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CHAIR'S MESSAGE

To: Fellow Tax Section Members
I have a lot of good news to report:

1. New Website and Free 24/7 Audio Video Library

First, as you may already know, we recently launched our **NEW** State Bar of Texas Tax Section website, along with a **FREE**, 24/7, audio video, CLE library for Tax Section members. The new website is not password-protected for anything except the free, 24/7, audio video, CLE library. The 24/7 Online CLE Instructions provide step-by-step help for using the library.

The free, 24/7, audio video, CLE library for Tax Section members is the first of its kind. No other section of the State Bar of Texas offers such a benefit. No other tax section in the nation offers this benefit.

The library currently contains 30 audio and video programs that State Bar of Texas Tax Section members can access at any time, including the State Bar of Texas Tax Section's highly acclaimed **11th International Tax Symposium**. We are positioned to add at least 30 new audio or video programs per year to the library.

Visit 24/7 Audio Video CLE to review the list of programs currently available. These programs are top quality CLE programs, presented by some of the best tax lawyers in the country. Most of the programs are basic and practical skills courses. Some of the programs are audio only, and some are video. You can listen to or watch them on a computer, or you can download them as a podcast and listen to them on an IPod.

We plan to add new programs to the library regularly, and you will be able to get all of your required CLE from this member benefit. Tax Section members who are accountants will also be able to obtain CPE credit for these programs.

Each year, our twelve State Bar of Texas Tax Section substantive committees will contribute at least one audio or video program to the free, 24/7, audio video, CLE library. We will also add the State Bar of Texas Tax Section's **Property Tax Law seminar,** which was held last month in Austin.

2. New Alliances with Local Bar Associations and CPAs

In addition, we have entered into alliances with the Dallas Bar Tax Section and the Houston Bar Tax Section to audio record most of their new programs and make them available free to our members. We will also have a place on the website that will store the outlines and articles from these outstanding programs.

WE THANK THE DALLAS BAR TAX SECTION AND THE HOUSTON BAR TAX SECTION FOR THEIR COOPERATION AND SUPPORT AND FOR ALLOWING US TO MAKE THEIR EXCELLENT PROGRAMS AVAILABLE TO THE ENTIRE STATE BAR OF TEXAS TAX SECTION MEMBERSHIP.

The benefits of the alliance with the Dallas Bar Tax Section and the Houston Bar Tax Section are readily apparent. The State Bar of Texas Tax Section has approximately 1950 members. Texas tax lawyers not in Dallas and Houston will now be able to access high quality CLE that was previously unavailable to them. The speakers will now speak to a much wider audience and will gain greater recognition. Dallas and Houston tax lawyers who can't make the live meetings in their cities can listen to the recordings on our website. At this point in time, many of the outlines and articles are unavailable after they are presented locally.

In addition, we plan to record the seminar that our State and Local Tax Committee presented to the Dallas Chapter of the Texas CPA Society in May and make the programs available to our members in the free, 24/7, audio video, CLE library.

For those of you who are technologically challenged, I can assure you that the library is easy to use. Try it. Invest five minutes to see how it works. We have tested it with some of the most technologically-challenged people we could find (i.e., State Bar of Texas Tax Section Officers and Council members – especially me). If you have mastered the process of sending and receiving an email, you can do this.

At the same time, let me also stress that we are trying to bring our members unprecedented new benefits on a very limited budget. We are new at this. There will inevitably be glitches! Please bear with us.

Texas Lawyers who are not members of the Tax Section are encouraged to join – simply download a Membership Application from our website and follow the instructions.

3. Tax Section Wins State Bar of Texas Pro Bono Award

I am very proud to report that the Tax Section won the 2009 State Bar of Texas Pro Bono Award for our new Tax Court Pro Bono Program. This award recognizes the outstanding efforts of our Pro Bono Committee and, in particular, our Pro Bono Committee Chair, Elizabeth Copeland. As Chair of our Pro Bono Committee, Elizabeth established the Nation's first state-wide Tax Court Pro Bono Program in Texas. The program encourages lawyers to offer pro bono consultation services to unrepresented or pro se taxpayers at calendar calls. Working with the U.S. Tax Court, lawyer volunteers mediate disputes between the IRS and Tax Court petitioners and provide advice to those taxpayers on presenting evidence at trial. Congratulations to Elizabeth and all of our Tax Section pro bono volunteers for a well deserved honor. More information on the Tax Court Pro Bono Program can be found on the Tax Section Website.

4. Stanley Blend Wins the 2009 Outstanding Texas Tax Lawyer Award

The Tax Section Council voted to award the 2009 Outstanding Texas Tax Lawyer Award to Stanley Blend. This is the highest award that our Section gives, and it has been awarded only five times in the past. This award recognizes Stanley for his outstanding reputation, expertise, and professionalism in the practice of tax law; his leadership in the State Bar of Texas and American Bar Association; his significant contributions to the general welfare of the community; his reputation for ethics; and his mentorship of other tax professionals. The award will presented at the Texas Federal Tax Institute in San Antonio which will be held June 11th and 12th.

5. Streamlining Costs

Like other organizations, the Tax Section must control costs and get the most out of every dollar we spend. I am pleased to report that with the savings realized by the transitioning of the newsletter to electronic format and the reduction of staff administrative costs, we are well positioned to cover the cost of maintaining the new website and of expanding the free, 24/7, audio video, CLE library as well as to cover the cost of travel and other expenses for the Tax Court Pro Bono Program and our other programs, initiatives, and meetings well into the future.

6. Texas Federal Tax Institute

Web-based CLE is an excellent tool, but there is no substitute for live, high quality CLE and the opportunity to network and to exchange ideas with your colleagues. The Texas Federal Institute is one of our best and most prestigious CLE programs. This year we are celebrating our 25th Anniversary. It will be held on June 11th and 12th at the Hyatt Hill country Resort in San Antonio. Click here for program details and to register for the Texas Federal Tax Institute, click here.

7. Annual Meeting

Finally, I encourage you to attend the Annual Meeting of the State Bar of Texas at the Hilton Anatole in Dallas on June 25th and 26th. Click here for detailed information on the Annual meeting, click here.

The Tax Section will present two programs on Friday morning, June 26th. The first is entitled: "Texas Tax Lawyers Go to Washington: Reliving the Experience." This is a continuation of our "Talks with Legends" series that we started at the Annual Meeting two years ago. This year the panel will consist of Bob Davis, who headed the Criminal Division of the Department of Justice during the first term of President Reagan; David Glickman, who was Deputy Assistant Secretary of the Treasury during President Reagan's first term; and Bill Bowers, who just returned from service as Senior Counsel, Department of the Treasury. Bill Elliott will moderate the panel. The program will start at 7:30 a.m. and end at 9:00 a.m. Breakfast will be served.

