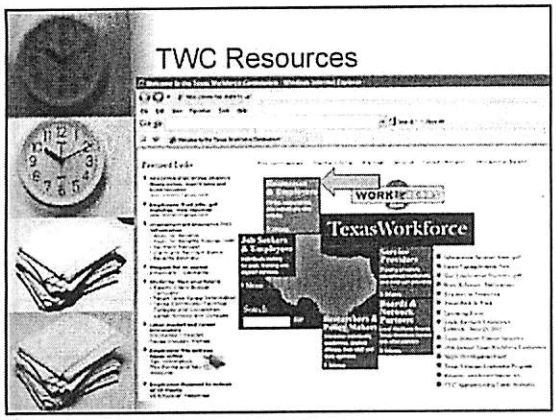
- Documenting warnings
- Letters of clarification
- Reference policies violated
- Explain effect on business
- Warn that future similar behavior or other behavior could result in termination of employment
- Provide a copy to employee

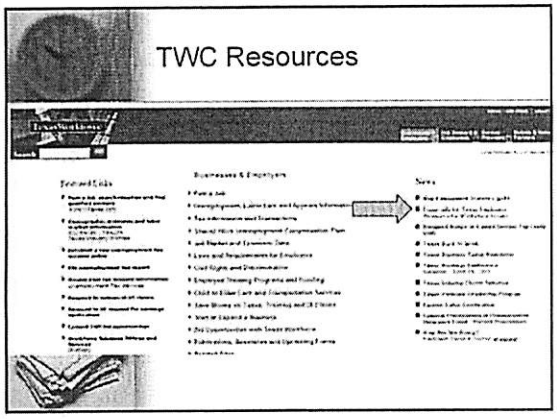
Terminating the Relationship

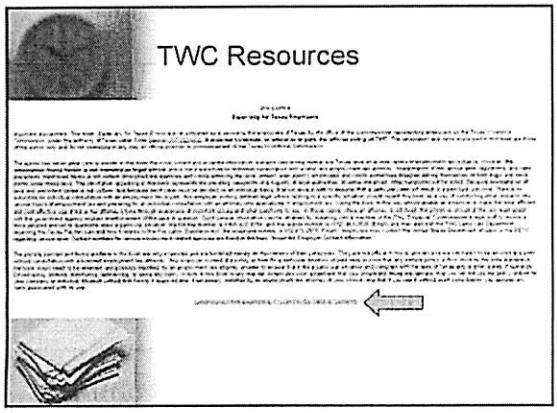
- Document the "last straw" event
- Prepare a checklist
- Prepare a script
  - Identify the "last straw" event
  - Do not use a counseling notice
  - Reference policies violated
  - Employment lawyer review
  - Don't deviate from the script

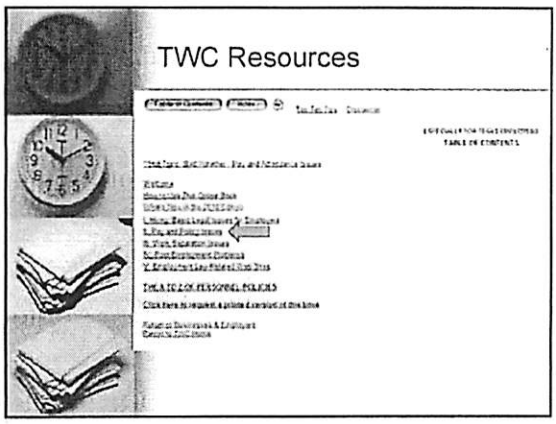
Policies and procedures

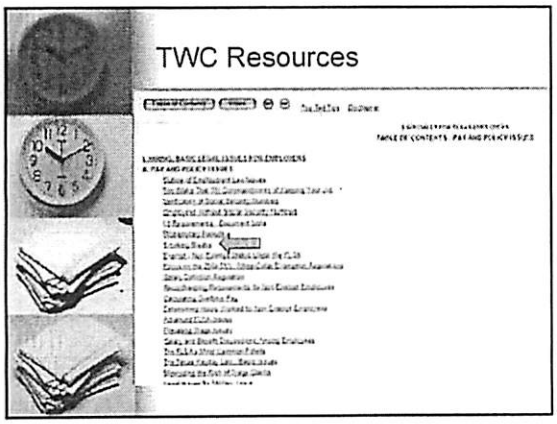
- Best defense against problems
- TWC resources
- Review and revise
- Document employee review

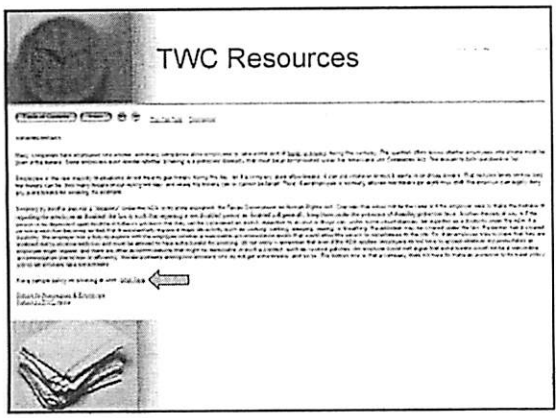

TWC Resources
TexasWorkforce


TWC Resources

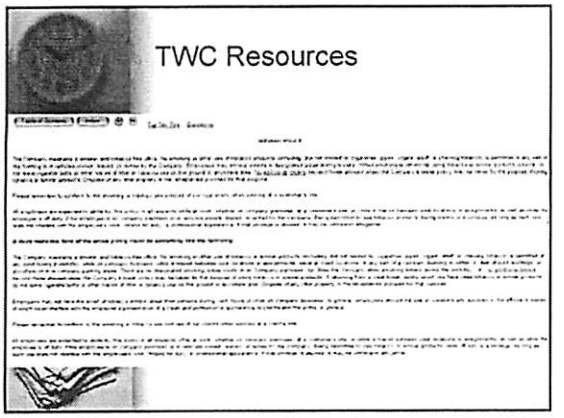

TWC Resources


TWC Resources


TWC Resources


TWC Resources

TWC Resources



Christi Mondrik

- Board Certified – Tax Law
- Mondrik & Associates
  515 Congress Ave, Ste 1850
  Austin, TX 78701
- (512) 542-9300
- cmondrik@mondriklaw.com
- www.mondriklaw.com

Practical Ethical Considerations of Administering a Tax Law Practice in the New iWorld – Part II of II

State Bar of Texas Section of Taxation

Annual Meeting

Prepared and Presented by:

Christina A. Mondrik, CPA, Esq.

Board Certified in Tax Law - Texas Board of Legal Specialization
Mondrik & Associates
515 Congress Avenue, Suite 1850
Austin, Texas 78701
(512) 542-9300; Fax: (512) 542-9301
cmondrik@mondriklaw.com
www.mondriklaw.com

Catherine C. Scheid, Esq.

Board Certified in Tax Law - Texas Board of Legal Specialization
Board Certified in Estate Planning & Probate - Texas Board of Legal Specialization
LLM in Tax Law - University of Houston

Law Offices of Catherine C. Scheid
4301 Yoakum Boulevard
Houston, Texas 77006
(713) 840-1840; Fax: (713) 840-1820
ccs@scheidlaw.com
www.scheidlaw.com

Catherine C. Scheid, Esq.

Board Certified in Tax Law - Texas Board of Legal Specialization
Board Certified in Estate Planning & Probate- Texas Board of Legal Specialization
LLM in Tax Law- University of Houston

Law Offices of Catherine C. Scheid
4301 Yoakum Boulevard
Houston, Texas 77006
(713) 840-1840; Fax: (713) 840-1820
ccs@scheidlaw.com
www.scheidlaw.com

Attorney Scheid is a native Houstonian who graduated with a Bachelor of Business Administration from Texas A&M University, College Station, Texas in 1986. She received her law degree from South Texas College of Law in Houston, Texas in 1988 and her Masters in Tax Law from the University of Houston Law Center, Houston, Texas in 1993.

She has concentrated her practice in the areas of wills, trusts, estate planning, asset protection, probate, guardianships and tax law. She also has extensive experience in the tax controversy area, representing individuals and businesses before the Internal Revenue Service in audits, appellate conferences and tax court litigation.

She is active in both the State Bar and Houston Bar Associations and is a past Chair of the Houston Bar Association Tax Section and Attorneys in Tax and Probate. Catherine served as the Chair of the Solo and Small Firm Committee for the Section of Taxation of the State Bar of Texas in 2009-2010 and continues to hold this position for 2010-2011.

She is Board Certified in both Estate Planning and Probate Law and Tax Law by the Texas Board of Legal Specialization. Attorney Scheid has her own firm

What is "cloud computing" and why do we want to spend our precious billable time considering something new and different when the old way works just fine? Remember, you cannot hold a cloud in your hand and you may not know where it is at all times. Can we make ourselves comfortable with our ethical duties to our clients and use cloud computing? Cloud computing may decrease the administrative costs of running our law offices. It is a safe assumption that a majority of the lawyers in the United States have a computer network within their offices that connects their computers to each other and to the server. We use desktops and laptops to create and work on our client files. The server stores all of our client files, client billing files and the unavoidable administrative files to run the law practice. In addition, most lawyers have a backup system so that they may retrieve and replace files in the event of an unexpected hurricane, tornado or fire. We literally all have a roof over our heads that protects our computer networks, server and backups. In my office I have my server and backup behind a door with a deadbolt for security. Please see Power Point slide #4 attached to this paper.[1] I like my locked door and I like the fact that I can take my back up tape from the day before home with me every night; it makes me feel as if I have control over the privileged client information with which I have been entrusted.

Texas Disciplinary Rules of Professional Conduct Rule 1.05 Confidentiality of Information under Comment 1 summarizes our duty and the reason for confidentiality very well:

> Both the fiduciary relationship existing between lawyer and client and the proper functioning of the legal system require the preservation by the lawyer of confidential information of one who has employed or sought to employ the lawyer. Free

---

[1] Prepared by John D. Walther, CPA and computer consultant with a BA in Accounting from Texas A&M and an MBA from Rice University. jdwalther@hotmail.com

> discussion should prevail between lawyer and client in order for the lawyer to be fully informed and for the client to obtain the full benefit of the legal system. The ethical obligation of the lawyer to protect the confidential information of the client not only facilitates the proper representation of the client but also encourages potential clients to seek early legal assistance.[2]

We are in the business of keeping secrets for better or for worse. Can we be part of this era of cloud computing since we all are bound by secrecy?

What is cloud computing? In a nutshell, cloud computing is delegating the custody, care, maintenance and back up duties of our client files and any other files we so choose to some one else. Please see Power Point slide #5 attached to this paper.[3] By using cloud computing we no longer have a "roof" over our heads protecting our "in house server" because we no longer have an "in house server". We would be utilizing the internet to access our client files in the cloud space that we rent from a cloud company. The cloud is the server, the backup, the archive and protection of all of our privileged client information with all the positives and negatives that accompany this method of data retrieval and storage. When using cloud computing there is a free flow of information between our desktop or laptop computers and the cloud where all our client information is stored. Remember you cannot hold a cloud in your hand and the cloud servicing our computers may be in India, Phoenix, Arizona, San Diego, California or maybe even off shore.

When considering whether to use cloud computing, according to computer consultant John

---

[2] Texas Disciplinary Rules of Professional Conduct & Texas Rules of Disciplinary Procedure Rule 1.05 Confidentiality of Information, Comment 1. Revised July 1995.

[3] Prepared by John D. Walther, CPA and computer consultant with a BA in Accounting from Texas A&M and an MBA from Rice University. jdwalther@hotmail.com

D. Walther, we want to know the following: (1) Where is the data?; (2) Who has access to the data?; and (3) What are our contractual rights to the data? In researching this paper, I was fortunate enough to be able to review a list of concerns and questions prepared by Yvonne Flood, Senior Project Manager for the College of Communications of Metro State College. Flood's list of concerns and questions are as follows:

1. Review the Purchase Agreement carefully as that document outlines the number of users; the set up fee; the number of free support incidents; the number of desktop PCs with the package; an anytime PC replacement; Mission Critical Outage Response Time; Regular Response Time; Regular Incident Resolution Time; Incident Cost; After Hours Incident Cost; Access To Managed Client Only Support Direct Extension; Secure Data Access; Antivirus/Antispyware management; Emergency Onsite Response; Remote Data Backup; Host Corporate Website; Design Corporate Website; Update Website; Software that will be used; Exchange Email; and Application Training. In addition there is usually a yearly cost comparison of an In-House Computer System of $34,000 to a cloud system of $9,500.[4]
2. Read the Statement of Work (SOW) and this document should outline the time-line to implement the cloud into your business; discuss the technical specifications of the hardware that will be used; the security of the facility where "your" server will be housed; whether you will share a server or have your own server; if you share a server then the guarantee of server security; outline whether they will provide a certification to you that your area of the server is secure; if there is a breach then

[4] Purchase Agreement Presentation by an anonymous company.

what is your recourse.;[5]

3. Read the Service Level Agreement (SLA) which should address the turnaround time in case of an outage. Industry standard expects 99.999% uptime. Determine if the cloud company responds to issues Monday through Sunday or Monday through Friday. The SLA will not address the cloud company's maintenance to their system and for how long. Make sure that the cloud company's maintenance schedule is acceptable to you.[6] The cloud company in the SLA needs to have a written policy on how it will notify you regarding an emergency upgrade or security patch and how long it would take to implement. An emergency upgrade or security patch should only occur when there is a critical security threat otherwise most other patches or upgrades can be implemented during regular maintenance.[7]

4. Ask for a copy of the cloud company's disaster recovery plan which should outline what happens when there is a security problem on their site, to their hardware, or at their facility. In addition, you need to know where the cloud company's backup is located and how long it will be until your services will be restored. The cloud company should have a duplicate system at an alternate location or everything should be backed up on a tape and sent to a remote location. The duplicate system or the back up tape at a remote location will allow you to retrieve your data if the main

---

[5] Letter from Yvonne Flood, Senior Project Manager for the College of Communications for Metro State College, Masters of Science in Computer Information Systems. (April 22, 2011).

[6] Id.

[7] Id.

> facility goes down. You also need to know who will have access to your data so it can be retrieved in case of an emergency. You need to have the authority, ownership and access to your own back up information so you can obtain it at any time.[8]

Compare the questions and concerns of an IT professional above to the questions and concerns of the ABA Commission on Ethics 20/20 Working Group on the Implications of New Technologies regarding Issues Paper Concerning Client Confidentiality and Lawyer's Use of Technology dated September 20, 2010.[9] The American Bar Association's Commission on Ethics 20/20 wrote a paper to invite comments regarding confidentiality related to the legal profession and the use of technology.[10] The ABA Commission focused on cloud computing and technology controlled by lawyers or their employees. [11] The ABA Commission defines cloud computing as the following examples: Mozy.com, Carbonite.com, AOL, Yahoo, Gmail and software as a service ("Saas"). [12] In the definition of Saas, the ABA Commission includes law practice management computer programs that assist lawyers with conflict checking, document management and storage, trust account management, timekeeping and billing.[13] The technology controlled by lawyers or their

---

[8] Id.

[9] ABA Commission of Ethics 20/20; To: ABA Entities, Courts, Bar Associations (state, local, specialty and international), Law Schools, Individuals, and Entities; From: ABA Commission on Ethics 20/20 Working Group on the Implications of New Technologies; RE: For Comment: Issues Paper Concerning Client Confidentiality and Lawyers' Use of Technology; Date: September 20, 2010.

[10] Id. at page 1.

[11] Id. at page 1 and 2.

[12] Id. at page 2.

[13] Id.

employees includes laptops, cell phones, flash drives, photocopiers and scanners.[14]

The ABA Commission focused on the fact that information, whether in electronic or physical form, may be stolen, lost or inadvertently disclosed.[15] The ABA Commission also distinguished between security measures that are ethically required and security measures that are considered "best practices." One of the examples in the ABA paper is that it may be best to install sophisticated firewalls and various protections against malware but it is not unethical to install more basic protections.[16] Another example is that it may be unadvisable to use a cloud computing company that does not meet industry standards regarding encryption but it is not necessarily unethical.