The second program will be a CLE presentation on "Organizing a Professional Services Firm in 60 Minutes Flat," by Barbara Spudis De Marigny, Dan Baucum, and Bill Elliott. This program should be of interest to Tax Section members as well as other members of the bar. The program will start at 10:45 a.m. and end at 11:45 a.m.

The annual business meeting of the Tax Section will take place at 1:45 p.m.

We have intentionally left the 9:00 am to 10:30 a.m. time slot open so that our members will be able to attend the State Bar Presentation on legal writing by Bryan Garner and, hopefully, Justice Antonin Scalia. Mr.Garner and Justice Scalia recently coauthored, ***Making Your Case: The Art of Persuading Judges.*** Justice Scalia has agreed to attend if the Supreme Court schedule so permits.

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We have also not scheduled our own separate Tax Section lunch program so that our members can attend the general State Bar of Texas Annual Meeting luncheon and keynote address by Doris Kearns Goodwin on “Lessons from Lincoln.”

I hope to see you there. Please let me know if you have any questions, comments or suggestions or if you would like to become more involved in our section.

Regards,

Dan Micciche, Chair
Section of Taxation
State Bar of Texas

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2009 Outstanding Texas Tax Lawyer Award

Stanley L. Blend

Stanley L. Blend's career as a tax lawyer spans 40 years and is built on the principles of unwavering quality and service to the Tax Bar.

Upon graduation from the University of Houston Law Center in 1967, Stanley served as a Staff Attorney in the Tax Court Litigation Division of the Office of Chief Counsel for the Internal Revenue Service until 1971. While working for the Chief Counsel's Office, Stanley attended Georgetown University Law Center and earned his L.L.M. in 1971.

In 1972, Stanley joined the firm that is now Oppenheimer, Blend, Harrison and Tate, Inc. (ìOppenheimer + Blendî) where he established a tax practice focused on providing the highest quality legal services to his clients. At Oppenheimer + Blend, Stanley has served as Chief Executive Officer, Chairman of the Board, and Practice Group Leader of the Property Exchange and Tax Groups.

In addition to his law practice, Stanley takes great pride in his involvement with the Taxation sections of both the State Bar of Texas and the American Bar Association and believes service to the Tax Bar is a vitally important responsibility of every tax lawyer. Stanley has served as the Secretary (1984-1985), Treasurer (1985-1986) and Chair (1987-1988) of the Section of Taxation of the State Bar of Texas. In addition, Stanley has served as both the Vice Chair (2002-2004) and Chair (2007-2008) of the of the American Bar Association Section of Taxation. He has also served as Council Director (1999-2002) and is the past Chair of the Partnership Tax Committee, with the American Bar Association.

Stanley has been a member of the Texas State Board of Public Accountancy, the American College of Tax Counsel, and has served on the Editorial Board of *The Practical Tax Lawyer*. Stanley has been recognized by Woodward/White, Inc. as one of the Best Lawyers in America©, by Texas Monthly Magazine as a Texas Super Lawyer and by Scene in SA Magazine as one of San Antonio's Best Tax Law Attorneys. Stanley is a frequent author and lecturer on all areas of tax law. Most importantly, Stanley is a friend and mentor to many.

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Section of Taxation Agenda

STATE BAR OF TEXAS ANNUAL MEETING

Friday, June 25th

7:30 a.m. **Legends Breakfast**

8:00 a.m **Texas Tax Lawyers Go to Washington: Reliving the Experience**

Robert E. Davis
Bob Davis headed the Criminal Division of the Department of Justice during the first term of President Reagan, 1982-83

David Glickman
David Glickman was Deputy Assistant Secretary of the Treasury during President Reagan's first term, 1981-83

William Bowers
Bill Bowers just returned from service as Senior Counsel, U.S. Department of the Treasury.

9:00 a.m. **State Bar Presentation: Legal Writing** *(will be held in a separate room)*
Justice Antonin Scalia *(invited)*
Bryan Garner

10:30 a.m. **Break**

10:45 a.m. **Power Tax Law: Organizing a Professional Services Firm in 60 Minutes Flat**

Moderator:
William D. Elliott
Law Offices of William D. Elliott, Dallas

Barbara Spudis De Marigny
Gardere Wynne Sewell LLP, Houston

Dan Baucum
Shackelford, Melton & McKinley, LLP, Dallas

11:45 a.m. **Break**

12:00 p.m. **General Session Luncheon**
Keynote Address: Lessons from Lincoln
Doris Kearns Goodwin

1:30 p.m. **Break**

1:45 p.m. **Annual Section Business Meeting**

2:30 p.m. **Adjourn**

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SECTION OF TAXATION
State Bar of Texas

The State and Local Tax Committee of the

Tax Section of the State Bar of Texas

is Proud to Present its

Annual Joint Meeting with the Office of the Texas Comptroller of Public Accounts

Friday, July 17, 2009
Lunch: 11:30 a.m. – 1:00 p.m.
Meeting: 1:00 p.m. – 4:30 p.m.

To be held at the
State Capitol
1400 Congress Avenue
Austin, Texas 78701

Lunch to be held at the Capitol Grill
(located one floor above the meeting room)

Meeting room is on the basement floor, E2.010

Agenda TBD
MCLE Credit Approved

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Friday

5.75 hours including .75 hour ethics

8:00 **Continental Breakfast**

8:15 **Announcements**
Course Director
Ronald W. Adzgery, *Houston*
Fulbright & Jaworski

8:30 **Estate and Gift Tax Update**
1 hr (.25 hr ethics)
Stanley M. Johanson, *Austin*
University of Texas School of Law

9:30 **Conservative Asset Protection Planning**
.75 hr (.25 hr ethics)
Toby M. Eisenberg, *Dallas*
Bisignano and Harrison

10:15 **Break**

10:30 **Retirement Benefits In Estate Planning** *.75 hr*
R. Eric Viehman, *Houston*
Vinson & Elkins

11:15 **How 409A Applies To You** *.75 hr*
Alison Sulentic, *Houston*
Baker Botts

12:00 **Break: Lunch Served**

12:15 **Lunch Presentation: Scams That Hit Lawyers** *.75 hr*
Alan D. Westheimer, *Houston*
Alan D. Westheimer, CPA/CFF, CFE

1:00 **Break**

1:15 **Drafting The Protest** *.75 hr*
James Stryker, *Tomball*

2:00 **Bankruptcy v. Installment Agreements v. Offer in Compromise** *1 hr (.25 hr ethics)*
Larry Jones, Jr., *Dallas*
Townsend & Jones

Elizabeth A. Copeland, *San Antonio*
Oppenheimer Blend Harrison & Tate

Marilyn S. Ames, *Houston*
Internal Revenue Service

3:00 **Adjourn**

Our thanks to our sponsor
State Bar of Texas
Insurance Trust

Come a day early and attend

Nuts & Bolts Tax Workshop

(Separate registration required.)

Wednesday

4 hours including 1 hour ethics

1:00 **Registration**

1:45 **Welcoming Remarks**
Course Director
Ronald W. Adzgery, *Houston*
Fulbright & Jaworski

2:00 **Wills and Trusts Drafting**
1.25 hrs (.25 ethics)
Fred R. Norton, Jr., *Texarkana*
Norton & Wood

3:15 **Partnership and LLC Agreement Drafting**
1.75 hrs (.5 hr ethics)
Michael Threet, *Dallas*
Akin Gump Strauss Hauer & Feld

Gene Wolf, *El Paso*
Kemp Smith

5:00 **Break**

5:15 **Buy/Sell Agreements**
1 hr (.25 hr ethics)
Jeffrey S. Hamilton, *Dallas*
Mincey-Carter

6:15 **Adjourn**

MCLE CREDIT

4 HOURS (1 ETHICS)
MCLE COURSE NO: 901177683
Applies to the College of the State Bar of Texas and the Texas Board of Legal Specialization in Tax Law and Estate Planning and Probate Law.

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WHERE IS THE "UNITED STATES" FOR FEDERAL TAX PURPOSES?

Andrius R. Kontrimas and Robert C. Morris[1]

I. Introduction

The question as to precisely what constitutes the United States as well as where it is located is a seemingly simple question. The answer to the question is relevant to determine the applicability of the federal tax jurisdiction of the United States as well as to the source of income. This article provides an analysis of the history and current law of defining the United States for federal tax purposes and specifically focuses on the contiguous coastal waters of the United States coastline particularly the Gulf of Mexico.

II. Historic definition of United States

With the adoption of the Sixteenth Amendment to the United States Constitution in 1913, both individuals and corporations could be taxed without apportionment.[2] Federal income tax was first established with the Revenue Act of 1913, which provided:

> "That the word "State or "United States" when used in this section shall be construed to include any Territory, Alaska, the District of Columbia, Porto (sic) Rico, and the Philippine Islands…"
>
> (Pub. L. No. 63-16, ch. 16, 63rd Cong., 1st sess., 38 Stat 114 at 177, Oct. 3, 1913).

The entry by the United States into World War I greatly increased the need for revenue and Congress responded by passing the 1916 Revenue Act.[3] The Revenue Act of 1916, Titles II (Estate Tax) and III (Munitions Manufacturers' Tax), modified the prior definition of United States by specifying that:

> The term "United States" means only the States, the Territories of Alaska and Hawaii, and the District of Columbia."
>
> (Pub. L. No. 64-271, ch 463, 64th Cong., 1st sess., 39 Stat. 756 at 777, 780).

The Revenue Act of 1924 modified the definition once again by providing that:

> The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.
>
> (Pub. L. No. 68-76, ch 234, 69th Cong, 1st sess., 43 State 253).

When the federal tax law was codified for the first time in 1939, the term United States was defined in Section 3797(a)(9) using the exact language from the Revenue Act of 1924. The Internal Revenue Code was recodified by the Internal Revenue Act of 1954. The definition of "United States," which had been previously been contained in section 3797 of the 1939 Code was recodified into Chapter 79, Section 7701(a)(9), where it remains to the present day.

In 1959, the definition of the United States in Section 7701(a)(9) was amended to reflect the admission of Alaska into the Union.[4] "the Territories of Alaska and Hawaii" was struck out and replaced by "the Territory of Hawaii." (Pub. L. 86-70, sec. 22, 86th Cong., 1st sess., 73 Stat 141 at 146). Shortly thereafter in 1960 the definition was changed to reflect the admission of Hawaii into the Union.[5] "the Territory of Hawaii and" was struck out. (Pub. L. 86-70, sec. 22, 86th Cong., 1st sess., 73 Stat 141 at 146).

Section 7701(a)(9) has not been amended since 1960 and today specifically provides that:

> The term "United States" when used in a geographical sense includes only the States and the District of Columbia.

III. The cannon shot rule and the precursor to the law of the sea

The 17th century Dutch jurist Cornelius van Bynkershoek contributed to the development of international law and the law of the sea aruging that coastal states have a right to their adjoining waters. National rights were limited to a specified belt of water extending from a nation's coastline to three nautical miles. The three nautical mile limit was developed by van Bynkershoek and referred to as the "cannon shot" rule; that is, the purported distance of a cannon shot fired from shore.[6]

All waters beyond national boundaries were considered international waters and available for use and free passage by all nations. In the early 20th century several governments expressed their desire to extend their national boundaries for mineral resource exploitation, fishing rights and to: provide the means to enforce pollution controls. As discussed in more detail below, the historical 3 mile territorial waters limit was extended to 12 nautical miles pursuant to the 1982 United Nations Convetion on the Law of the Sea.

IV. "United States" Defined for Federal Tax Purposes

Although the Internal Revenue Code[7] generally defines the United States in a fairly restrictive geographical sense as "only the States and the District of Columbia,"[8] the Internal Revenue Service ("IRS") has advocated for a much more expansive definition of the "United States" in court cases, published guidance, and private letter rulings. The IRS looks to either the Outer Continental Shelf Lands Act of 1953 ("OCSLA"),[9] Presidential Proclamation 5928,[10] or Section 638 as support for its expanded definition of the United States depending on the specific activity that the IRS is examining and/or attempting to tax.

A. Outer Continental Shelf Lands Act Expands "United States"

The OCSLA was enacted in 1953 with the broad purpose of encouraging the discovery and development of natural resources located in the outer continental shelf of the United States (the "Outer Continental Shelf").[11, 12] Specifically, OCSLA extended the U.S. Constitution and laws and civil and political jurisdiction of the United States to

> the subsoil and seabed of the outer Continental

> Shelf and to all artificial islands, and all installations and other devices permanently or temporarily attached to the seabed, which may be erected thereon for the purpose of exploring for, developing, or producing resources therefore, or any such installation or other device (other than a ship or vessel) for the purpose of transporting such resources, to the same extent as if the outer Continental Shelf were an area of exclusive Federal jurisdiction located within a State…[13]

The United States' claim of exclusive right to the exploration and exploitation of natural resources located in the Outer Continental Shelf is consistent with customary 20th century international law that generally permits countries to claim exclusive development rights to the natural resources of the subsoil and seabed of the continental shelf areas extending 200 nautical[14] miles from their coastline.[15, 16]

B. IRS Uses OCSLA to Expand "United States" for Structures Attached to Outer Continental Shelf

Although the IRS has acknowledged in an internal memorandum that its position is not "free from doubt,"[17] the IRS has long contended that the definition of "United States" in Section 7701(a)(9) was extended to include the Outer Continental Shelf by virtue of OCSLA when a structure is attached to the seabed.