The following is a list of the confidentiality-related concerns from cloud computing in the ABA memorandum:

1. Unauthorized access to confidential client information by a vendor's employees (or sub-contractors) or by outside parties (for example hackers) via the internet;
2. The storage of information on servers in countries with fewer legal protections for electronically stored information;
3. A vendor's failure to back up data adequately;
4. Unclear policies regarding ownership of stored data;
5. The ability to access the data using easily accessible software in the event that the lawyer terminates the relationship with the cloud computing provider or the provider changes businesses or goes out of business;

---

[14] Id.

[15] Id.

[16] Id.

6. The provider's procedures for responding to (or when appropriate, resisting) government requests for access to information;
7. Policies for notifying customers of security breaches;
8. Policies for data destruction when a lawyer no longer wants the relevant data available or transferring the data if a client switches law firms;
9. Insufficient data encryption; and
10. The extent to which lawyers need to obtain client consent before using cloud computing services to store or transmit the client's confidential information.[17]

With all the ABA's concerns regarding cloud computing, the Commission is also asking the question of whether the ABA Formal Ethics Opinion 08-451, which addresses a lawyer's obligations when outsourcing work to lawyers and non-lawyers, should apply to cloud computing[18]. The Commission is also asking the question whether the Model Rule of Professional Conduct 5.3 and the comments should be amended due to cloud computing. Model Rule 5.3 addresses a lawyer's ethical obligations to supervise non-lawyer assistants and the comment makes clear that the duty of supervision extends to non-lawyers who serve as independent contractors.[19]

The ABA Commission is concerned with the existing cloud computing industry standards and the terms and conditions that would be essential for lawyers as follows:

1. The ownership and physical location of stored data;
2. The provider's back up policies;

---

[17] Id. at page 3 and 4.

[18] Id. at page 4.

[19] Id.

3. The accessibility of stored data by the provider's employees or sub-contractors;
4. The providers's compliance with particular state and federal laws governing data privacy (including notifications regarding security breaches);
5. The format of the stored data (and whether is compatible with software available through other providers);
6. The type of data encryption; and
7. Policies regarding the retrieval of data upon the termination of services.[20]

The Commission has also formulated a list of concerns regarding "Local" technology and the issues surrounding what happens when laptops, flash drives and smart phones are lost or stolen as follows :

1. Providing adequate physical protection for devices like laptops or having methods for deleting data remotely in the event that a device is lost or stolen;
2. Encouraging the use of strong passwords;
3. Purging data from devices before they are replaced such as computers, smart phones and copiers with scanners;
4. Installing appropriate safeguards against malware (e.g. virus protection, spyware protection);
5. Installing adequate firewalls to prevent unauthorized access to locally stored data;
6. Ensuring frequent back ups of data;
7. Updating computer operating systems to ensure that they contain the latest security protections;

[20] Id at page 5.

8. Configuring software and network settings to minimize security risks;

9. Encrypting sensitive information, and identifying (and, when appropriate, eliminating) metadata from electronic documents before sending them; and

10. Avoiding "wifi hotspots" in public places as a means of transmitting confidential information (e.g. sending an email to a client).[21]

I know two lawyers whose computer systems were hacked. One lawyer opened himself to a hacker through facebook. The second lawyer is not sure how the hacker gained access to his server but this second lawyer does do a lot of internet work. The solutions to both problems were expensive because computer specialists had to be brought in to fix the problem and then include the billable hours lost when the computers are down.

The ABA Commission also discussed cyberinsurance and cyberliability insurance in the memorandum. Cyberinsurance is insurance to protect against the cost to replace lost information due to cyberattacks or the expense of post-cyberattack compliance obligations.[22] Cyberliability insurance is insurance that protects against for example lawsuits arising from a lawyer's failure to protect confidential electronic information.[23] Cybliabillity insurance may provide coverage for lawsuits not covered by our professional liability insurance.[24]

In 2010 EDUCAUSE Quarterly published a paper titled *If It's in the Cloud, Get It on Paper: Cloud computing Contract Issues*. This paper explains how the cloud computing provider's standard

---

[21] Id. at page 5 and 6

[22] Id. at page 6.

[23] Id.

[24] Id.

contract is written in favor of the company, which is to be expected.[25] If we decide to go the cloud computing avenue then we need to negotiate the contract with the service provider, as we would negotiate a contract for a client.[26] There are various forms of cloud computing such as software as a service (SaaS), infrastructure as a service (IaaS) and platform as a service (PaaS). The contract issues associated with any of the forms of cloud computing have contract issues that need to be addressed as follows: 1) service level agreement; 2) data processing and storage; 3) infrastructure/security; 4) vendor relationship.[27] The service level agreement is the road map for the relationship between the cloud company and us. It is therefore imperative that the service level agreement addresses the following: 1) uptime; 2) performance and response time; 3) error correction time; 4) infrastructure/security.[28] Note that standard contracts usually exclude from uptime the downtime for scheduled maintenance or maintenance that was announced in advance.[29] There should be specific remedies and/or compensation in the service level agreement, such as a monetary credit to the customer if the system goes down. For example, "if Google does not meet the Google Apps. SLA and the Customer meets its obligations under this Google Apps SLA, Customer will be eligible to receive the Service Credits described below.....".[30]

---

[25] Thomas J. Trappier, *If It's in the Cloud, Get It on Paper: Cloud Computing Contract Issues*, 33 EDUCAUSE Quarterly, EQ (2010) http://www.educause.edu/EDUCAUSE+Quarterly/EDUCAUSEQuarterlyMagazineVolum/IfItsintheCloudGetItonPaperClo/206532

[26] Id. at page 1.

[27] Id.

[28] Id. at page 2.

[29] Id.

[30] Id.

A service level agreement should also include a customer's right to audit performance records and daily service quality statistics.[31] Apparently, Salesforce.com, Microsoft, Google and Amazon allow audits. There are also 3rd parties that will monitor cloud servers such as Cloudkick.[32] Apparent Networks provides a cloud provider scorecard.[33]

Since our data will be traveling over the internet in cloud computing, the contracts need to address the following: 1) ownership of data; 2) disposition of data; 3) data breaches; 4) location of data; 5) legal/government requests for access to data.[34] If there is data breach then the service provider should indemnify the customer. There is an example of indemnification language in the University of Minnesota's Google Apps for Education contract as follows: "6.5 Personally Identifiable Information. Each party acknowledges that, in the course of performance hereunder, they may receive personally identifiable information that may be restricted from disclosure under the Health Insurance Portability and Accountability Act (HIPAA) and/or the Family Education Rights and Privacy Act (FERPA). Notwithstanding any other provision of this Agreement, each party will be responsible for all damages, fines and corrective action arising from disclosure of such information caused by such party's breach of its data security or confidentiality provisions hereunder."[35]

---

[31] Id.

[32] Id. at page 3.

[33] Id.

[34] Id.

[35] Id at page 4.

Which law applies, where the data is located or where I am located?[36] It would be important for the geographic location of the data to be addressed in the contract with the cloud company.[37]

The infrastructure/security of the cloud company and where the computers are housed is also of utmost importance. Investigate the cloud computer company's business continuity, encryption, firewalls, physical security.[38] All the foregoing needs to be in the contract with the cloud company. In addition, you want the contract to reflect your right to inspect the computer company's security where it houses the computers which is a Data Center Inspection. [39] The contract should address how you will retrieve your information if your data is lost due to an error omission of the cloud computing company.[40]

The contract also needs to address several Vendor Relationship issues such as price caps, functionality, termination, mergers and acquisitions and vendor outsourcing.[41] You need to focus not only on the buy in cost to the cloud but the cost to maintain your relationship with the cloud company over the years. You need to know before the cloud company adds or deletes a feature or a function of a service and this fact should be memorialized in the contract.[42] Address in the contract

---

[36] Id.

[37] Id.

[38] Id. at page 5.

[39] Id.

[40] Id. at page 6.

[41] Id. at page 6 and 7.

[42] Id. at page 6.

how you can terminate the relationship with the cloud company and how the cloud company may terminate with you. For example, "Unless otherwise required by law, Vendor may not withdraw availability of the Services during the Term of this Agreement without first providing University with ninety (90) days advance notice of same, and then only if Vendor is withdrawing availability from all its customers."[43] There are new cloud companies and more established cloud companies and they will merge with each other and separate from each other. So the contract needs to address mergers, acquisitions and assignments such as "Assignment - This Agreement shall be binding on the parties and their successors (through merger, acquisition or other process) and permitted assigns. Neither party may assign, delegate or otherwise transfer its obligations or rights under this Agreement to a Third Party without the prior written consent of the other party."[44]

Some of the cloud companies may outsource some of their work to other companies. The contract with the cloud company needs to address whether a service will be outsourced and that even if a service is outsourced that the cloud company is still ultimately responsible for all aspects of the contract. [45] At the end of the EDUCAUSE Quarterly paper, which outlined certain clauses that should be in a contract with a cloud computing company, the author shared that "UCLA selected a SaaS solution because the benefits of getting a new enterprise-wide service up and running quickly while not having to establish and maintain the supporting infrastructure outweighed the risks of adopting a cloud computing solution.[46]

---

[43] Id.

[44] Id at page 6 and 7.

[45] Id. at page 7.

[46] Id.

If you would like to see some standard contracts for cloud computing you may read the contracts for Amazon Web Services, Google Apps for Education, Microsoft Windows Azure, and Salesforce.com. The City of Los Angeles also has a computer cloud contract to replace its email and to add Google office and automation and collaboration tools dated November 10, 2009.

On Saturday, April 9, 2011, the Houston Chronicle published an article titled *Cloud Storage The Sky's the Limit.*[47] The article begins with "Goodbye, flash drive. Farewell, compact disks. Hello cloud.".[48] Some individuals are storing information in virtual servers or other hardware stored remotely but many businesses with sensitive data are not. The legal field is one of those businesses with sensitive data.

According to a Houston.com study in the year 2011 the cloud storage and disaster recovery services are suppose to grow three to five times.[49] In the Houston.com study, 36% of more than 500 respondents reported that they plan to utilize a cloud in 2011 while 80% said they were holding off until the next upgrade.

In 2010 the cloud industry generated an estimated $68 billion which is 17% higher than in 2009, according to Gartner, an IT research firm.[50] According to Scott Gibson, director of product for big data at Rackspace Hosting claims that customers are beginning to appreciate the advantages of the cloud's unlimited storage space. Rackspace Hosting is storing about 40 gigabyte of data as

---

[47] Valentino Lucio, *Cloud storage: The Sky's the Limit*, Houston Chronicle, April 9, 2011, at A1 at D4.

[48] Id,

[49] Id.

[50] Id.

compared to 10 gigabyte just a few years ago.[51] The last little jewel in the Houston Chronicle article comes from Mark Perry, who is a vice president of San Antonio based Globalscape, and he encourages the use of data encryption, password protection and "....don't leave sensitive data in the cloud for prolonged periods."[52]

On April 15, 2011 The New York Times published an article titled *The Business Market Plays Cloud computing Catch-Up.* [53] According to Timothy F. Breshman, an economist at Stanford University, "the cutting edge of innovation is on the consumer side - digital technologies for consumption activity, play, entertainment and social-networked communication -and not in corporations anymore."[54] In the New York Times article cloud computing is described as a way for customers over the internet to remotely access information held in big data centers. According to analysts, cloud computing will manage computing workloads more efficiently and potentially reduce costs by half.[55] IBM has introduced a range of cloud services such as processing and storage "metered pay-for-use formula."[56] According to the New York Times article IBM is planning to offer different levels of guaranteed security, support and availability. IBM is predicting $7 billion in cloud revenue by 2015. "We're moving to where the puck is going in this industry," said Steven

---

[51] Id.

[52] Id.

[53] Steve Lohr, *The Business Market Plays Cloud Computing Catch-Up*, The New York Times, April 15, 2011 at B1.

[54]Id.

[55]Id..

[56] Id.

A. Mills, IBM's senior vice president for software and hardware.[57]

In April 2011, Dell announced that it was planning to invest $1 billion over the next two years to build ten new data centers and expand customer support for cloud services.[58]

The last bit of interesting information in the New York Times article is the fact that the United States Government has endorsed the cloud model in 2011. Vivek Kundra, the White House chief information officer, wrote a "Federal Cloud Computing Strategy" report. In the report Mr. Kundra estimated one-fourth of the government's total spending ($20 billion) would be for migrating to the cloud.[59]

In April 2011, there was an article published in the ABA Journal titled *The Trouble with Terabytes (As bulging client data heads for the cloud, law firms ready for a storm).*[60] In the Terabytes article the example of modern e-discovery that is given is the Viacom v. YouTube lawsuit that was filed in 2008. The judge ordered 12 terabytes of data to be turned over according to Matthew Knouff, who is general counsel of Complete Discovery Source, a New York City-based electronic discovery services provider.[61] One terabyte equals 50,000 trees and 10 terabytes equals all the printed collections of the Library of Congress.[62]

In 2010 Deloitte Forensic Center, which is a think-tank that researches ways to mitigate the

---

[57] Id.

[58] Id.

[59] Id.

[60] Joe Dysart, *The Trouble with Terabytes As bulging client data heads for the cloud, law firms ready for a storm.* ABA Journal, April 2011 at 33-37, 62.

[61] Id. at 33.

[62] Id.

results of illegal and unethical business practices, conducted a study, which showed that only 9% of businesses believed they were well prepared to electronically capture and store digital information from cloud computing programs.[63] The greatest concern with data, whether created within the walls of a lawfirm or brought in a lawfirm from outside, is the loss of control.[64] This loss of control of data seems to be at the top of the list of concerns for the IT folks and the ABA folks. E-discovery firms and IT folks are developing ways to keep sensitive data protected[65] and hopefully the protection will allow lawyers to feel comfortable enough to store our client data in the cloud. According to Nick Brestoff, who is the Western regional director of discovery strategy and management at International Litigation Services of Aliso Viejo, California, "the significantly lower cost of using the cloud is driving the data's migration beyond the firewall, - the data is leaving the building."[66] As I was researching this cloud topic the lower administrative costs of the cloud certainly peeked my interest since I run a small shop and am constantly watching expenses. However, attorney client privilege and protecting my clients' privacy keeps singing loudly in my ears.

E-discovery experts stress asking the cloud services providers a lot of questions about their policies and practices for managing and protecting our data.[67] In addition, clarifying with the cloud service providers who is responsible for stolen data is also of great importance. Many cloud service

---

[63] Id.

[64] Id. at 34.

[65] Id.

[66] Id.

[67] Id.

providers limit their liability or disclaim any liability for stolen data.[68] Deborah Motyka Jones, who is a client services manager at Seattle-based Lighthouse Document Technologies, suggests negotiating indemnification language in the contract with the cloud service provider for losses of data that are the cloud provider's fault.[69] According to Matthew Knouff, who is general counsel of Complete Discovery Source, a New York City-based electronic discovery service provider, says that many cloud service providers reserve the right to modify any content that you put in the cloud which Knouff explained as losing control of data through proprietary data formats.[70]

One of the most disturbing revelations in researching this cloud topic was the fact that "a service provider cannot be held liable for disclosing information pursuant to a legitimate governmental order, and a civil suit cannot be brought against the U.S. government for disclosure violations," per Knouff.[71] Knouff believes that the cloud service providers can disclose the sensitive data with out prior notice to the lawyer. Therefore, Knouff suggests negotiating a notice provision in the contract with the cloud service provider so we receive notice if an entity or government is interested in obtaining our sensitive data.

Law firms need to consider negotiating for additional physical copies of data from the cloud service provider. Knouff believes that lawyers should be required to back up their data and that backing up data should not just be considered best practices.[72] One of the reasons backups are vital

---

[68] Id. at 35.

[69] Id.

[70] Id.