One possible rebuttal to the IRS's position is that if OCSLA did expand the definition of the United States for federal tax purposes, then Section 638, discussed later in this article, which expanded the definition of the United States for exploration and exploitation activities, was unnecessary. Section 638 was enacted after OCSLA, and would therefore be redundant. The IRS addressed this argument in GCM 38644 stating:

> [T] his specific reference by Congress to the OCS in section 638 was simply an attempt to avoid any doubt about the applicability of the income tax provisions of the Code to Outer Continental Shelf operations. Consequently, the specific geographical treatment of the Outer Continental Shelf in connection with certain natural resource operations provided in section 638 should not give rise to any negative implications regarding the status of the Outer Continental Shelf for other purposes of the Code.

The IRS, relying on OCSLA, has determined that a fixed drilling site "located in international waters, is a part of the United States for purposes of Section 7701(a)(9) of the Code."[18] In Rev. Rul. 77-197, an aviation company furnished helicopter transportation services between a petroleum company's base of operations in Alaska and its offshore drilling site which was a fixed structure located in international waters on the outer continental shelf. The IRS considered whether the transportation excise taxes under Sections 4261(a) and 4271(a) applied to amounts paid for this transportation. For these excise taxes to apply, the transportation in question must both begin and end in the United States.

The IRS reasoned that OCSLA extended the jurisdiction of the United States "to the submerged lands known as the Continental Shelf and all artificial islands and fixed structures erected thereon exploring, developing, removing, and transporting resources therefrom." (Emphasis added.)[19] Therefore, because the air transportation began in the United States (the company's base in Alaska) and ended in the United States (the fixed drilling site on the Outer Continental Shelf), the excise taxes under Sections 4261(a) and 4271(a) was determined to be applicable.

In Rev. Rul. 56-505, 1956-2 C.B. 891, the IRS determined that the documentary stamp tax imposed under Section 4371 on a foreign insurance policy "with respect to, hazards, risks, losses, or liabilities wholly or partly within the United States" applies to a foreign insurance policy covering oil drilling operations on the Outer Continental Shelf.[20] In ruling that the risks insured by the foreign insurance policy covering oil drilling operations on the Outer Continental Shelf were within the United States, the IRS cited and relied on specific sections of OCSLA.

The IRS has also relied on OCSLA in the employment tax arena to conclude that services performed for a foreign employer by resident and nonresident aliens to operate an oil rig which was temporarily attached to the Outer Continental Shelf are "employment" within the United States for FICA purposes.[21, 22]

In Rev. Rul. 81-257, 1981-2 C.B. 214, the IRS ruled that the transportation excise tax imposed under Section 4261(a) generally on the transportation of a person by air beginning and ending in the United States applied to helicopter service to, from, and between semi-submersible drilling rigs and other floating drilling rigs "when such rigs are engaged in oil and gas drilling on the Outer Continental Shelf." The IRS concluded that under OCSLA, when semi-submersible and other floating drilling rigs are engaged in oil and gas activities on the Outer Continental Shelf and therefore are temporarily attached to the seabed, they are within the United States as defined in Section 7701(a)(9). The IRS cited the 1978 amendment[23] to the OCSLA which inserted the phrase "and all installations and other devices permanently or temporarily attached to the seabed" in lieu of "and fixed structures." The IRS stated:

> This amendment was not intended to change existing law, but to clarify that Federal law is to be applicable to all activities on all devices in contact with the seabed for exploration, development, and production. H.P. Rep. No. 95-1474 (Conf. Rep.), 95th Cong. 2nd Sess. 80 (1978). Such activities include activities on drilling ships and semi-submersible drilling rigs when they are connected to the seabed by drillstring pipes or other appurtenances on the [OCS]. H.R. Rep. No. 95-590, 95th Cong., 2nd Sess. 128 (1978).

The IRS also held that the excise tax generally imposed by Section 4261(a) on the transportation of persons that begins and ends in the United States does not apply "when the rigs are being moved at sea" (and therefore are not temporarily attached to the seabed).

In Rev. Rul. 83-143, 1983-2 C.B. 196, the IRS ruled that the excise tax imposed under Section 4261(a) on the transportation of a person by air that begins and ends in the United States does not apply to amounts paid for the helicopter transportation of persons from the United States to semi-submersible or floating drilling rigs and to other vessels moving or being moved through international waters. Instead, the excise tax imposed under Section 4261(c) on the transportation of persons by air that begins or ends in the United States applies to such transportation.

By ruling that the excise tax under Section 4261(c) applied, the IRS implicitly recognized that the rigs were not located within the United States when not attached to the seabed. The IRS distinguished Rev. Rul. 77-197 and Rev. Rul. 81-257, which held that the excise tax imposed under Section 4261(a) applies to amounts paid for the transportation of persons by air from the United States to a "fixed drilling platform" located on the Outer Continental Shelf, and to air transportation to, from, and between drilling rigs when they are "temporarily attached to the seabed" in the Outer Continental Shelf.

C. OCSLA Does Not Apply if Structure Not Attached to Seabed

As evidenced in Revenue Rulings 81-257 and 83-143, the IRS has at least implicitly acknowledged that the OCSLA does not extend the definition of the United States for taxing purposes to include the waters above the Outer Continental Shelf. "[T]his Act shall be construed in such a manner that the character of the waters above the Outer Continental Shelf as high seas and the right to navigation and fishing therein shall not be affected."[24] Therefore, the IRS must rely on other authority for its position that the United States' taxing jurisdiction extends to its territorial waters.

D. IRS Relies on Presidential Proclamation 5928 to Expand "United States" to Territorial Seas

The IRS has relied on Presidential Proclamation 5928 to extend the definition of the United States for federal tax purposes when activities are conducted at sea. For most purposes, including taxation, the United States has historically considered its boundaries as extending out to its so-called "territorial seas."[25] Current international law permits a country's territorial seas to extend 12 nautical miles.[26] Although the United States has not yet ratified the 1982 United Nations Convention on the Law of the Sea,[27] Presidential Proclamation 5928 confirms that the United States' territorial waters extend 12 nautical miles from the U.S. coastline.

The IRS, relying on Presidential Proclamation 5928, determined in a private letter ruling that consulting and advisory services performed by foreign employees of a U.S. corporation on fishing vessels that do not begin until the vessel is more than 12 nautical miles from the coastline of the United States are performed outside of the United States.[28]

In PLR 9012023, a U.S. corporation provided consulting and advisory services to U.S. businesses engaged in the fishing industry regarding catching and processing fish to be exported to a certain foreign country by stationing on its clients' fishing vessels employees who were citizens of the country to which the fish were to be exported. The foreign employees did not perform any services until the fishing vessels were more than 12 nautical miles from the United States coast. The IRS concluded that the services of the foreign employees were performed outside of the United States.

In a later PLR, with facts very similar to those in PLR 9012023, the IRS refused to determine whether U.S. territorial waters extended 3 or 12 nautical miles from the United States coastline.[29] Although the IRS determined that consulting services rendered more than 12 miles from the U.S. coastline aboard fishing vessels by foreign employees were performed outside the United States, the IRS declined to decide whether U.S. territorial waters extended 3 or 12 nautical miles from the U.S. coastline. It is unclear whether the IRS is reconsidering the 12 nautical mile rule or simply refused to address the issue because the taxpayer represented that no services were performed within 12 nautical miles of the U.S. coastline.[30]

V. Special Definition of "United States" With Respect to Exploration and Exploitation Activities

A. Section 638: Personal Services with Respect to Mines, Oil and Gas Wells, and Other Natural Deposits

The Code contains an expanded definition of the "United States" with respect to natural resource and exploitation activities. Section 638 provides that "for purposes of applying the provisions of this chapter," (i.e. Chapter 1 of the Code), the term "United States" when used in a geographical sense includes the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.[31] Therefore, under this expanded definition of the United States, those performing personal services within the Outer Continental Shelf related to the exploration and exploitation of natural resources are within the United States for federal tax purposes. Unlike the IRS's rulings relying on OCSLA, it is not necessary that a structure be attached to the seabed.[32] Section 638 only requires that the taxpayer operate within the Outer Continental Shelf.

The IRS and Treasury Department have interpreted the phrase "engaged in or related to" the exploration or exploitation of natural resources very broadly. For example, a physician conducting routine physical examinations on a platform to determine whether personnel should continue to work on that platform is engaged in activities related to the exploitation of oil.[33] Likewise, a cook (whose sole duties consist of cooking meals) stationed on a ship exploring for oil is engaged in activities relating to the exploitation of oil.[34]

The IRS has ruled that income earned by a foreign corporation from exploratory drilling in the Outer Continental Shelf is U.S. source income.[35] In Revenue Ruling 80-64, a foreign corporation operated a dynamic positioning drill ship to gather information about the soil conditions in the Outer Continental Shelf. The ship did not anchor while on location, and floated above the seabed or subsoil except for the drill pipe and bit that penetrated the seabed and subsoil in drilling

The IRS, relying by analogy on Treas. Reg. ß 1.638-1(f), Ex. 5, concluded that Section 638 applied to the foreign corporation's Outer Continental Shelf activities. In Treas. Reg. § 1.638-1(f), Ex. 5, a domestic corporation chartered a ship from another domestic corporation to explore a foreign country's continental shelf for oil. The foreign country exercised taxing jurisdiction with respect to the exploration for or exploitation of natural resources in its continental shelf. Example 5 of Treas. Reg. § 1.638-1(f) concluded that the entire income derived from the domestic corporation's oil exploration activities over the foreign country's continental shelf should be sourced to that foreign country.

In applying this example to the foreign corporation in Rev. Rul. 80-64, the IRS concluded that Example 5 "illustrates by analogy that Section 638 of the Code extends United States taxing jurisdiction to a drill ship operating in the United States continental shelf even though the ship does not rest on, or is not anchored to, the seabed and does not penetrate the subsoil except to remove core samples." The IRS concluded that the income derived by the foreign corporation from the exploratory drilling of subsoil in the Outer Continental Shelf "is income from sources within the United States for purposes of Section 861 of the Code."

B. IRS Extends the Ambit of Section 638 Even Further in Recent Private Letter Ruling

In PLR 200823005, the IRS determined that the income earned by owners of foreign flagged vessels pursuant to time charter arrangements where the vessel owners provided and compensated marine crews for vessels that transport divers performing activities on the floor of the Outer Continental Shelf was U.S. source income. Each of the vessels had a dynamic positioning system which allowed the vessel to maintain its position on location without the use of anchors. The diving services performed by employees in the Outer Continental Shelf consisted of "the removal and repair of underwater oil and natural gas pipelines, inspection, maintenance and repair of production platforms and wellheads and the salvage of pipeline and production equipment." The captain and crew of the vessels in PLR 200823005 were not involved in the subsurface activities; rather, such activities were performed solely by the employees of the contractor of the vessel.

The IRS determined that although the services performed by the divers did not constitute the actual drilling of oil and gas wells, "such repair and remediation of oil and gas infrastructure are clearly related to the exploitation of natural resources, and fall within the ambit of § 638." The IRS also took the position that because the taxpayer's activities in the Outer Continental Shelf "are related to the exploration for or exploitation of mines, oil and gas wells, or other natural resources with the meaning of § 638," the income derived by each foreign vessel owner from the taxpayer pursuant to the time charter arrangement is income from sources within the United States.

It is uncertain whether the IRS's expansive view of Section 638 expressed in PLR 200823005 with respect to the vessel owners would survive a court challenge. As noted above, the captain and crew of the vessels in PLR 200823005 were not directly involved in the exploitation and exploration of natural resources.[36] The IRS attributed the activities of the contractors to the vessel owners. Such a connection may be too remote and a court may find that the IRS has overreached in applying Section 638 as it did in Ocean's Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714 (1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993).

In Ocean Drilling Exploration Co., a corporation's subsidiary insured mobile drilling rigs that operated in the Outer Continental Shelf which were owned by its corporate parent, and provided reinsurance for unrelated parties. The taxpayer deducted the amounts paid to the subsidiary as insurance premiums, and did not include the premiums earned by the subsidiary in the taxpayer's gross income because the taxpayer took the position that the Outer Continental Shelf is not part of the United States for purposes of Section 953.[37]

The government argued that the expanded definition of the United States under Section 638 should apply because Section 953 is within Chapter 1 of the Code, and the language of "with respect to the exploration and exploitation of natural resources" refers to any activity relating to the exploration and exploitation of natural resources, including providing insurance for drilling rigs.