[71] Id.

[72] Id.

is because if lawyers decide to utilize a cloud service provider who ultimately goes bankrupt, our backups allow us to continue taking care of our clients. This cloud storage is new and has appealing qualities but will it endure the test of time?

Another important issue to consider regarding cloud data storage would be the interaction between the lawyer's network and the computer systems of the cloud therefore, requesting and keeping updated a data map of how information travels through the firm's network and how the firm's data interacts with the cloud's system.[73] A current data map of the cloud service provider's storage and processes will also be helpful in e-discovery situations so retrieval of the data is more economical.

What about backing up your mobile phone and protecting that information? V Cast Media Manager from Verizon Wireless will back up cell phones as well as third- party service providers that will manage mobile phones.[74] Collecting a forensic image of a mobile phone may be done by utilizing the following software programs: (1) Guidance Software's EnCase Neutrino; (2) Access Data's Mobile Phone Examiner; (3) Paraben [Corp.'s] Device Seizure; and (4) Logicube Inc.'s CellDEK and CellDEK TEK.[75]

If the lawfirm has a lot of money to spend, then there are in house servers that are behind the lawfirm's firewall. Therefore all the security and control that the lawfirm has over its internal IT system may also exist over the lawfirm's e-mail.[76] According to Knouff if you loose your cell

---

[73] Id.

[74] Id.

[75] Id.

[76] Id.

phone there is a program named Lookout that will allow you to remotely delete the data from your phone.[77]

Are there ethical issues with disappearing e-mails? A type of software that makes emails disappear is Vaporstream Inc.'s Electronic Conversation Software.[78] According to Cathy Duplissa-Lopez, who is a project manager of electronic data and e-discovery at the Phoenix office of lawfirm Fennemore Craig, at least one form of disappearing email may be subject to a government subpoena or similar request and be susceptible to a wiretap in a manner similar to a phone call.[79]

If a lawyer decides to use a cloud service provider then does the lawyer have an ethical obligation to tell the clients about the cloud? Newton of Themis Solutions argues that lawyers do not have an ethical obligation to communicate to the clients that the storage of data is in with a cloud service provider.[80] Whether a lawfirm uses cloud data storage or in house data storage the chances of losing data, security breaches or governmental subpoenas still exist.

In 2010 Deloitte Forensic Center performed a survey that showed 62% of information technology professionals and legal professionals have misgivings about Corporate America's zeal to use social media.[81] The survey concluded that many employees believe the information posted on Facebook is safe from discovery. Currently case law provides that cites like Facebook are

---

[77] Id.

[78] Id. at 36.

[79] Id.

[80] Id.

[81] Id. at 37.

generally protected from third party disclosure.[82] However, according to Margaret N. Boyle, who is an associate at Babst, Calland, Clements and Zomnir in Pittsburg, a few courts have held that when relevant private posts are discoverable from parties to the litigation.[83] Even more troubling is that social networks retain the right to redefine what they consider private without communicating with their users.[84]

It is being suggested by Nick Brestoff, who is the Western regional director of discovery strategy and management at International Litigation Services of Aliso Viejo, California, that lawfirms will need to re-engineer themselves and acquire binocular vision to be able to glean the facts from the computer data.[85] E-discovery will need to be integrated into a law firm's regular course of business.[86]

The Federal Rules of Civil Procedure have been updated to provide for litigators the rules to be followed in e-discovery. On December 1, 2006 the Federal Rules of Civil Procedure (FRCP) were amended to add e-discovery sections. FRCP numbers 16, 26, 33, 34, 37 and 45 provide for attorneys to specifically address electronic e-discovery issues.

On April 22, 2011, the New York Times published an article by Stephen Lohr which addressed the problems with Amazon's Computer Services being down two days in a row.[87]

---

[82] Id.

[83] Id.

[84] Id.

[85] Id.

[86] Id.

[87] Steve Lohr, *Amazon's Trouble Raises Cloud Computing Data*, The New York Times, April 23, 2011 at B1.

Amazon hosts thousands of corporate customers such as Pfizer and Netflix plus several thousands of start up companies.[88] The New York Times Article reports that cloud computing will grow by more than 25% a year and eventually be a $55.5 billion dollar business by 2014.[89] The chief strategy officer of Rackspace compared Amazons trouble to an airplane crash but reminds us that airplane travel is still safer than traveling in a car. It follows that it may be safer to allow a cloud computing company to take care of our data instead of data centers run by individuals.[90]

In April 2011 The Texas Lawyer published an article by Dr. Gavin W. Manes, the President and CEO of Avansic which is an e-discovery and digital forensics business.[91] According to Dr. Gavin there are two uses of cloud computing for lawyers, which are the storage of data and the storage and reviewing of data for litigation. Dr. Gavin cleverly defines cloud computing as "server farms" where high-powered computers are warehoused and provide enormous processing power and data storage to customers.[92] There are two types of clouds, software and hardware.[93] Examples of software are Hotmail and Gmail. DropBox is also a software where lawyer share file space.[94] An example of hardware is a customer buying processing power on a computer to run a computer application such as an animation company using an external computer to produce high quality 3-D

---

[88] Id.

[89] Id.

[90] Id. at page 2.

[91] Gavin W. Manes, *Cloud Computing and the Legal Profession.* Texas Lawyer, April 2011.

[92] Id. at page 1.

[93] Id.

[94] Id.

graphics.[95]

Cloud computing can be cost effective but cloud computing can present security and privacy concerns that apply to all lawyers.[96] A security concern in connection with cloud computing is the fact that the computers holding the data may not be within the borders of the United States and therefore subject to another set of laws that are not sensitive to the privacy and privilege rules.[97] On page two of the April 2011 Texas Lawyer article there is a list of Dr. Gavin's concerns in considering cloud computing.

On June 6, 2011 The New York Times published an article titled *Apple Unveils Cloud' Music and Storage Service*.[98] According to Steve Jobs the iCloud will simplify how people manage content and apps across devices.[99] When Apple announced the iCloud, the critics' first comments were security and how Apple would protect and secure peoples' data.

An article published on June 21, 2011 in Enhanced Online News addressed identity management in the Cloud. The article discussed a company named Ping Identity Corporation, which is the leading company in Cloud Identity Security. IDC Worldwide Identity and Access Management estimated that the market for Identity Management products, similar to those of Ping Identity, was $1.07 Billion in 2010 and will grow by approximately 49% to 1.6 Billion by 2014.

---

[95] Id.

[96] Id.

[97] Id. at page 2.

[98] Miguel Helft, *Apple Unveils Cloud' Music and Storage Service*, The New York Times, June 6, 2011 at B1.

[99] Id. at page 1.

"Ping Identity provides cloud identity security solutions to more than 600 of the world's largest companies, government organizations and cloud businesses."[100] Ping also assists 40 of the Fortune 100 companies in securing "hundreds of millions of employees, customers, consumers and partners using secure, open, standards like SAML, OpenID and OAuth."

Security and loss of control has been the theme of cloud computing whether we are interviewing a computer consultant, IT professionals, reading an ABA memo or newspaper articles. Can we ethically leap into the cloud? As lawyers can we protect our clients secrets in the cloud? The risk benefit analysis of utilizing a cloud verses having our own "in house" servers and backups will be one each one of us has to make on our own.

[100] *Ping Identity Fuels Growth with $21M in Financing*, Enhanced Online News, June 21, 2011.

Cloud Computing in the Legal Profession

Catherine C. Scheid, Esq.

Board Certified in Tax Law - Texas Board of Legal Specialization
Board Certified in Estate Planning & Probate - Texas Board of Legal Specialization
LLM in Tax Law- University of Houston

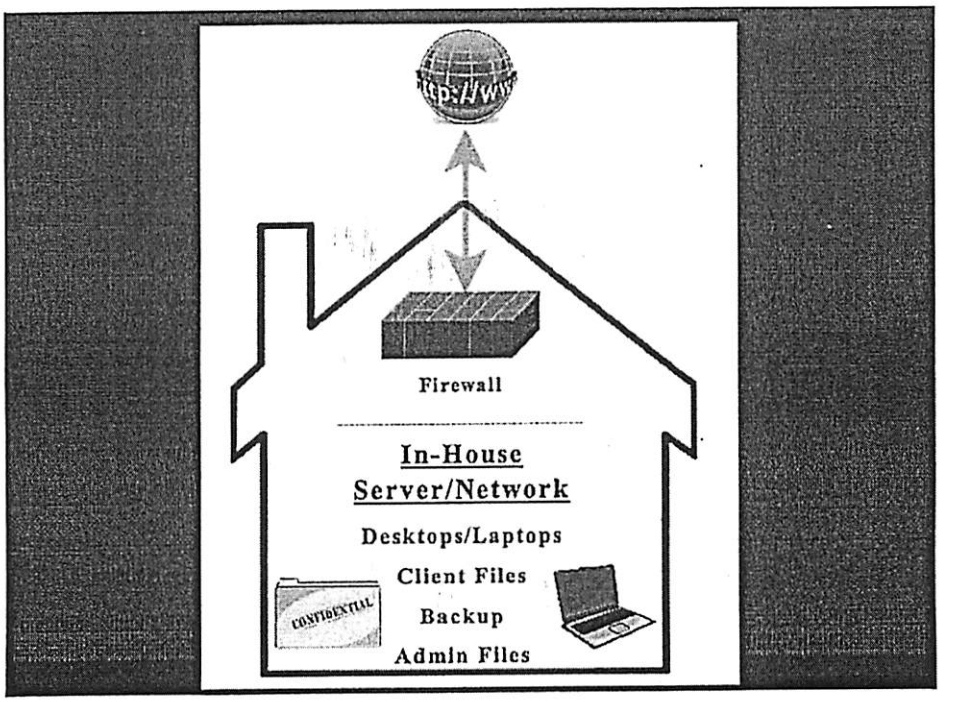
Law Offices of Catherine C. Scheid
4301 Yoakum Blvd.
Houston, Texas 77006
(713) 840-1840 | (713) 840-1820 fax
ccs@scheidlaw.com

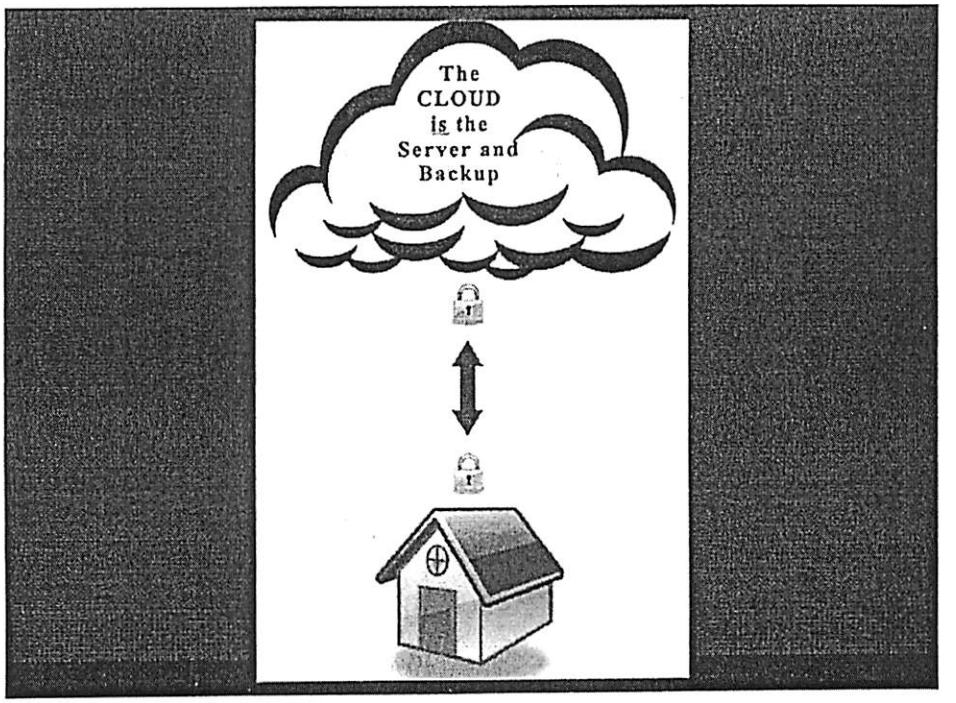
Texas Disciplinary Rules of Professional Conduct Rule 1.05 Comment 1

- Both the fiduciary relationship existing between lawyer and client and the proper functioning of the legal system require the preservation by the lawyer of confidential information of one who has employed or sought to employ the lawyer. Free discussion should prevail between lawyer and client in order for the lawyer to be fully informed and for the client to obtain the full benefit of the legal system. The ethical obligation of the lawyer to protect the confidential information of the client not only facilitates the proper representation of the client but also encourages potential clients to seek early legal assistance.

What is Cloud Computing?

- Cloud Computing is delegating the custody, care, maintenance and back up duties of our client files and any other files we so choose to some one else
- The Cloud is the server, back up, the archive and protection of all of our privileged client information
- Using Cloud Computing allows for a free flow of information between our desktop or laptop computers and the Cloud, which is where the information is stored





Concerns

- Where is the data?
- Who has access to the data?
- What are our contractual rights to the data?

Purchase Agreement

- Set up fee
- Number of users
- Number of free support incidents
- The number of desktop PCs with the package
- An anytime PC replacement
- Mission Critical Outage Response Time (Server/Network Unavailable)
- Regular Response Time
- Regular Incident Resolution Time
- Incident Cost
- After Hours Incident Cost
- Access To Managed Client ONLY Support Direction Extension
- Secure Data Access
- Antivirus/Antispyware management
- Emergency Onsite Response
- Remote Data Backup
- Host Corporate Website
- Design Corporate Website
- Update Website
- Software that will be used
- Exchange Email
- Application Training

Statement of Work (SOW)

- Outline the timeline to implement the Cloud into your business
- Technical specifications of the hardware that will be used
- The security of the facility where "your" server will be housed
- Whether you will share a server or have you own server
- Provide a certification to you that your area of the server is secure
- What if there is a breach then what is your recourse

Service Level Agreement (SLA)

- Turnaround time in case of an outage
- Expects 99.999% uptime
- Responds to issues Monday through Sunday or Monday through Friday
- SLA will not address the Cloud company's maintenance to their system and for how long
- Make sure to schedule a maintenance schedule that suits you
- Have a written policy that they must notify you regarding an emergency upgrade or security patch and how long it will take to implement

Cloud Company's Disaster Security Plan

- What happens when there is a security problem with:
  - their site
  - their hardware
  - their facility
- Where is the Cloud Company's backup?
- How long will it be until you services are restored in the event of a problem?
- Who will have access to your data during an emergency?
- Make sure you have the authority, ownership and access to your own backup

ABA Commission on Ethics 20/20 Working Group

- ABA Commission considers the following as Cloud Computing:
  - Mozy.com
  - Carbonite.com
  - AOL
  - Yahoo
  - Gmail
  - Software as a Service (SaaS)
- The ABA includes in SaaS all of our law practice management computer programs, such as:
  - conflict checking
  - documentation management
  - storage
  - trust account management
  - timekeeping
  - billing

ABA Confidentiality-Related Concerns

1. Unauthorized access to confidential client information by vendors employees (or sub-contractors) or by hackers via the internet
2. The storage of information on servers in countries with fewer legal protections for electronically stored information
3. A vendor's failure to back up data adequately
4. Ownership of stored data
5. The ability to access the data in the event that the lawyer terminates the relationship or the provider changes businesses or goes out of business
6. The provider's procedures for responding to (or when appropriate, resisting) government requests for access to information
7. Policies for notifying customers of security breaches;
8. Policies for data destruction when a lawyer no longer wants the relevant data available or transferring the data if a client switches law firms
9. Insufficient data encryption
10. Client consent before using cloud computing services to store or transmit the client's confidential information.

ABA Concerns Regarding "Local" Technology (laptops, flash drives, smart phones, etc.)