The court rejected the government's argument on various grounds and concluded that the insurance premiums received were not income derived from the insurance of property in the "United States" for purposes of Section 953.[38] The court noted that the specific references in the legislative history of Section 638 to "purposes of the exploration for, or exploitation of, natural resources," "source of income from mining activities," "natural resource activity," and "personal services performed" are references to mining activities and to personal services performed at mining sites, not to insurance activities. The relationship between insurance activities and mining was too remote. The court also noted that any doubt as to the meaning of Code provisions must be resolved in favor of the taxpayer.[39]

C. IRS Uses Regulations to Further Expand Section 638 Definition of the "United States" to Other Chapters of the Code

As noted above, Section 638 provides that its expanded definition of the United States applies "for purposes of applying the provisions of this chapter," i.e. Chapter 1 of the Code. However, the IRS, through Treas. Reg. § 1.638-1(a), has extended the definition of the United States contained in Section 638 to other chapters of the Code. Treas. Reg. § 1.638-1(a) provides that the expanded definition of the United States applies "for purposes of applying any provision of chapter 1, 2, 3, or 24 …."[40]

The IRS attempted to explain its extension of the reach of Section 638 in a technical memorandum, 1970 T.M. Lexis 35 (1970), in connection with its notice of proposed rulemaking with respect to the regulations under Section 638. In 1969, Congress added Section 1441(f), which provides that "[f]or sources of income derived from, or for services performed with respect to, the exploration or exploitation of natural resources on submarine areas adjacent to the territorial waters of the United States, see section 638." According to the IRS, this "indicates that chapter 3 of the Code also is affected by the definitions contained in section 638." Moreover, the IRS argued that Section 1441 refers to "income from sources within the United States," which necessarily involves the rules of Chapter 1 of the Code and thus Section 638. The IRS noted that wage withholding under Chapter 24 of the Code generally deals with the place where services are performed, not where income is sourced; however, wage withholding for nonresident aliens could have been dealt with under Chapter 3, but the Foreign Investors Tax Act, Pub. L. No. 89-809 (1966), gave authority to change such wage withholding rules from Chapter 3 to Chapter 24. The IRS also cited a committee report with respect to the addition of Section 638 to the Code that indicates that its definitions are meant to apply to employment tax provisions as well as income tax provisions; Chapter 24 is part of Subtitle C of the Code, which deals with employment taxes (although Chapter 24 itself deals with income tax withholding).

It is uncertain whether the IRS's extension of Section 638 to other Chapters of the Code would survive a court challenge. A court may find that the IRS exceeded its underlying statutory when promulgating Treas. Reg. § 1.638-1(a), and therefore hold the regulation invalid.[41]

VI. Conclusion

The seemingly simple question of what constitutes the United States, particularly with respect to its outer continental shelf, does not have a comparably simple answer. The answer may differ, depending on the specific activity that the IRS is examining and/or attempting to tax.

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As noted at the start of this article, the Code generally defines the "United States" as "only the States and the District of Columbia." However, despite this limited definition, the IRS has articulated a much broader definition of the "United States" when determining the applicability of the federal tax jurisdiction of the United States as well as to source income. Whether a court would agree with all of the IRS's stated positions is uncertain.

In particular, due to uncertainty regarding the proper interpretation of Section 638 with respect to certain offshore activities that are not directly related to the exploration or exploitation of subsurface mineral rights, taxpayers need to be mindful of the existing published authorities including the Ocean's Drilling case and PLR 200823005 to determine their potential federal tax liabilities from the conduct of activity over or on the Outer Continental Shelf.