1. Physical protection for devices, such as computers, smart phones and copiers with scanners, or having methods for deleting data remotely in the event that a device is lost or stolen
2. Encouraging the use of strong passwords
3. Purging data from devices before they are replaced
4. Installing safeguards against malware (e.g. virus protection, spyware protection);
5. Installing adequate firewalls to prevent unauthorized access to locally stored data;
6. Ensuring frequent backups of data;
7. Using the latest security protections;
8. Configuring software and network settings to minimize security risks;
9. Encrypting sensitive information
10. Avoiding wifi hotspots in public places as a means of transmitting confidential information (e.g. sending an email to a client).

Houston.com Study

- 36% of more than 500 respondents reported that they plan to utilize a cloud in 2011
- 80% said they were holding off until the next upgrade

The Business Market Plays Cloud Computing Catch-Up (New York Times article)

- IBM introduces a range of cloud services, such as processing and storage metered pay-for-use formula
- IBM is planning to offer different levels of guaranteed security, support and availability
- In April 2011, Dell announced $1 billion plan to build 10 new data centers and expand cloud services
- U.S. Government has endorsed cloud model in 2011
- U.S. official reports estimated 1/4th of government's total spending ($20 billion) will be for migrating to the cloud

State Bar Texas Annual Meeting
June 24, 2011

Handling an IRS Controversy: Practical Advice and Recent Developments

Emily Parker
Thompson & Knight LLP
One Arts Plaza
1722 Routh Street Ste. 1500
Dallas, Texas 75201
(214) 969-1502

Victoria Sherlock
KPMG LLP
700 Louisiana, Suite 3100
Houston, Texas 77002
(713) 319-2895

Val J. Albright
Gardere Wynne Sewell LLP
3000 Thanksgiving Tower
1601 Elm Street
Dallas, Texas 75201
(214) 999-4825

This outline was prepared by Brent Gardner, Tax Associate at Gardere Wynne Sewell in Dallas.

I. Mayo – How it Affects Tax Litigation

a. History

i. *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944)

1. "This court has long given considerable weight and in some cases decisive weight to Treasury Decisions and to interpretive regulations of the Treasury and other bodies that were not of adversary origin. We consider that the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."

ii. *National Muffler Dealers Association v. United States*, 440 U.S. 472 (1979)

1. The Supreme Court in *National Muffler* set forth multiple factors against which the validity of a regulation should be tested.

2. "A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent reenactments of the statute."

iii. *Chevron USA, Inc. v. National Resources Defense Council*, 467 U.S. 837 (1984)

1. The Supreme Court set forth broad two-part test in *Chevron*:

a. Step One: If the intent of Congress is clear . . . the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.

b. Step Two: If the statute is silent or ambiguous . . . the question for the court is whether the agency's answer is

based on a permissible construction of the statute – i.e., the regulation is upheld unless it is "arbitrary" or "capricious" or manifestly contrary to the statute.

iv. Post-*Chevron* Supreme Court Decisions

1. *United States v. Mead Corp.*, 533 U.S. 218 (2001)

a. *Chevron* deference to regulations is appropriate when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law and that the agency interpretation claiming deference was promulgated in the exercise of that authority.

b. Where 46 Customs agents issued 10,000 rulings per year, the rulings were not intended to have the force of law.

c. Issuance of a regulation only after notice-and-comment procedures is a significant sign that a regulation merits *Chevron* deference.

2. *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 345 F.3d 1120 (2003), rev'd 545 U.S. 967 (2005)

a. Agency inconsistency with prior judicial decisions is not a basis for declining to analyze the agency's interpretation under the *Chevron* framework, so long as the earlier interpretation was not based on the statute's plain language.

b. *Mayo Foundation for Medical Education and Research v. United States*, 131 S.Ct. 704 (2011)

i. The issue before the Supreme Court was whether the medical residents working in the Mayo Clinic were "students," who would be exempt from FICA taxes under Section 3121(b), or employees, who would be subject to FICA taxes.

ii. In response to a growing number of claims for refund of FICA taxes withheld and paid from the wages of medical residents, the Treasury Department provided additional clarity to the definition of "student" by issuing regulation § 31.3121(b)(10)-2(d)(3)(iii), which provided that "the services of a full-time employee" – which includes an employee normally scheduled to work 40 hours or more per week – "are not incident to and for the purpose of pursuing a course of study." The practical effect of the regulation was to deny "student" classification to medical residents, leaving them subject to FICA taxes.

iii. Mayo Foundation argued that under the *National Muffler* factors the Treasury regulation was not a valid interpretation of the unambiguous text of Section 3121(b).

iv. The Supreme Court disagreed with Mayo Foundation and held that Treasury regulations, which are not less authoritative than regulations issued by other agencies, are entitled to *Chevron* deference.

v. *Chevron* deference was especially appropriate because the regulation at issue was issued pursuant to an explicit authorization to prescribe needful rules and regulations, and only after notice-and-comment procedures.

vi. That the regulation was issued pursuant to the Treasury Department's general authority under Section 7805(a) "to prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code, did not change the result.

c. Recent application

Since the *Mayo* decision, various courts in five cases have decided the validity of the same Treasury regulation. The results have been mixed; some courts determined that *Mayo* does not apply and overruled the regulation, while others have applied *Mayo* and upheld the regulation.

At issue in the following cases was the validity of Treas. Reg. § 301.6501(e)-1, which applies the extended six-year statute of limitations under Section6501(e)(1)(A) to situations where a taxpayer has overstated basis (e.g., a common feature of a Son-of-BOSS tax shelter). Section 6501(e)(1)(A), applies where a taxpayer "omits from gross income" items included therein that constitute more than 25% of the gross income stated on a taxpayer's return.

Although the IRS has been successful in challenging Son-of-Boss tax shelters, in some instances, the IRS did not discover the tax shelter until after the normal three-year limitations period had expired. As a result, the IRS has argued that the extended limitations period of Section 6501(e)(1)(A) should apply to such transactions. See *Bakersfield Energy Partners, LP*, 568 F3d 767 (9th Cir. 2009), and *Salman Ranch Ltd.*, 573 F3d 1362 (Fed. Cir. 2009).

In *Bakersfield* and *Salman Ranch*, the Ninth and Federal Circuits respectively held that misstatements of basis did not trigger the six-year limitations period of Section 6501(e)(1)(A). In so holding, the courts relied on the holding in *Colony, Inc.*, 357 U.S. 28 (1958), where the Supreme Court determined that the use of the word "omits" in Section 275(c), a predecessor provision of Section 6501(e)(1)(A), did not extend to overstatements of basis. In dicta, the Supreme Court stated that

Section 6501(e)(1)(A), which was not effective as to the years before the Court, was unambiguous.

In response to the taxpayer victories in *Bakersfield* and *Salman Ranch*, the Treasury Department promulgated Treas. Reg. § 301.6501(e)-1, which provides that:

> In the case of amounts received or accrued that relate to the disposition of property, and except as provided in paragraph (a)(1)(ii) of this section, gross income means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property. Consequently, except as provided in paragraph (a)(1)(ii) of this section, **an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of section 6501(e)(1)(A)(i).**
>
> (Emphasis added)

i. *Home Concrete & Supply, LLC v. United States*, 107 AFTR 2d 2011-767 (4th Cir. 02/07/2011)

In *Home Concrete*, the Fourth Circuit first held that the effective dates of Treas. Reg. § 301.6501(e) did not include the tax years at issue. In spite of its conclusion that the regulations were inapplicable, the court went on to analyze the validity of the regulations under *Mayo*. *Chevron* deference, the court noted, is only applicable where a Treasury regulation interprets an "ambiguous" statute. However, "[b]ecause the regulation here interprets 'omits from gross income' under § 6501(e)(1)(A), and the Supreme Court declared that statute unambiguous [in *Colony*], we do not believe that the regulation is entitled to controlling deference." Thus, Treas. Reg. § 301.6501(e)-1 conflicted with the unambiguous language of the statute and failed the step one analysis under *Chevron*.

ii. *Burks v. United States*, 107 AFTR 2d 2011-824 (5th Cir. 02/09/2011)

As in *Home Concrete*, the Fifth Circuit in *Burks* evaluated the validity of Treas. Reg. § 301.6501(e)-1, and concluded that the regulation was not entitled to *Chevron* deference because § 6501(e)(1)(A) is unambiguous pursuant to *Colony*. The Fifth Circuit viewed the regulations as an attempt by the government "to 'trump' what is established precedent on what constitutes an 'omission from gross income' for purposes of § 6501(e)(1)(A)."

Furthermore, in a footnote the court suggested that even if § 6501(e)(1)(A) were ambiguous, "it is unclear whether the [r]egulations would be entitled to *Chevron* deference under *Mayo*. . . ." Significantly, "in *Mayo* the Supreme Court was not faced with a situation where, during the pendency of the suit, the treasury promulgated determinative, retroactive regulations following prior adverse judicial decisions on the identical legal issue." The Fifth Circuit viewed giving "[d]eference to what appears to be nothing more than an agency's convenient litigating position" as "entirely inappropriate" (internal citations omitted). The court went on to note that the government "may not take advantage of his power to promulgate retroactive regulations during the course of a litigation for the purpose of providing himself with a defense based on the presumption of validity accorded to such regulations" (internal citations omitted).

Moreover, "*Mayo* emphasized that the regulations at issue had been promulgated following notice and comment procedures." Treas. Reg. §301.6501(e)-1 were issued without notice and comment. Although notice and comment was allowed after the regulations were final, this procedure "is not an acceptable substitute for pre-promulgation notice and comment."

iii. *Grapevine Imports, Ltd. v. United States*, 107 AFTR 2d 2011-1288 (Fed. Cir. 03/11/2011)

In contrast to *Home Country* and *Burks*, the Federal Circuit in *Grapevine* concluded that Treas. Reg. § 301.6501(e)-1 was entitled to *Chevron* deference. Although the Federal Circuit previously decided in *Salman Ranch* that the six-year statute of limitations was not applicable based on an overstatement of basis, the court now concluded that the new regulations were an "intervening authority" that must be considered.

The court then concluded that, pursuant to *Salman Ranch* and *Colony* the language of § 6501(e)(1)(A) was ambiguous. The Treasury Department and the IRS, therefore, have the authority to address the ambiguity though regulations and that such regulations are entitled to *Chevron* deference. "That the Treasury Department had not exercised its interpretive authority over the relevant language until after the Court of Federal Claims granted summary judgment does not diminish the Department's authority, nor its right to have its interpretations, when promulgated, respected by the judiciary – so long as they are reasonable."

Although Treas. Reg. § 301.6501(e)-1 was not initially subject to notice and comment procedures, this "procedural shortcoming" was rendered "moot" by the issuance of the final form of the regulations.

iv. *Carpenter Family Investments, LLC v. Commissioner*, 136 T.C. No. 17 (4/25/2011)

The Tax Court, in *Intermountain Ins. Serv. Of Vail, LLC v. Commissioner*, 134 T.C. 211 (2010), the Tax Court held invalid the temporary Treasury regulations that preceded Treas. Reg. § 301.6501(e)-1. In *Carpenter Family*, the Tax Court considered "whether anything in the final regulations or their preamble or *Mayo* warrants revision of [the] *Intermountain* holding." As in *Home Concrete* and *Burks*, the Tax Court concluded that the regulations were not valid.

Relying on the principles set forth in the Supreme Court's decision in *Brand X*, the Tax Court held that an agency could "revisit and reject a past judicial statutory construction but only if the construction arose from "assessing the wisdom of . . . policy choices and resolving the struggle between competing views of the public interest." The Supreme Court' decision in *Colony* "reveals unambiguous [C]ongressional intent rather than a policy choice the Court was making in the absence of agency guidance." *Colony* is therefore a *Chevron* step one holding, "which is contradicted by, and thus renders invalid, the final regulations."

v. *Salman Ranch Ltd. v. Commissioner*, 107 AFTR 2d 2011-xxxx (10th Cir. 5/31/2011)

Salman Ranch, Ltd. is a partnership, the tax benefits realized by the partners of which have been the subject of several cases.

As with the cases above, the Tenth Circuit was asked in *Salman* to determine whether Treas. Reg. § 301.6501(e)-1 is a valid regulation. The court first acknowledged that, pursuant to *Mayo*, that Treasury regulations are given *Chevron* deference.

Applying the first step of *Chevron*, the Tenth Circuit addressed "whether Congress's intent is clear with respect to whether the phrase 'omits from gross income an amount' in § 6501(e)(1)(A) includes overstatements of basis . . . ." Again, the focus turned to the Supreme Court's decision in *Colony*, which the Tenth Circuit viewed as a mere choice by the Supreme Court between "competing interpretations of the statute." Therefore, the Tenth Circuit concluded, *Colony* "does not, and cannot, resolve this question for purposes of *Chevron* step one."

Moving to step two of *Chevron*, the court evaluated whether the Treasury regulation was a permissible construction of the statute. Although the *Colony* decision addresses one possible interpretation of Section 6501(e)(1)(A), the Tenth Circuit did not view *Colony* as holding that the statute was unambiguous. Thus, because the regulation is not "arbitrary,

capricious, or manifestly contrary to the statute," the Tenth Circuit held that the regulation was valid in spite of the Supreme Court's decision in *Colony*.

That Treas. Reg. § 301.6501(e)-1 was issued during the course of litigation and did not undergo notice-and-comment proceedings, did not persuade the court to alter its decision. The court noted that pursuant to *Mayo*, it is "immaterial to [the] analysis that [the] regulation was prompted by litigation." And as in *Grapevine* the court concluded that the issuance of final regulations rendered the notice-and-comment issue moot.

vi. *Intermountain Insurance Service of Vail v. Commissioner*, 107 A.F.T.R. 2d 2011-964 (C.A. D.C. 6/21/2011)

As noted above, the Tax Court in *Intermountain* ruled that temporary Treas. Reg. § 301.6501(e)-1T– predecessor to § 301.6501(e)-1 – was invalid under *Colony*. Therefore, the Tax Court concluded that under *Colony*, overstatements of basis are not "omissions from gross income" that trigger the six-year limitations period under Section 6501(e). The Commissioner appealed the Tax Court's decision to the D.C. Circuit Court of Appeals.

The D.C. Circuit first noted that, pursuant to *Mayo*, "courts assessing Treasury regulations that interpret the tax code . . . must apply the two-step framework of *Chevron*." In applying step one of *Chevron*, the court first considered the impact of *Colony* and concluded that, although dealing with a predecessor to Section 6501(e)(1)(A), *Colony* did not consider the meaning of current Section 6501(e)(1)(A). The Supreme Court's reference in *Colony* to "the unambiguous language of Section 6501(e)(1)(A)" was a reference to the newly included subsection Section 6501(e)(1)(A)(i), which the D.C. Circuit agreed was "unambiguous." The D.C. Circuit then evaluated the text of Section 6501(e)(1)(A) and found that it was not unambiguous.

Prior to turning to *Chevron* step two, the D.C. Circuit addressed Intermountain's argument that the regulations should not be given *Chevron* deference at all because the regulations were "promulgated in a manner that lacked the fairness and deliberation that should underlie a pronouncement meriting *Chevron* deference given that the Commissioner reactively issued the regulations immediately following the rejection of his identical litigating position by two Courts of Appeals and the Tax Court" (internal quotations omitted). Quoting *Mayo*, the court concluded that "it [is] immaterial to our analysis that a regulation was prompted by litigation."

Moving to *Chevron* step two, the D.C. Circuit summarily held that the regulation was a reasonable interpretation of the statute.

The court also dismissed several additional arguments related to alleged defects in the procedure by which the regulations were promulgated.

See also, *UTAM Ltd. v. Commissioner* (C.A. D.C. 06/21/2011) 107 AFTR 2d 2011-967, decided by the D.C. Court of Appeals and issued on the same day as *Intermountain.*

d. What does it all mean?

i. One thing is clear post-*Mayo*: Treasury regulations are entitled to *Chevron* deference. But the *Chevron* steps apparently leave enough wiggle-room that courts will still reach different results when applying the *Chevron* steps.

ii. Open issues:

1. What deference should be given to other guidance (PLRs, Revenue Rulings, FAQs)

a. *Skidmore* deference only – i.e., deference to the extent that persuasive?

b. None of these are subject to notice and comment.

2. Role of legislative history in *Chevron* step one?

a. *Mayo* attempts to focus solely on the plain words, but *Chevron* expressly focuses on whether "the intent of Congress is clear." *See generally*, Irving Salem, *Mayo Dissected: Some Dragons Slain, Some Still Breathing Fire*, Tax Notes, March 14, 2011.

b. See discussion in cases above related to *Colony*, one interpretation is that the plain text was ambiguous, but that the meaning became clear in light of legislative history. See Jeremiah Coder, *Officials Comment on Interpreting Mayo*, 2011 TNT 16-4 (January 25, 2011).

3. Does *Chevron* apply only where regulations are issued in accordance with the procedures of the Administrative Procedures Act ("APA")?

    a. Generally, the APA requires that an agency (1) publish a notice of proposed rulemaking in the Federal Register along with a proposed regulation, (2) permit notice-and-comment by affected parties, and (3) provide an effective date of the final regulations that is at least thirty days after the notice of proposed rulemaking is published.

        i. Notice-and-comment is not generally required for "interpretive" regulations.

            1. However, under the APA, "interpretive" regulations that are issued without notice and comment may not be intended to have the "force of law," which is a requisite for *Chevron* deference. *See*, *Mead.*

    b. Prior studies indicate that Treasury fails to follow the APA in nearly 41 % of regulations issued.[1]

    c. Necessity of notice-and-comment procedures?

        i. *Mead* recognized the importance of these procedures, but some courts (see discussion above) have held that such procedures may not be required where final regulations have been issued.

        ii. Temporary Treasury regulations are not issued after notice and comment.

4. What, if any, difference remains between legislative versus interpretive Treasury regulations?

    a. *Mayo* states that *Chevron* inquiry "does not turn on whether Congress's delegation of authority was general or specific."

    b. Legislative vs. interpretive distinction subsumed by ambiguity analysis? – *Mayo* suggests that this is the proper analysis.

[1] Hickman, Kristin E., *Coloring Outside the Lines: Examining the Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements* 82 Notre Dame L. Rev. 1727, 1760 (June 2007).

c. But most regulations promulgated under general authority of § 7805(a) are "interpretive" regulations the issuance of which might not be subject to or in accordance with the Administrative Procedures Act. For example, interpretive regulations are generally not subject to notice-and-comment procedures, a "significant" sign that a regulation merits *Chevron* deference.

5. The extent of the government's ability to overturn adverse judicial decisions during the pendency of litigation?

   a. For example, through retroactive regulations.

6. Continued application of *National Muffler*?

iii. Government commentary on *Mayo* application

1. The DOJ recently suggested that it will not argue for *Chevron* deference for Revenue Rulings or Revenue Procedures. See Marie Sapirie, *DOJ Won't Argue for Chevron Deference for Revenue Rulings and Procedures, Official Says*, 2011 TNT 90-7 (May 10, 2011).

   a. However, in *Tualatin Valley Builders Supply, Inc. v. United States*, 522 F.3d 937 (9th Cir. 2008), the government argued for *Chevron* deference for a Revenue Procedure and prevailed on that and other grounds. Although an unusual situation, the government may not be entirely willing to concede this issue in the future.

2. The IRS believes that temporary Treasury regulations are entitled to *Chevron* deference, but proposed regulations are not.

3. An IRS official has stated that *Mayo* opens the door for the government to issue regulations to shape pending and ongoing litigation. See Jeremiah Coder, *News Analysis Mayo's Unanswered Questions*, 2011 TNT 43-2 (Mar. 4, 2011).

4. One IRS official interpreted *Mayo* as enabling the government to issue "more guidance faster" because the IRS will not need to spend as much time trying to determine which standard of analysis it should apply. See Amy S. Elliot, *Mayo Decision 'Means More Guidance Faster' From IRS, Official Says*, 2011 TNT 15-7 (Jan. 24, 2011).

II. *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009).

a. Case discussion[2]

In 1999, Veritas US entered a cost sharing agreement (CSA) with a newly formed Ireland affiliate(Veritas Ireland) for the research and development of certain software products (Products). As part of the agreement, Veritas US granted Veritas Ireland the right to use certain pre-existing intangibles. As consideration for the use of the intangibles, Veritas Ireland made a $166 million buy-in payment to Veritas US based on the comparable uncontrolled transaction (CUT) method to calculate the value of the assets. In addition, Veritas US and Veritas Ireland entered a technology licensing agreement for certain intangibles on an ongoing basis, as well as an assignment of existing sales. The average useful life of the Products was estimated to be four years.

Rejecting the taxpayer's CUT valuation for an income valuation approach, the IRS determined the arm's-length buy-in to be $2.5 billion and determined a deficiency on that basis (later reduced to $1.675 billion). The IRS also asserted that the buy-in amount must take into account access to Veritas US's R&D and marketing teams, distribution channels, customer lists, trademarks, trade names, brand names, and sales agreements, as well as streams of income that were projected in post-transaction periods (and ignored actual results in these periods). Essentially, the IRS took an "aggregate" approach to valuing the assets (as opposed to on an asset-by-asset basis) and treated the overall intangibles as being the transferred asset, regardless of the actual terms of transfer. The IRS's theory treated the CSA as "akin to a sale."

The CUT approach employed by the taxpayer, on the other hand, used a "bottom-up" approach of literally valuing each asset that was transferred.

The Tax Court rejected the IRS's valuation and found its assessment to be "arbitrary, capricious, and unreasonable" – the standard for rejecting an assessment under § 482. The IRS had used the wrong useful life for the Products (a perpetual life) and the wrong discount rate for a discounted cash flow methodology, and had not understood which "precisely which items were valued." The IRS also sought to include intangibles developed after the CSA effective date, while the buy-in under the pertinent Treasury regulations was limited to the "pre-existing" intangibles. Finally, the IRS took into account items that were not transferred by Veritas USA but rather were self-developed by Veritas Ireland (such as its own business model and supply chain). In short, the court rejected the IRS's position and found the taxpayer's CUT method to be the better valuation method.

b. IRS response – business as usual?

[2] See discussion in Lowell, *This Week With Cym Lowell*, RIA 05/30/2011.

i. Action on Decision 2010-005 (Nov. 10, 2010)

1. Despite its loss in *Veritas*, the IRS is still on a crusade against the CUT/CUP methods of valuation.

2. The IRS "will continue to apply the aggregate valuation to interrelated transactions related to a CSA where, under the facts and circumstances, such valuation provides the most reliable measure of an arm's length result."

III. Alternative Dispute Resolution Techniques – Are They Working?

a. Rev. Proc. 2009-44 governs post-Appeals mediation

i. Involvement of Exam?

1. See IRM 8.26.5.4.6: Appeals has the discretion to communicate *ex parte* with the Office of Chief Counsel, the originating function (e.g., Compliance), or both in preparation for or during the mediation session. Appeals also has the discretion to have Counsel, the originating function, or both participate in the mediation proceeding to present the position and views of the Service, and to rebut representations and arguments made by the taxpayer.

b. Fast Track options

c. Early referral to Appeals

IV. A Harsh Result? – *Lattice Semiconductor Corp v. Commissioner*, T.C. Memo. 2011-100 (May 9, 2011)

a. The IRS did not abuse its discretion when it denied an accrual method taxpayer's request to change its accounting method so it could deduct certain prepaid expenses. The prepaid contract benefits did not exceed 12 months, but the contract periods continued through two tax years.

b. At the time of the taxpayer's request to change accounting methods, Treasury and IRS had issued pronouncements stating that forthcoming regulations would allow use of the 12-month rule. However, the announcements of proposed rulemaking cautioned taxpayers not to seek an accounting method change until after the regulations were finalized.

c. The taxpayer's request preceded the effective date of the final regulations by over a year. Without receiving consent from the IRS for the change in accounting

method, the taxpayer took the expenses. The IRS rejected the taxpayer's request to change accounting methods and denied the tax benefits.

d. The taxpayer argued that the Seventh and Ninth Circuits had allowed the use of a 12-month rule for similar expenses and that the taxpayer's change of accounting position should have been granted even though the regulations were not final.

e. The Tax Court distinguished the cases cited by the taxpayer and held that the IRS was justified in enforcing the effective date of the final regulations.

V. Taxpayer's Argument Regarding Business Expense "Carries" The Day – *Dagres v. Commissioner*, 136 T.C. No. 12 (Mar. 28, 2011)

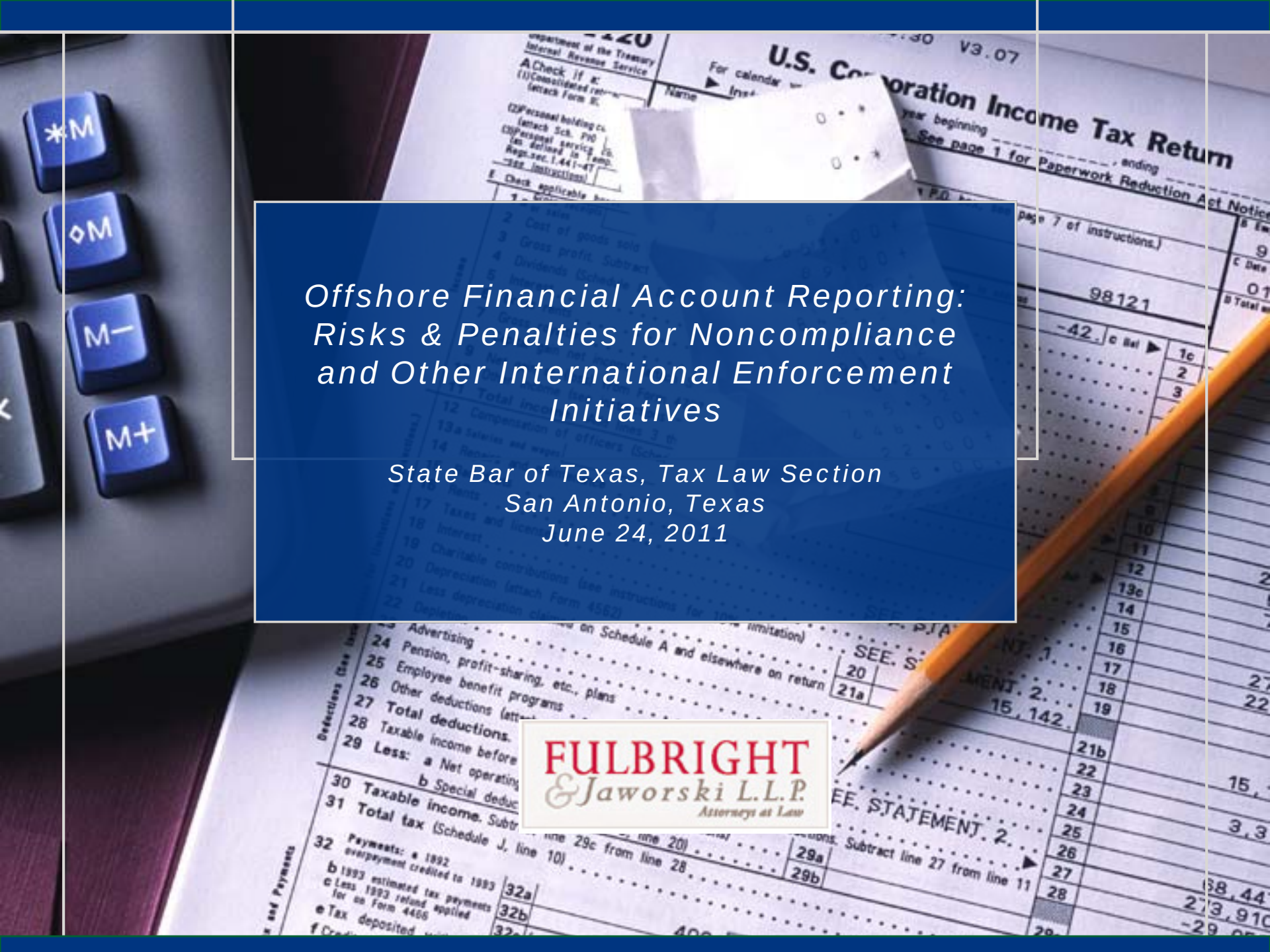
a. Taxpayer's work for a "venture capital" fund was determined to constitute a "trade or business" (as opposed to investment) even though his compensation was predominantly capital gain (i.e., carried interest). Although classified as capital gain, the Tax Court concluded that the income received by the taxpayer from the venture capital funds was compensation for personal services.

b. Additionally, the taxpayer was permitted to deduct bad debt expenses associated with the venture capital business as ordinary (rather than capital) losses.

VI. IRS Ex Parte Communications With Appeals on Remand OK – *Hoyle v. Commissioner*, 136 T.C. No. 22 (May 23, 2011)

a. Communications between the IRS Chief Counsel lawyer and Appeals in a case remanded from the Tax Court to Appeals did not constitute an impermissible *ex parte* communication because the communications were "solely procedural, ministerial, or administrative."

VII. Other



Offshore Financial Account Reporting: Risks & Penalties for Noncompliance and Other International Enforcement Initiatives

State Bar of Texas, Tax Law Section
San Antonio, Texas
June 24, 2011

FULBRIGHT & Jaworski L.L.P.
Attorneys at Law

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or tax-related matter[s].

Notice: We are providing this presentation as a commentary on current legal issues, and it should not be considered legal advice, which depends on the facts of each situation. Receipt of the this presentation does not establish an attorney-client relationship. The listed attorneys and/or other attorneys may provide services in connection with a particular matter.

Bradley Birkenfeld: Victim or Villain?

Birkenfeld's Story

2001 Begins work at UBS in Geneva

2005 Claims discovery of conspiracy files whistleblower claim

2007 Approaches DOJ disclosing

- UBS offices involved
- Key UBS bankers with their US clients and contact information
- Total number of US accounts maintained in Switzerland
- UBS strategy using encrypted laptops

Immunity requested

Birkenfeld's Story (cont'd)

2008 Pleads guilty to conspiracy

2009 Sentenced to 40 months – 10 months larger than DOJ requested

2010 Files Complaint with DOJ office of Professional Responsibility

Begins serving sentence in Schuylkill, Pennsylvania

Petitions President Obama for pardon or clemency

Tax Whistleblower Claims

Whistleblower Concerns

- Law Firms are targeting employees of corporations to come forward with whistleblower claims
- The Ferraro Law Firm publishes the "Ferraro 500" – a reorganization of the Fortune 500 by the size of the companies' tax reserves
- The Fortune 500 ranks corporations based on their gross revenue
- Workpapers and work product generated in assessing Schedule UTP disclosure requirements create an additional incentive for whistleblowers to reveal potentially devastating information to the IRS

Whistleblower Concerns (cont'd)

Company	Ferraro 500 Rank	Fortune 500 Rank	Revenue (in millions)	Profits (in millions)	Tax Reserve (in millions)
General Electric	1	4	156,779	11,025	8,719
Pfizer	2	40	50,009	8,365	7,657
AT&T	3	7	123,018	12,535	7,523
J.P. Morgan Chase & Co.	4	9	115,728	11,728	6,608
General Motors	5	15	104,589	n/a	5,410
Microsoft	6	36	58,437	14,569	5,403
Bank of America	7	5	150,450	6,276	5,253
Wells Fargo	8	19	98,636	12,275	4,921
AIG	9	16	103,189	-10,949	4,844
IBM	10	20	95,758	13,425	4,790

Whistleblower Concerns (cont'd)

Q&A From The Ferraro Law Firm's Website:

- Will my employer fire me?
  - "We have a number of ways in which we can help maintain the confidentiality of your identity"
  - "In many states, firing an employee who provided information pursuant to a federal statute would be an unlawful discharge in violation of public policy that would subject the employer to a lawsuit by the discharged employee. It would be like winning two lotteries, one for the tax whistleblower case, and one for the unlawful discharge."