ENDNOTES

1 Andrius R. Kontrimas is a partner and Robert C. Morris is an associate with the law firm of Fulbright & Jaworski LLP in Houston, Texas.
2 Mertens, Law of Federal Taxation, §. 3:64.
3 From the U.S. Treasury Fact Sheet on the History of the U.S. Tax System: http://www.treas.gov/education/fact-sheets/taxes/ustax.shtml
4 Alaska was admitted as a State on January 3, 1959.
5 Hawaii was admitted as State on August 21, 1959.
6 It is questionable whether cannons of the 17th century had anything approaching a 3 nautical mile range.
7 Unless otherwise indicated, all references to "Section" herein are to the Internal Revenue Code of 1986, as amended as of the date hereof (the "Code"), and references to "Treas. Reg. §" herein are to the Treasury regulations, as most recently adopted or amended as of the date hereof.
8 Section 7701(a)(9). The Treasury Department has not issued any regulations under Section 7701(a)(9) that further expand the definition of the United States.
9 43 U.S.C. §§ 1331-1356.
10 Proclamation No. 5928, 54 Fed. Reg. 777 (December 27, 1988). Proclamation 5928, entitled Territorial Seas of the United States, was signed by President Ronald Reagan in 1988.
11 Continental shelves have been defined as those slightly submerged portions of the continents that surround all the continental areas of the earth. They are a part of the same continental mass that forms the lands above water. They are that part of the continent temporarily (measured in geological time) overlapped by the oceans. The outer boundary of each shelf is marked by a sharp increase in the slope of the sea floor. It is the point where the continental mass drops off steeply toward the ocean deeps. Generally, this abrupt drop occurs where the water reaches a depth of 100 fathoms or 600 feet, and, for convenience, this depth is used as a rule of thumb in defining the outer limits of the shelf. Along the Atlantic coast, the maximum distance from the shore to the outer edge of the shelf is 250 miles and the average distance is about 70 miles. In the Gulf of Mexico, the maximum distance is 200 miles and the average is about 93 miles. H.R. Rep. No. 413 Cong., 1st Sess. 2 (1953).
12 OCSLA defines the "Outer Continental Shelf" as "all submerged lands being seaward and outside of the areas of lands beneath navigable waters as defined in section 2 of the Submerged Lands Act (Public Law 31, Eighty-third Congress, first session) [43 USCS § 1301], and of which the subsoil and seabed appertain to the United States and are subject to its jurisdiction and control."
13 43 U.S.C. § 1333(a)(1).
14 Two hundred nautical miles equal 227.174 miles.
15 See FMC Corp & Subs v. Comm'r., 100 TC 595 (1993) citing 1982 United Nations Convention on the Law of the Sea, opened for signature December 10, 1982, A/CONF.62/122, 21 I.L.M. 1261 (1982). Although the court notes that the United States has not ratified the 1982 United Nations Convention on the Law of the Sea, the court points out that "in 1983 the United States in effect agreed to accept the substantive provisions of the Convention other than those dealings with deep-seabed mining." See Proclamation No. 5030, signed by President Ronald Reagan, 48 Fed. Reg. 10,605 (March 10, 1983) (proclaiming the Exclusive Economic Zone of the United States to a distance of 200 nautical miles).
16 A nation's continental shelf area may extend beyond 200 nautical miles if certain criteria are satisfied, the "Extended Continental Shelf." The United States Extended Continental Shelf Task Force is currently coordinating efforts to define the limits of the U.S. Continental Shelf. See www.state.gov/g/oes/continentalshelf/index.htm for additional information.
17 Gen. Couns. Mem. 38644 (Feb. 27, 1981).
18 Rev. Rul. 77-197, 1977-1 C.B. 344.
19 Id.
20 The IRS position asserted in this revenue ruling is contrary to the holdings of the Claims Court and Federal Circuit in Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714 (1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993). The Ocean Drilling & Exploration Co. case is discussed later in this article.
21 Rev. Rul. 86-108, 1986-2 C.B. 175. Thomas Bissel, the author of International Aspects of U.S. Social Security and Unemployment Taxes, 917-3rd Tax Mgmt. Portfolio (BNA) at A-21 (2007) has expressed doubt as to whether this is correct in view of the Federal Circuit's decision in Ocean Drilling & Exploration Co.
22 Section 3121(e)(2) defines the United States for employment tax in a geographical sense as the several states, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, and American Samoa. Treas. Reg. § 31.3121(e)-1(b).
23 Outer Continental Shelf Lands Act Amendments of 1978, Pub. L. No. 95-372, § 203(a), 92 Stat. 634 (1978).
24 43 U.S.C. § 1332(2).
25 See Rev. Rul. 75-483, 1975-2 C.B. 286.
26 Under the 1982 United Nations Convention on the Law of the Sea, the territorial waters of a country extend 12 nautical miles from its coastline, with control over other areas in a contiguous zone extending another 12 nautical miles. In the contiguous zone, a country may enforce its customs, taxing, immigration, and pollution laws.
27 Senator Hillary Clinton, speaking at her January 13, 2009 Senate Confirmation hearing as nominee for Secretary of State, testified that ratifying the Law of the Sea Treaty was long overdue and a priority for her. Transcript available at www.cfr.org/publication/18225/transcript_of_hillary_clintons_confirmation_hearing.html.
28 PLR 9012023.
29 See PLR 9610015.
30 If the United States ratifies the Law of the Sea Treaty, the IRS may take the position that services performed up to 24 nautical miles from the United States coastline are performed within the United States.
31 Section 638.
32 For purposes of Section 638, "persons property or activities which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits need not be physically upon, connected, or attached to the seabed or subsoil … to be deemed to be within the United States …" Treas. Reg. § 1.638-1(c)(1).
33 Treas. Reg. § 1.638-1(f), Ex. 3.
34 Treas. Reg. § 1.638-1(f), Ex. 6.
35 Rev. Rul. 80-64, 1980-1 C.B. 158,
36 The U.S. Customs has ruled that a vessel engaged in pipe-laying is not being used for the purpose of "exploring for developing, or producing resources" from the Outer Continental Shelf as such term is used in OCSLA. *See, e.g.*, U.S. Customs Letter Ruling 111126 (1990). However, the standard under OCSLA and the standard under Section 638 are different. Section 638 uses the language "with respect to the exploration and exploitation of natural resources" as opposed to "for the purpose of exploring for, developing, or producing resources." Moreover, U.S. customs rulings need not be consistent with IRS rulings. Nevertheless, such authority may be helpful in a court challenge to PLR 200823005.
37 If the court had held that the Outer Continental Shelf was a part of the United States for purposes of Section 953, the subsidiary's income from insuring drilling rigs in the Outer Continental Shelf would have been Subpart F income under Section 952(a)(1) as "income derived from the insurance of United States risks (as determined under § 953)" and therefore includible in the parent corporation's gross income.

38 The court's ruling is directly contrary to Treas. Reg. § 1.638-1(f), example 8.

39 The court cited two Supreme Court cases in support of this position, Porter v. Commissioner, 288 U.S. 436 (1933), and United States v. Merriam, 263 U.S. 179 (1923).

40 Chapter 2 of the Code, which encompasses Sections 1401 through 1403, provides rules for tax on self-employment income. Chapter 3 of the Code, which encompasses Sections 1441 through 1464, provides rules for federal income tax withholding on payments to nonresident aliens and foreign corporations. Chapter 24 of the Code, which encompasses Sections 3401 through 3406, provides rules for wage withholding.

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PAYING OTHER PEOPLE'S TAXES: CURRENT ISSUES IN EMPLOYMENT TAXES AND TRANSFEREE LIABILITY

M. Todd Welty, Laura L. Gavioli, and Claire I. Wade[1]

Are your clients having difficulty paying their employment taxes? Are they taking advantage of the current environment and acquiring other businesses? This article focuses on issues arising in employment tax examinations and transferee liability for those and other taxes.

When times get tough, employers often turn to "alternative" forms of financing. One "alternatives," not paying withheld employment taxes to the federal government and using those funds as a short-term loan to the company, may be the most costly form of financing. Failure to pay of employment taxes can result in personal liability for the full amount of the tax owed, and potential criminal liability.

What are Employment Taxes?

Employment Taxes are the FICA and Medicare taxes that are withheld when wages are paid to an employee.[2] Employees receive a credit against their tax liability for the taxes withheld.[3] The IRS has no recourse against the employees if the employer does not remit the employment taxes to the IRS. Once the employer deducts these taxes from the employee's wages, these taxes are then held by the employer "in trust" for the United States.

What happens if the Employment Taxes are not paid by the employer to the United States?

Under Section 6672,[4] all persons deemed responsible can be held personally liable for the Employment Taxes. Section 6672(a) states:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 or part II of subchapter A of chapter 68 for any offense to which this section is applicable.

This is called the Trust Fund Recovery Penalty, or TFRP, but it is really a mechanism for making individuals personally liable for unpaid taxes. There is no additional "penalty." The amount of the "penalty" is equal to the amount of unpaid taxes. Corporations and limited liability forms offer no protection against personal liability for employment taxes. This is because"[t]he purpose of section 6672 is to permit the IRS to pierce the corporate veil to reach the individual(s) who are responsible for a corporation's failure to pay its duly owed taxes."[5] Multiple agents and officers may all be deemed responsible and may be held jointly and severally liable.

Section 6672 applies to all taxes in which there is a corresponding withholding or collection obligation. This covers a broad range of taxes from federal excise taxes to payments of gambling winnings. For example, in *Brinskele*, the Court of Federal Claims found that a former CEO of a telecommunications company could "potentially be held liable under IRC § 6672 for the federal communications excise taxes that were collected by his company … but which [the company] failed to pay over to the government."[6]

Who Can be Liable?