Whistleblower Concerns (cont'd)

Can Foreigners Get Rewards?

- "Foreigners working in the headquarters of a foreign multinational are ideally placed to identify underpayments by U.S. subsidiaries or branches. In addition, foreigners working in foreign subsidiaries or branches of a U.S. multinational are also in a great place to discover information about how the subsidiary or related entity is being used to underpay U.S. taxes"

Are All Tips the Same?

- "…maybe you have an email that says, 'We need to come up with a business purpose for this transaction.' This is a good start and a tax lawyer can help you develop the information about the transaction that will assist the IRS in understanding why this information is relevant to a potential underpayment of taxes"

Whistleblower Concerns (cont'd)

Moreover, with respect to Final Schedule UTP, the Ferraro Law Firm states:

- "The current disclosure requirements do not require corporations to report all of the relevant information about the uncertain tax position, such as the amount of the reserve, the taxpayer's rationale in taking the position, the nature of the uncertainty, or the taxpayer's risk calculation. This leaves ample opportunity for persons with information about a corporation's uncertain position to come forward and provide the IRS with additional information about the uncertain tax position, including hazards of the tax position and analysis of the support against the tax position"

IRS Pays First Award to Whistleblower

- On April 7, 2011, the IRS paid a CPA $4.5 million for disclosing a Fortune 500 company's failure to pay $20 million in taxes

- The CPA was working in the company's accounting department when he discovered the information that he ultimately disclosed to the IRS

Internal Revenue Code § 7623

- Relevant Provisions
  - Applies to disclosure of tax, penalties, interest, and other additions in dispute exceeding $2,000,000
  - Substantially contributes to administrative or judicial actions resulting in collections
  - Award between 15% and 30% of collections in typical situations
  - Whistleblower can file in Tax Court if dissatisfied with the award

Increased Incentives for Whistleblowers

- Proposed Treas. Reg. § 301.7623-1(a) expands the circumstances in which a whistleblower can recover an award

- In addition to receiving awards for information that results in the IRS collecting additional taxes, Whistleblowers can now receive awards for revealing information that results in the denial of a claim for refund and/or a reduction of an overpayment credit balance used to satisfy a tax liability

Schedule "B"

SCHEDULE B (Form 1040A or 1040)
Department of the Treasury Internal Revenue Service (99)
Name(s) shown on return

Interest and Ordinary Dividends
► Attach to Form 1040A or 1040. ► See instructions on back.

OMB No. 1545-0074
2009
Attachment Sequence No. 08
Your social security number

Part I Interest
(See instructions on back and the instructions for Form 1040A, or Form 1040, line 8a.)

		Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions on back and list this interest first. Also, show that buyer's social security number and address ►	
1		

Part III Foreign Accounts and Trusts
(See instructions on back.)

You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

		Yes	No
7a	At any time during 2009, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See instructions on back for exceptions and filing requirements for Form TD F 90-22.1		
b	If "Yes," enter the name of the foreign country ► _____		
8	During 2009, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 17146N **Schedule B (Form 1040A or 1040) 2009**

received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

6 Add the amounts on line 5. Enter the total here and on Form 1040A, or Form 1040, line 9a . . . . . ► 6

Note. If line 6 is over $1,500, you must complete Part III.

Part III Foreign Accounts and Trusts (See instructions on back.)

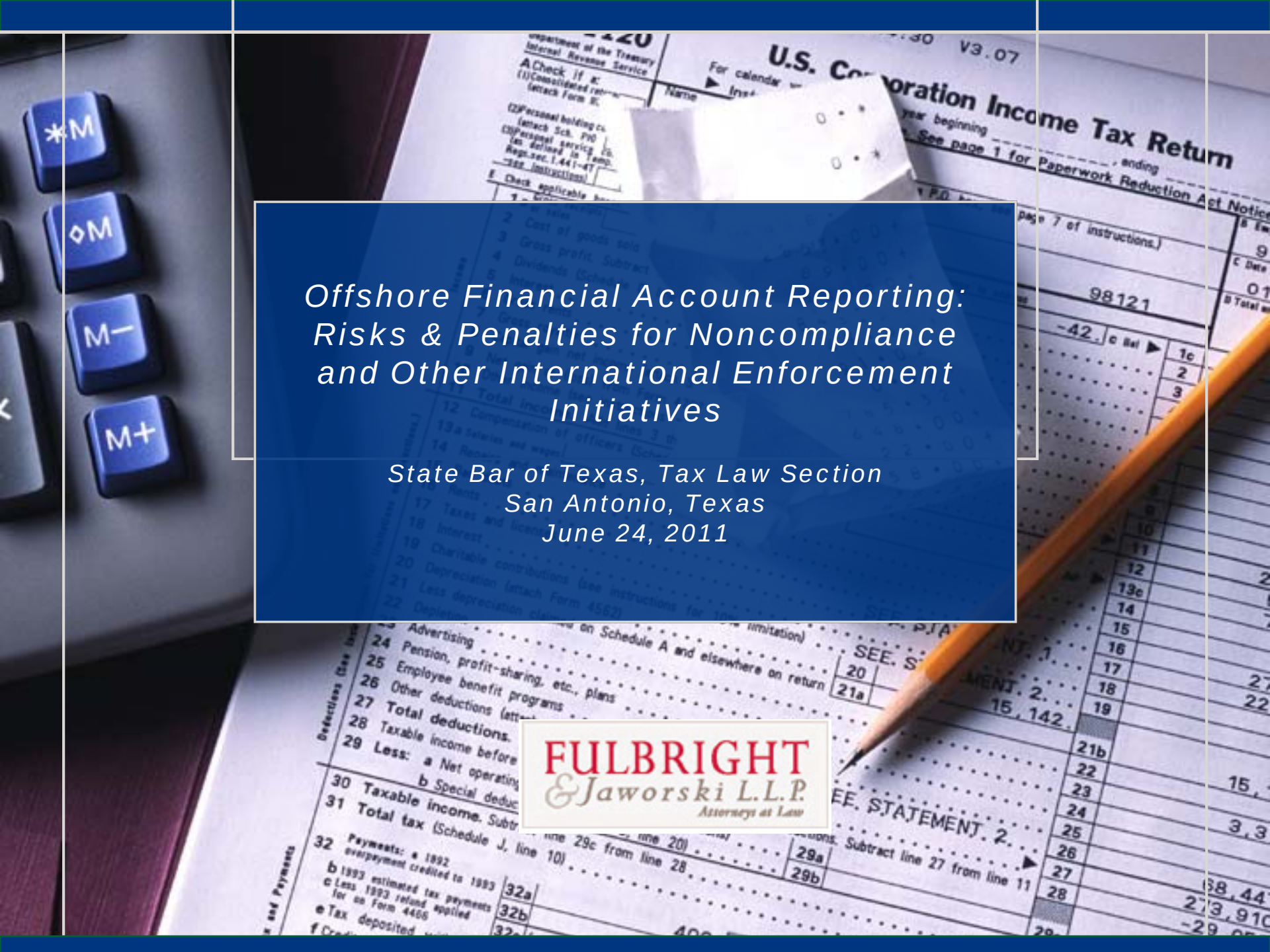
You must complete this part if you (a) had over $1,500 of taxable interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust. Yes No

7a At any time during 2009, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See instructions on back for exceptions and filing requirements for Form TD F 90-22.1 . . . . . .

b If "Yes," enter the name of the foreign country ► _____

8 During 2009, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back . . . . . .

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 17146N Schedule B (Form 1040A or 1040) 2009



Offshore Financial Account Reporting: Risks & Penalties for Noncompliance and Other International Enforcement Initiatives

State Bar of Texas, Tax Law Section
San Antonio, Texas
June 24, 2011

FULBRIGHT & Jaworski L.L.P.
Attorneys at Law

The 2010-2011 Texas Legislature
Texas State Tax Legislative Review and Case Law Update

Christi Mondrik, CPA, Esq.
Board Certified – Tax Law
Texas Board of Legal Specialization

Mondrik & Associates
515 Congress Avenue, Suite 1850
Austin, Texas 78701
(512) 542-9300
(512) 542-9301 (Fax)
cmondrik@mondriklaw.com
www.mondriklaw.com

Austin Bar Association
Business, Corporate and Tax Section
September 15, 2011
Austin

Table of Contents

BACK TO TABLE OF CONTENTS

I. Disclaimer

The information and views presented in this paper are those prepared by and of the authors. This paper provides information on general tax issues and is not intended to provide advice on any specific legal matter or factual situation. It highlights certain changes made during the 82nd Regular Session and Special Called Session of the Texas Legislature and is not designed to be a comprehensive analysis of all pertinent changes. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship or an accountant-client relationship. Readers should not act upon this information without seeking professional counsel.[1]

II. Introduction – 82nd Texas Legislature

This paper addresses select Texas state tax updates from the 82nd Texas legislature and recent court cases.

The 82nd Session of the Texas Legislature convened on Jan. 11, 2011 for what they hoped would be 140 days of productive legislative activity ending on May 30th. You can argue about whether or not the session was productive, but it was not over by May 30. May 30th came with the legislature failing to pass a budget for the next biennium. That's the only bill the legislators must pass and they didn't. So on May 31st they started the first special session of the 82nd Texas Legislature.

During the special session, the primary tax bill was the budget bill, Senate Bill 1, which was signed by the governor on July 19, 2011. That bill contained several state tax provisions, both substantive and procedural, that may have significant impact on taxpayers and tax professionals.

III. Texas Franchise Tax

A. SB 1, Article 37 – Extension of $1 million (indexed) exemption

In 2008 and 2009, the Texas franchise tax exemption, under which a taxpayer could file a no tax due report, was $300,000 of total gross revenues. For 2010 and 2011, the exemption was raised to $1 million of total gross revenues. The 2011 legislature has extended this limit to apply to the 2012 and 2013 reports as well.[2] The amount is indexed biennially for inflation. A taxpayer filing a short period return must evaluate its revenue pro-rata for the portion of the year its report covers.

In 2008 and 2009, small business credits applied to businesses with revenues between $300,000 and $900,000. Under the revised legislation, these small business credits restart, to the extent they apply, in January 2004, when the exemption decreases to $600,000.

[1] In accordance with IRS Circular 230, this communication does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues discussed herein, and with respect to such tax issues, this communication was not written, and cannot be used by you, for the purpose of avoiding Federal tax penalties that could be asserted against you.

[2] The exemption limit had been scheduled to go down to $600,000 in 2012 and subsequent periods.

B. SB 1, Article 31 – Qualified Live Event Promotion Companies (effective 1/1/2012)

This revision to the franchise (margin) tax allows for qualified live event promotion companies to exclude from total revenue payments made to artists in connection with the provision of a live entertainment event or live event promotion services.[3] The exclusion does not apply to movie theaters, weddings, or carnivals. The live event promotion company must meet various requirements including:

- Receiving at least 50% of its total revenue from live event promotion services;
- Maintaining a permanent nonresidential office from which the live event promotion services are provided or arranged; and
- Employing 10 or more full-time employees; etc.

C. SB 1, Article 31 – Qualified Courier and Logistics Companies (effective 1/1/2012)

This revision allows for qualified courier and logistics companies to exclude from total revenue payments made to nonemployee agents for the performance of delivery services on behalf of the taxable entity.[4] The companies must meet various requirements, including:

- Receiving at least 80% of its total revenue from two or more of a list of courier and logistics services enumerated in the statute;
- Being registered as a motor carrier;
- Maintaining various types of minimum insurance;
- Maintaining a permanent nonresidential office;
- Employing at least 5 full-time employees; etc.

Livery services,[5] floral delivery services, motor coach services, taxicab services, building supply delivery services, water supply services, fuel or energy supply services, restaurant supply services, commercial moving and storage companies and overnight delivery services are specifically excluded from this treatment.

Also, in order to qualify for this treatment, the courier and logistics companies must not be delivering items the taxable entity or its affiliates sold.

D. SB 1, Article 51.01 – Apparel Rental Companies (effective 1/1/2012)

This revision allows for apparel rental companies, such as tuxedo rental businesses, to qualify as retailers or wholesales in order to obtain a reduced 0.5% tax rate. In order to qualify for the reduced rate the apparel rental companies' activities must be classified as Industry 5999 or 7299 of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget.[6]

---

[3] SB 1, Section 31, 82nd Legislature, First Special Session (sent to the governor 6/29/2011).

[4] SB 1, Section 31, 82nd Legislature, First Special Session (sent to the governor 6/29/2011).

[5] A livery service is a business that offers vehicles, such as automobiles or boats, for hire. (see, e.g., http://www.thefreedictionary.com/livery, definition 5).

[6] The statute defines retail and wholesale trade by referring to the federal Office of

In addition, the apparel rental company must meet the other requirements for the reduced retail/wholesale rate:

- A taxable entity's total revenues from retail and wholesale activities must exceed the total revenues from its other activities.[7] Generally, if the business activity has an SIC code numbered in the 5000's (Division F or Division G), it's a wholesaling or retailing activity. This bill expands that definition to include Industry 7299.

- Less than half of the taxable entity's revenue from activities in retail or wholesale trade must come from the sale of products produced by the taxable entity or by an entity that is part of the same affiliated group.[8] This means a retailer or wholesaler must sell more goods produced by others than it does of its own goods or those produced by its affiliates. The manufacturer exclusion doesn't apply to restaurants and bars (specifically, activities classified in Major Group 58 of the SIC Manual "Eating and Drinking Places").[9]

- The taxable entity cannot sell retail or wholesale utilities and qualify for the half-percent rate. This includes telecommunications, electricity, and gas.[10]

E. SB 1, Article 31.01 – Franchise Tax Job Creation Credit Extension (effective 9/1/2011; expires 9/1/2017)

This revision extends franchise tax credits for certain job creation activities to December 31, 2016. The prior extension had been through December 31, 2012. A corporation with unused credits may claim them on or with the tax report for the period in which the credit was established.

If the corporation was allowed to carry forward unused credits, the corporation may continue to apply those credits on or with each consecutive report until the earlier of the date the credit would have expired under the terms of Tax Code Chapter 171, Subchapter P, Tax Code, had it continued in existence, or December 31, 2016, and the former law under which the corporation established the credits is continued in effect for purposes of determining the amount of the credits the corporation may claim and the manner in which the corporation may claim the credits.

Management and Budget's Standard Industrial Classification Manual. If the business activity has an SIC code numbered in the 5000's (Division F or Division G), it's a wholesaling or retailing activity. The U.S. Department of Labor offers a Standard Industrial Classification (SIC) search online at http://www.osha.gov/pls/imis/sicsearch.html .

[7] Texas Tax Code § 171.002(c)(1).

[8] Texas Tax Code § 171.002(c)(2).

[9] Texas Tax Code § 171.002(c-1). The Comptroller amended Rule 3.584 in 2010 to state that the Comptroller won't consider a product to be "produced" if modifications made to the acquired product do not increase the sales price of the product by more than 10%. This determination of whether a product is "produced" is relevant for determining if the retail tax rate applies. The reduced rate of 0.5% applies only if a taxable entity derives its predominate revenues from retail or wholesale trade of goods not manufactured by the entity or its affiliates.

[10] Texas Tax Code § 171.002(c)(3).

F. SB 1, Article 45 – Exemption for Unincorporated Political Committees

The 2011 legislation adds a franchise tax exemption for unincorporated political committees. The exemption applies to "an unincorporated entity organized as a political committee under the Election Code or the provisions of the Federal Election Campaign Act of 1971 (2 U.S.C. Section 431 et seq.)."

G. *TGS-NOPEC Geophysical Co. v. Combs*[11]

The Texas Supreme Court recently held that a taxpayer's receipts from licensing seismic data were receipts from a sale of an intangible asset and therefore should be apportioned based upon the location of the payor. The franchise tax is apportioned based upon the ratio of Texas gross receipts to total gross receipts.[12]

Receipts from services are apportioned to the location where the service is performed. If services are performed both inside and outside Texas, they are apportioned to on the basis of the fair value of the services performed in Texas.[13]

Receipts from sales or leases of tangible personal property delivered to Texas purchasers are Texas receipts.[14] Revenues from the lease or sublease (or rental or subrental) of real property are apportioned to the location of the property.[15]

The apportionment of intangibles depends on the type of intangible. Net gains or losses on sales of intangibles held as capital assets or investments are apportioned to the location of the payor. Examples include: stocks, bonds, commodities, futures contracts, patents, copyrights, licenses, trademarks, franchises, goodwill and general receivable rights.[16]

TGS required its customers to enter into nonexclusive master license agreements describing TGS's seismic data as proprietary. For many years, the Comptroller had characterized the licenses as intangibles and apportioned the revenues based upon the location of the payor's domicile. In 2004, the Comptroller audited TGS and recharacterized the revenue as apportionable to Texas as receipts from licenses used here. The Court determined the Comptroller's characterization conflicted with her rule, which allocates receipts from software licenses based upon the location of the payor. Since the license was used to transfer the underlying intangible, the Court determined TGS had appropriately apportioned the gross receipts based upon the location of payor and was entitled to recover its payment of tax, penalties and interest.

H. *Taylor & Hill, Inc. v. Combs*[17]

[11] ___ S.W.3d ___, 2011 WL 2112763 (Tex.) 54 Tex. Sup. Ct. J. 1023.

[12] The revised franchise tax based on the margin calculation also apportions the tax base to Texas based on gross receipts. This is similar to the prior version of the franchise tax with one very important distinction: there is no throwback provision! Many taxpayers continue to erroneously apportion all gross receipts to Texas when they may not be required to do so.

[13] Tax Policy News, September 2010.

[14] Tax Policy News, June 2010.

[15] Tax Policy News, September 2010.

[16] Tax Policy News, June 2010.

[17] Travis County District Court Cause No., D-1-GN-10-004429.

This case considered whether a business classified as a staff leasing could take the cost of goods sold deduction, or in the alternative whether a Tax Code §171.101(d) election to do so precluded post-audit use of the compensation deduction to calculate margin. The District Court determined that since it was a staff leasing company it was required to take the compensation deduction. Therefore, the compensation deduction was allowed.

In its examination of the original 2009 franchise tax report, the Comptroller asserted that Taylor & Hill, a registered professional engineering firm, was not eligible to compute margin by deducting cost of goods sold. The auditor denied the cost of goods sold deduction and assessed tax by applying the 70 percent of total revenue calculation. Taylor & Hill paid the assessment under protest and filed suit to recover the additional tax paid for the 2009 report year.

Taylor & Hill asserted that it is a professional and engineering staffing firm serving the oil and gas industry and that it temporarily assigns its employees to its clients to supplement its clients' workforce in special situations. Taylor & Hill receives payments from its clients in exchange for the labor provided by its employees. These payments include reimbursement for wages, payroll taxes on those wages, employee benefits and worker's compensation benefits for the employees that it assigns to the client companies.

The judge ruled that Taylor& Hill is a temporary employment service and is therefore entitled to take the revenue exclusion for staff leasing companies and to use compensation (as required by Tax Code Section 171.101(b)) to compute its taxable margin on its 2009 Franchise Tax Report.

I. Administrative Hearings

Most of the hearings decisions have involved the timeliness of an election to deduct compensation or cost of goods sold, or the classification of a business as wholesale or retail in order to qualify for the reduced tax rate.

Hearing No. 104,076 (untimely election) The taxpayer filed an amended franchise tax report claiming a refund based upon the argument that it was filed to correct a mistake and contending that the report form is flawed, because it does not allow taxpayers to affirmatively make a required taxable margin election. The Comptroller conceded the cost of goods sold amount reflected in the original report was mistakenly understated, but rejected the amended report because it was filed after the report due date and changed the taxable margin calculation from 70% of total revenue to the cost of goods sold method. The ALJ affirmed the denial of the refund based on the taxpayer's failure to demonstrate tax was paid erroneously.

Hearing No. 103,450 (untimely election) The taxpayer filed an amended Texas Franchise Tax Report for 2008, in which it recalculated its taxable margin using the Cost of Goods Sold deduction rather than the E-Z Computation rate method, which it had used to file its original 2008 franchise tax report. The ALJ upheld the Comptroller's denial of the claim based on 34 Tex. Admin. Code Section 3.584, which the Comptroller contends precludes a taxable entity from changing its election to use the COGS deduction after the due date of the report.

Hearing No. 103,083 (untimely election) The taxpayer filed an amended Texas Franchise Tax Report for 2008, in which it recalculated its taxable margin using the Cost of Goods Sold (COGS) Deduction rather than the 70 percent of revenue limitation used to file its original 2008 franchise tax report. The ALJ denied the refund claim on the same basis as in Hearing No. 103,450.

Hearing No. 103,807 (untimely election) The taxpayer filed a refund claim for franchise tax it contends was paid erroneously. The ALJ confirmed the Comptroller's denial of the refund

because the taxpayer failed to demonstrate it paid the tax erroneously. Specifically, the taxpayer sought to make a late election by filing an amended Texas Franchise Tax Report for report year 2009 in which it recalculated its taxable margin using the compensation deduction rather than the 70% of revenue limitation it used to calculate tax in its original 2009 report.

Hearing No. 104,059 (untimely election) The taxpayer filed an amended Texas Franchise Tax Report for 2009, in which it recalculated its taxable margin using the compensation deduction rather than the E-Z Computation rate method, which it had used to file its original 2009 franchise tax report. The ALJ denied the refund claim on the same basis as in Hearing No. 103,450.

Hearing No. 103,340 (tax rate) A business that markets cosmetics and skin care products and treatments filed its 2008 franchise tax report using a tax rate of 0.5 percent. The Comptroller denied the use of the reduced rate because more than 50% of the items the business sold were manufactured by its affiliate. The ALJ upheld the assessment, but recommended penalty waiver.

Hearing No. 103,786 (tax rate) The administrative law judge determined the taxpayer was primarily in the business of automobile servicing and repair and didn't qualify for the reduced 0.5% rate. The taxpayer owned and operated thirteen (13) business locations catering primarily to retail customers. The locations provided a variety of automotive services, such as brakes, alignment, suspension, batteries, mufflers, and tires, as well as the sale of automotive parts and supplies to retail customers. The taxpayer also purchased and resold parts and supplies to retail customers, some of which it installed on customers' vehicles, and some of which it sold "over the counter" to its retail customers, who took the uninstalled items with them. The taxpayer's Combined Operations Income Statements showed that revenue from the sales of parts accounted for 51.4% of Petitioner's total revenue.

The ALJ determined the SIC system didn't support the taxpayer's contention that its sales of parts may be excluded from revenue derived from sale and installation services. Establishments primarily engaged in both selling and installing automotive parts are considered to be engaged in services (see comments at SIC Code 5531). Establishments primarily engaged in the sale and installation of automobile exhaust systems are classified as engaged in services, and the sale of mufflers, tail pipes, and catalytic converts is considered to be incidental to the installation of those products (see SIC Code 5533). Similarly, establishments primarily engaged in the sale and installation of automotive transmissions are classified as engaged in services, and the sale of transmissions and related parts is considered incidental to the installation (see SIC Code 7537). The ALJ determined the taxpayer could not exclude the value of parts and supplies from the revenue received from its service activity, and therefore did not receive most of its total revenue from activities in retail trade.

Hearing No. 103,824 (tax rate) The administrative law judge determined the taxpayer's business of selling Internet domain names didn't qualify for the reduced 0.5% rate. The taxpayer classified its business as SIC Code 5045, which is within Division F. That code applies to establishments primarily engaged in the wholesale distribution of computers, computer peripheral equipment, and computer software. The Comptroller's examiner concluded the business was best described by SIC Code 8999, which describes businesses that sell services not otherwise classified, and that its taxable margin should have been calculated using the 1.0 percent rate. However, according to the decision, the taxpayer didn't provide sufficient evidence to refute the examiner's position.

Hearing No. 104,092 (tax rate) In filing its 2008 franchise tax report, the taxpayer determined it was subject to the franchise tax rate of one-half percent of taxable margin that applies to taxable entities primarily engaged in retail or wholesale trade. The Comptroller determined that Petitioner was subject to a one percent rate and assessed tax and interest accordingly. The Administrative Law Judge agreed.

The taxpayer provided environmental control systems for commercial and industrial buildings. Its "open protocol" control systems allowed building components such as chillers, boilers, air handling units, lighting, and security systems to function in a coordinated manner, even though they may be manufactured by different firms. The taxpayer obtained the proprietary right to sell the control systems within the Texas and Louisiana markets. Its customers were general contractors, industrial users, building owners, municipalities, universities and similar institutions. The taxpayer sold the control systems and also performed the design and installation services necessary to integrate the control systems into the building.

The ALJ determined the taxpayer would be primarily engaged in wholesale trade only if its revenue from distribution of specialized equipment that it did not install exceeded its revenue from equipment that it did install. Since the taxpayer had not alleged or proved it acted only as a distributor with regard to any of the specialized equipment, the ALJ denied the reduced rate.

Hearing No. 103,263 (penalty waiver but no adjustment based on fairness argument) The taxpayer filed a no tax due report and contended that the State's franchise tax liability calculation produced a grossly distorted result, which was incompatible with the constitutional ban on taxation of interstate commerce. The Comptroller and ALJ agreed to waive penalties but otherwise rejected the contention. The decision states that the taxpayer didn't produce evidence to support the constitutional claim.

J. Passive Entities

Effective for reports originally due on or after Jan. 1, 2011, a passive entity that is registered (or required to be registered) with either the Secretary of State or the Comptroller's office must file Form 05-163 to affirm the entity qualifies as passive for the period upon which the tax is based. For purposes of administrative convenience, the Comptroller's Rule 3.582 originally stated that only passive entities that have notified the Comptroller or Secretary of State that they are doing business in Texas must file an information report the first year that the entities qualify as passive. Now they are required to file subsequent annual reports stating whether the entities continue to qualify as passive. Under the revised rules, a passive entity that has not notified the Comptroller or the Secretary of State that it is doing business in Texas is still not required to register with or file a franchise tax report with the Comptroller's office.

However, any passive entity that no longer qualifies as passive must file a franchise tax report for the period in which the entity does not qualify as passive, and any subsequent periods, until the entity once again files as a passive entity. In addition, an entity that receives notification from the Comptroller asking if the entity is taxable must reply to the Comptroller within 30 days of the notice and provide proof of its status.

K. New Entities

Historically, each entity subject to franchise tax was required to file an initial franchise report, and thereafter an annual franchise tax report. The initial report period and deadline were different from the annual reporting and deadlines, which caused a great deal of confusion for new taxpayers. The Comptroller exercised her authority under Texas Tax Code § 111.051 to simplify the process. The Comptroller amended Rule 3.584 to incorporate these changes.

The Comptroller has revised her policy to allow for annual reporting beginning with the first franchise tax report an entity is required to file. The first franchise tax report filed by a taxable entity that becomes subject to the tax on or after October 4, 2009 will be an annual report. The first annual report will be due May 15 of the year after the calendar year the entity became subject to the tax. [18]

Under the new procedures, a new taxable entity's first report will be an annual report due May 15 in the year following the calendar year the entity became subject to the tax. The first annual report will be based on the accounting period beginning on the date the entity became subject to the franchise tax and ending on the last accounting period ending date used for federal income tax reporting purposes in the calendar year before the year the report is originally due.

[18] Tax Policy News October 2009. *See also* changes to Comptroller Rule 3.584.

IV. Texas Sales and Use Tax

A. SB 934 - Additional Criminal Investigation Provisions (effective 09/01/2011)

This provision has raised the attention of taxpayers and tax practitioners throughout the state. It expands the Comptroller's ability to investigate and prosecute tax fraud.

The statute broadly includes in the fraud provisions:

- Failing to pay a tax or file a report when due as a result of fraud or intent to evade tax;
- Altering, destroying, or concealing any record, document, or thing, or presenting to the Comptroller any altered or fraudulent record, document, or thing;
- Otherwise engaging in fraudulent conduct for the apparent purpose of affecting the course or outcome of an audit, investigation, redetermination, or other proceeding before the Comptroller;
- Failing to file a motor fuel tax report or pay motor fuel tax as a result of fraud or intent to evade tax.

It also increases criminal penalties for sales tax nonpayment and concealing resale certificate information.

In addition, it adds money laundering and organized criminal activity to tax fraud crimes. The statute gives the Comptroller the authority to employ criminal investigators under new Tax Code Section 111.0045.

The statute also tolls the statute of limitations for assessment during the pendency of a criminal proceeding. It also specifies what records must be maintained during this time, including sales receipts, invoices, or other equivalent records showing all sales and use tax, and any money represented to be sales and use tax, received or collected on each sale, rental, lease, or service transaction during each reporting period.

B. SB 1, Article 4 - Tax Record Keeping Requirements. (effective 10/1/2011)

Before amendment, Section 111.0041 required taxpayers to keep records for four years, in most cases. While there have always been exceptions for substantial understatements, fraud and statute waivers, the amendment extends also the time that taxpayers must maintain records to substantiate and verify a claim regarding the taxes, penalties, and interest to at least four years, and longer when:

- any tax, penalty, or interest may be assessed, collected, or refunded by the Comptroller; or
- an administrative hearing is pending before the comptroller, or a judicial proceeding is pending, to determine the amount of the tax, penalty, or interest that is to be assessed, collected, or refunded

As a practical matter, it is generally prudent for taxpayers to retain records during a pending administrative or legal proceeding until the matter is fully resolved.

The amendment also provides that a taxpayer must produce contemporaneous records and supporting documentation appropriate to the tax or fee for the transactions in question to substantiate and enable verification of the taxpayer's claim related to the amount of tax, penalty, or interest to be assessed, collected, or refunded in an administrative or judicial proceeding.

Contemporaneous records and supporting documentation appropriate to the tax or fee may include, for example, invoices, vouchers, checks, shipping records, contracts, or other equivalent records, such as electronically stored images of such documents, reflecting legal relationships and taxes collected or paid. The legislative history indicates that summary records would be insufficient to substantiate a claim without supporting contemporaneous records.

C. SB 1, Article 13 – Expedited Sales Tax Payment.

In August 2013, taxpayers will be required to prepay their regular August 2013 sales and use tax payments (based on July collections). The Comptroller will allow a credit for 25% of the prepayment for taxes on the September 2013 return. This is a budget-balancing provision, which the legislators project will add $231 million to the state's 2012-2013 budget.

D. SB1, Article 12 – Revised Resale Definition. (effective 10/1/2011)

This provision amends the definition of a "sale for resale" to apply special provisions for certain federal (defense and security) contracts. Specifically, under the revised definition a "sale for resale" won't include the sale of tangible personal property or a taxable service to a purchaser who acquires the property or service for the purpose of performing a service that is not subject to sales tax. This provision is designed to reverse by statute recent court

rulings in which taxpayers prevailed on the resale issue.[19]

E. SB1, Article 30 – Expanded Retailer Definition. (effective 1/1/2012)

This provision amends Section 151.008 to clarify that the definition of a "retailer engaged in business" includes:

- a retailer that holds a substantial ownership interest in, or is owned in whole or in substantial part by, a person who maintains a business location in Texas, provided certain conditions are met; and

- a retailer that holds a substantial ownership interest in, or is owned in whole or in substantial part by, a person who maintains a distribution center, warehouse or similar location in Texas and who delivers property sold by the retailer to consumers.

This provision does not seek to require sales tax collection by all online retailers, only those with substantial ownership interests. This bill is specifically designed to address large retailers, such as Amazon.com, which has a distribution facility in North Texas. Amazon is currently challenging an assessment of around $269 million in sales and use tax.[20]

F. HB 268 – Registration Requirements for Agricultural Exemption (6/17/2011).

This provision will require a special registration number for purchasing certain timber and agricultural items exempt from sales and use tax. Texas Tax Code Sec. 151.316 (the "agricultural exemption") exempts from sales and use tax a purchase of machinery or equipment exclusively used or employed on a farm or ranch in the production of food for human consumption, feed for animal life, or other agricultural products to be sold in the regular course of business.[21] The exemption applies to equipment used on a "farm or ranch," which the law defines to include "one or more tracts of land used, in whole or in part, in the production of crops, livestock, or other agricultural products held for sale in the regular course of business."[22]

A taxpayer claiming a timber or agricultural exemption after the effective date must apply for an obtain a registration number in order to qualify for the exemption for certain agricultural products and timber operations.

---

[19] *c.f.* Recent court rulings in *Roark Amusement & Vending LP v. Combs*, No. 03-10-00105-CV (Tex. App. - Austin 01-26-2011) and *7-Eleven, Inc. v. Combs*, 311 S.W.3d 676 (Tex. App. - Austin 2010, pet. denied) (original opinion dated August 31, 2009 withdrawn), which held that the resale exemption applied regardless of the taxability of the ultimate transaction.

[20] News reports indicate that Amazon tried to make a deal with the legislature for a safe-harbor provision by promising to add 6,000 jobs and $300M capital investment, but its negotiations apparently did not provide the legislature sufficient incentive to prevent this provision. Governor Perry vetoed a bill with a similar provision during the regular legislative session on the grounds that such a bill risked significant unintended consequences.

[21] Texas Tax Code Sec. 151.316(a)(7).

[22] Texas Tax Code Sec. 151.316(c)(1).

The legislation provides for the Comptroller to establish an application process to obtain the registration number and a uniform renewal date.

G. HB 268 – Agricultural Exemption for Dairy Farmers (effective 9/1/2011).

This provision exempts tangible personal property incorporated into or attached to a structure located on a commercial dairy farm, which is used or employed exclusively for the production of milk and is either a free-stall dairy barn or a dairy structure used solely for maternity purposes.

H. SB 776 – Additional Requirements for Customs Brokers (Export Exemption) (effective 9/1/2011).

This provision requires prior authorization for customs brokers or authorized employees to use alternative methods of documenting exempt export sales. It also increases other restrictions on customs broker stamps and increase prices for selling export stamps to customs brokers.

I. SB 1732 – Exemptions for post exchanges (effective 6/17/2011).

This provision exempts items sold, leased or rented to, or stored, used or consumed by a post exchange. Post exchanges are established on state military property to sell, lease or rent goods and services, including tobacco products, prepared foods and beer and wine. They are similar to those operated by the U.S. armed forces.

J. SB 1927 – Tax Free Sales for Certain Exempt Organizations (effective 6/17/2011).

This exemption allows volunteer firefighters and emergency service organizations to hold ten tax-free sales or auctions during a calendar year, subject to certain restrictions.

K. *7-Eleven, Inc. v. Combs*, 311 S.W.3d 676 (Tex. App. - Austin 2010, pet. denied) (original opinion dated August 31, 2009 withdrawn).

The recent case of *7-Eleven, Inc. v Combs*, Docket No. 03-08-00212-CV (Tex. App – Austin, August 31, 2009) involved a Texas convenience store operator owned retail stores (company stores) and franchised other locations. In a recent hearing on cross-motions for summary judgment, the Court determined that the company was entitled to a resale exemption for financial software purchased and then transferred to the out-of-state franchise locations. The Court was unable to determine, based upon the evidence presented, whether the company owed tax on software delivered to company stores located outside Texas.

Transfer of the software was integral to performing taxable data processing services transferred to the franchisees. The software provided the method and means by which franchisees recorded financial information and transmitted it to the company's host computer.

The Comptroller argued that the service benefit location was primarily in Texas. However, the statute doesn't require that the transferor not obtain any benefit from the software; rather, the purchaser's intent to transfer the property as an integral part of a taxable service controls whether the exemption applies. The Court ruled that the exemption does not require that the reseller actually collect tax on the taxable item.

L. *Roark Amusement & Vending LP v. Combs*, No. 03-10-00105-CV (Tex. App. - Austin 01-26-2011).

The recent case of *Roark Amusement & Vending LP v. Combs*,[23] applied the resale exemption to toys purchased for placement into amusement crane machines.

Roark Amusement & Vending, L.P. ("Roark") owned and leased coin-operated amusement crane machines. It paid Texas sales tax on its lease payments for the machines and an annual occupation tax for each machine it owned in Texas. Amusement services are generally taxable under Texas Tax Code § 151.0110; however, Tex. Tax Code §151.335 specifically exempts coin-operated amusement services on which an occupation tax is paid.

Roark sought a refund of the sales tax it paid on the plush toys used to stock the machines, arguing that the toys are subject to the resale exemption because they are transferred as an integral part of Roark's taxable amusement services. The Comptroller argued that the resale exemption didn't apply because Roark did not collect and remit sales and use tax from its customers.

The Court held that the application of the resale exemption does not turn on whether the taxpayer can show that the subject items are actually resold and taxed in Texas.[24] Further, Court held that Tex. Tax Code § 151.301 does not transform the character of an item from taxable to nontaxable; rather, it remains a taxable item, but is one that is subject to an exemption. Accordingly, the Court held that the amusement Roark's services were "taxable services" for purposes of the resale exemption and therefore Roark was entitled to the exemption on plush toys it purchased for transfer as an integral part of its amusement services. The transfer occurred as Roark transferred care, custody and control of the items, either permanently or temporarily, by allowing the customer to operate the crane arm. If the customer successfully operated the crane arm, it would move the toy to the tray transferring permanent care, custody and control to the customer. Ultimately, the items purchased for resale transferred to customers. Therefore, they were purchased for resale.

M. *Combs v. Health Care Services Corp*., No. 03-09-00617-CV (Tex.App. - Austin 03-16-2011).

In *Combs v. Health Care Services Corp*.,[25] the Third Court of Appeals applied the resale exemption to tangible personal property Blue Cross / Blue Shield (predecessor to Health Care Services Corp.) transferred to the federal government under Federal Acquisition Regulation (FAR) clauses.[26]

The taxpayer administered three different health insurance programs: Medicare Part A, Medicare Part B, and the Federal Employees Health Benefit program. Each contract required

[23] Cause No. 03-10-00105-CV (Tex. App. - Austin 01-26-2011, pet. filed April 11, 2011).

[24] citing *7-Eleven, Inc. v. Combs*, 311 S.W.3d 676 (Tex. App. - Austin 2010, pet. denied) (original opinion dated August 31, 2009 withdrawn).

[25] Cause No. 03-09-00617-CV (Tex.App. - Austin 03-16-2011).

[26] *C.f.* Senate Bill 1, 82nd Leg., 1st C.S., which modified the definition of "sale for resale."

Blue Cross to perform a variety of administrative functions. In return, the federal government reimbursed Blue Cross for certain costs it incurred as direct costs. Blue Cross sought a refund for sales tax for taxable items it purchased in connection with its performance of the three contracts.

The Comptroller appealed, arguing that Blue Cross was not entitled to the resale exemption with respect to any of its purchases because it "resold" only nontaxable administrative services to the federal government. The Comptroller further argued that, even if title to some taxable items passed to the federal government under the FARs, such items were only incidental to Blue Cross's sale of nontaxable services because the contracts did not require the purchase of taxable items. The Court held Blue Cross was entitled to a refund of sales taxes paid while performing services under a federal government contract under the resale exemption.

N. *Delta Air Lines v. Combs,* 318 S.W.3d 523 (Tex. App. – Austin 2010).

The Third Court of Appeals in *Delta Air Lines v. Combs,*[27] held the taxpayer was not entitled to a resale exemption for janitorial and repair services purchased to maintain airport property leased from the government. Although the government owned the airport where the services were delivered, Delta was the party responsible under the lease for keeping the leased premises clean and orderly. Therefore, Delta owed tax as the consumer of the services, and the services themselves did not transfer to the government.

[27] 318 S.W.3d 523 (Tex. App. – Austin 2010).

V. Texas State Tax Nexus

A. HB 1841 – Internet Hosting (effective June 17, 2011).

This provision clarifies a person whose only connection with this state is using "internet hosting" services is not doing business in Texas. "Internet hosting" involves providing unrelated users Internet access to computer services using property the provider owns, leases and manages. The user may store or process the user's data or use software that the provider owns, licenses or leases. It does not include telecommunications services.

B. SB 1, Article 30 – Distribution Centers (effective 1/1/2012)

Modifies Texas Tax Code § 151.107 to clarify that an out-of-state entity establishes nexus when it "maintains, occupies, or uses in this state permanently, temporarily, directly or indirectly or through a subsidiary or agent by whatever name, an office, distribution center, sales or sample room or place, warehouse, storage place or any other physical location where business is conducted."[28]

The legislative revisions include an entity that holds a substantial ownership interest in, or is owned in whole or substantial part by, a person who maintains a business location in Texas if:

- The retailer sells the same or substantially similar line of products under a business name that is the same

[28] SB 1, Section 30.02, 82nd Legislature, First Special Session (sent to the governor 6/29/2011).

as or substantially similar to the entity with nexus; or

- The facilities or employees of the entity with a location in Texas are used to (1) advertise, promote or facilitate sales by the out-of-state retailer; or (2) perform any other activity of the retailer intended to establish or maintain a marketplace in Texas, such as receiving or exchanging returned merchandise.

They also include as "doing business in Texas" an entity that holds a substantial ownership interest in, or is owned in whole or substantial part by, a person who:

- Maintains a distribution center, warehouse or similar location in Texas; and

- Delivers property sold by the retailer to consumers.

The legislative changes define "ownership" to include: direct ownership, common ownership, and indirect ownership through a parent entity, subsidiary or affiliate. Ownership is treated as "substantial" if there is at least 50% ownership of the total combined voting power of all classes of stock for a corporation or the beneficial ownership of stock of the corporation. For trusts, the measure is at least 50% direct or indirect beneficial interest in the trust corpus or income. For LLCs, it is measured by at least 50% direct or indirect membership interest or beneficial interest. For other entities, such as partnerships or associations, the measure is at least 50% direct or indirect interest in the capital or profits of the entity.

C. *Gallend Henning Nopak, Inc. v. Combs*, 317 S.W.3d 841, (Tex. App. – Amarillo, July 14, 2010).

The Amarillo Court of Appeals considered whether a Wisconsin corporation was responsible for paying Texas franchise tax due to the contacts of its one Texas-based employee.

The corporation had been filing employee wage reports for its Texas employee, which initiated the audit. The employee was a regional manager, which serviced distributors' needs in seven and a half (7½) states, including Texas. The corporation contended the presence of a single employee was insufficient to establish nexus within the taxing state.

However, the Court determined that the employee's physical presence here went beyond a *de minimis* presence and was sufficient to establish nexus for Texas franchise tax purposes. The Court acknowledged that the employee's "primary job was investigating, handling, or otherwise assisting in resolving customer complaints,"[29] and determined that "[a]n activity regularly conducted within Texas pursuant to a company policy or on a continual basis shall normally not be considered trivial."[30]

VI. Property Tax

A. HB 1090 – Interest Rates on Refunds (effective 9/1/2010).

This provision amends Section 42.43 to reduce the interest paid on refunds from 8% to the prime rate (currently 3.25%) plus 2%, up to 8%.

[29] *Id*. at 845.
[30] *Id*.

B. HB 1887 – Property Tax Protests and Appeals.

This provision provides administrative changes for Appraisal Review Board (ARB) hearings. Under the revised statute, no ARB training course may be held by the chief appraiser or appraisal district employee, a CAD board member, or an ARB member. In addition, no chief appraiser, appraisal district employee, CAD board member, taxing unit officer or employee, or attorney for appraisal district or taxing unit with an ARB member may communicate about a training course.

No communication by a CAD board member or property tax consultant or attorney representing a party with an ARB member may be made if it is intended to influence the ARB member's decision in his or her capacity as an ARB member (except during a hearing on a protest, other proceeding before the ARB, or a social conversation). The bill also prohibits legal counsel for an ARB whose firm represented a property owner, taxing unit, or the appraisal district in the previous year. Moreover, no advocacy by ARB counsel is allowed at a hearing or proceeding. The counsel must disclose all relevant legal authority and material facts.

The statute also revised payment requirements for Motion for Corrections and Protests. A taxpayer filing a motion under Section 25.25 or 41.411 must comply with the "payment under protest" provisions contained in new Section 25.26 and 41.4115, which are similar to the Section 42.08 payment requirements (to pay the amount of taxes due on the portion of the taxable value of the property that is the subject of the motion that is not in dispute before the delinquency date or the property owner forfeits the right to proceed to a final determination of the motion). The legislation clarifies that the pendency of a motion filed under Section 25.25 does not affect the delinquency date for the taxes on the property that is the subject of the motion.

New attorney notification provisions require attorneys who accept an engagement or compensation from a third party to represent a person in an appeal must provide notice to the person represented that:

- the attorney has been retained by a third party to represent the person;
- explains the attorney's ethical obligations to the person in relation to the third party, including the obligation to ensure that the third party does not interfere with the attorney's independent judgment or the attorney-client relationship;
- describes the general activities the third party may perform in the appeal;
- explains that compensation will be received by the attorney from the third party; and
- informs the person that the person's consent is required before the attorney may accept compensation from the third party. (New Section 42.30)

Christina A. Mondrik, CPA, Esq.
Board Certified – Tax Law
Texas Board of Legal Specialization

Mondrik & Associates
515 Congress Avenue, Suite 1850
Austin, Texas 78701
(512) 542-9300
(512) 542-9301 (Fax)
cmondrik@mondriklaw.com
www.mondriklaw.com

Christi Mondrik, attorney, focuses her practice on state and federal tax controversies and litigation. She is board certified in Tax Law by the Texas Board of Legal Specialization. Ms. Mondrik has handled IRS cases involving substantial corporate, individual and estate taxes. Her state tax experience includes disputes arising under Texas franchise tax, sales and use tax, fuel taxes, severance taxes, motor vehicle sales tax, and other state taxes. Ms. Mondrik is also a CPA.

Ms. Mondrik represents the firm's state tax clients in administrative and legal proceedings before the Comptroller's office, the State Office of Administrative Hearings and the Texas state courts. She also represents federal tax clients at the administrative appeals level and in proceedings before the United States Tax Court and the United States District Courts. She is licensed to practice in the United States Tax Court, the United States District Court, Western District of Texas, and all of the Texas state courts

Ms. Mondrik has served on the State Bar of Texas Tax Section's governing council and has served as chair and vice-chair of its Tax Controversy, CLE and Solo and Small Firms Committee Committees. Ms. Mondrik is currently a member of the State Bar Tax Section's governing council for the 2010-2012 term.

Ms. Mondrik was the 2009-10 President of the Austin Chapter of CPAs. She has also served as manager of education and leadership and chair and vice-chair of its Oversight Council. Ms. Mondrik also serves on Texas Society of Certified Public Accountants (TSCPA) Board, the State Bar of Texas and TSCPA State Taxation Committees, and the TSCPA Committee on Relations with the IRS. Ms. Mondrik was the 2009-10 chair of the State Tax Conference Committee. She remains the 2009-2011 chair of the TSCPA state taxation committee. As chair of the state and local tax committee of the TSCPA, she was a principal drafter of comments submitted by the TSCPA in response to legislation implementing the Texas margin tax and to administrative rules promulgated under the margin tax. The TSCPA awarded Ms. Mondrik the Young CPA of the Year Award for 2009-2010. The award is bestowed on a CPA who is a member of TSCPA and a local chapter, 39 years or under, and has made significant contributions to the accounting profession and the community and is a member of at least one other professional organization.

Ms. Mondrik earned her B.B.A. in Accounting and her J.D., with honors, both from the University of Texas at Austin. She is a frequent author and lecturer on state taxation and federal tax controversies. She has been licensed as an attorney by the State of Texas since 2001.