Only a "responsible person" who "willfully" fails to collect, truthfully account for, or pay over the taxes can be liable for the TFRP. There are no further requirements for liability, such as a requirement that the employer be unable to pay before personal liability can attach.[7]

A "responsible person" is any person required to collect, truthfully account for, and pay over any tax.[8] 6671(b) defines person as including "an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs." Responsible persons can also be individuals outside the formal business structure such as creditors, lenders, and sureties. For example, in *Commonwealth National Bank of Dallas*, the CEO, the corporation's lending bank, and the bank's officer were all found to be responsible persons.[9]

The standard for determining who is responsible is whether the individual exercises control over the financial affairs of a business—the disbursement of funds and priority of payments to creditors. Courts look at various factors, but no one factor controls. These factors include whether the taxpayer "(i) is an officer or member of the board of directors; (ii) owns a substantial amount of stock in the company; (iii) manages the day-to-day operations of the business; (iv) has the authority to hire or fire employees; (v) makes decisions as to the disbursement of funds and payment of creditors; and (vi) possesses the authority to sign company checks."[10] In *Bean*, the Southern District of Texas recently found that a taxpayer was a responsible person even though he did not manage the day-to-day operations of the business because he: "(i) was the sole owner of [the company] with 100 percent of the issued stock; (ii) …was in weekly, at times daily, contact with the management of [the company], ensuring the company's liquidity; (iii) because of his weekly/daily contact ensuring liquidity, as well as his ownership and control, can be said to have substantial involvement in disbursements and payments to creditors beyond that of merely an arm's length lender; (iv) as owner and ultimate controller of the business could, had he wished, hired or fired anyone; and, finally, (iv) all company checks were signed or stamped with Dr. Bean's signature so, undoubtedly, he had authority to issue those checks."[11]

Volunteers of charitable organizations are specifically exempted from Section 6672 if they meet three requirements under Section 6672(e): "(i) solely serving in an honorary capacity, (ii) does not participate in the day-to-day or financial operations of the organization, and (iii) does not have actual knowledge of the failure on which such penalty is imposed." The exemption does not apply if the application thereof results in no person being liable for the penalty. The application of Section 6672(e) is very limited, as an individual who would qualify for the exemption would likely not meet the standard for being a responsible party. In fact, there are no reported cases in which a taxpayer has fallen within the 6672(e) exemption to liability.

Once the taxpayer is found to be a responsible person, the taxpayer bears the burden to disprove his willfulness.[12] Willfully is defined as "meaning, in general, a voluntary, conscious, and intentional act."[13] There are three standards of willfulness, deliberately, knowingly, and recklessly. A deliberate choice is when an individual chooses to pay other creditors instead of paying the government. An individual has knowledge of nonpayment when that individual knows that the government is not being paid, and permits payments to other creditors to continue. Reckless disregard occurs when an individual who fails to investigate or correct mismanagement after notification of non-payment. In *Bean*, the Southern District of Texas found that the taxpayer exhibited reckless disregard an obvious risk when he continually provided funds to keep a company operating while he "knew the company was failing to operate at the most basic levels. He included himself in the management of [the company], lecturing the officers of the company on the need to pay drivers, insurance premiums and installments on trucks. He knew that there were insufficient funds in the payroll and operating accounts."[14]

While the statute provides no reasonable cause exception, some circuits recognize a reasonable cause exception and find that the responsible person is not willful if they have reasonable case for concluding that no withholding taxes were due. The 5th Circuit has held that "'reasonable cause' is part of the civil test in determining whether the failure to collect, account for, and pay over was willful."[15] However,"[t]he reasonable cause defense to a section 6672 action is exceedingly limited and may not be asserted by a responsible person who knew that the withholding taxes were due, but who made a conscious decision to use corporate funds to pay creditors other than the government."[16] Advice from an attorney or tax professional can be reasonable cause, but this is less persuasive in this context than it is for other penalties.[17]

Strategies During an Employment Tax Investigation.

One of the most important things to do is to keep current. If the company is continuing to not pay employment taxes, the "responsible person's" personal liability will increase. When making additional tax payments, the corporation should specifically designate in writing that all payments are to be applied o the principal only of the trust fund taxes. To be personally liable for the tax, the responsible person needs only to be responsible *when* the tax becomes due. For example, the taxpayer in *Haslett* was not a 'responsible person' for an early liability because he was only a director with no official role in operations or direct control. However, when "he assumed the role of CEO … Haslett became the individual with "the final word" over payment" and was found to be the responsible person for assessments 30 days after becoming CEO.[18]

Even if the corporation does not have enough funds to pay the employment taxes currently the corporation can have an installment agreement with the IRS. Offers in Compromise may also be available.

Check to see if the statute of limitations has expired. Where employment tax returns are timely filed, the TFRP may be assessed within three years from April 15 of the year following the calendar year in which the taxes were required to be withheld or collected.

Establish that the failure to pay was not willful. The Second, Third, and Ninth Circuits, have found that the taxpayer does not act willfully if the nonpayment is caused by an act beyond the taxpayer's control. Other issues, such as health problems may be a defense to willfulness if the problems severely limit the taxpayer's ability to work. In *Young*, Plaintiff's stroke resulted in lack of participation in corporate affairs, preventing summary judgment on the issue of willfulness.[19] A reasonable belief that the taxes were in fact being paid negates willfulness, as does a good faith belief the taxes were not due. This belief must be made in good faith but does not need to be objectively reasonable. Of course, a defense based on the defendant's view that the tax laws are invalid or unconstitutional does not negate willfulness.

Criminal Charges

Non-payment of employment taxes may also lead to criminal liability under Section 7202, felony willful failure to collect or pay over tax, and 7203, misdemeanor willful failure to file return, supply information, or pay tax. Criminal liability under both Section 7202 and 7203 are subject to a six-year statute of limitations. The maximum penalty under Section 7202 is $10,000 and five years imprisonment. The maximum penalty under Section 7203 is $25,000 and one year imprisonment.

Transferee Liability

The current economic climate also presents a wealth of opportunities for investors. Investing in a distressed business or other distressed assets may raise significant federal tax issues. Under certain conditions, a purchaser may be liable for unpaid federal taxes incurred by the previous owner.

Transferee Liability for Trust Fund Recovery Penalty Taxes

Generally, third parties unconnected with a prior business are not liable for TRFP unless they otherwise qualify as "responsible persons" under Section 6672. This means that generally a purchaser of a business will not be liable for unpaid employment taxes incurred prior to closing. A purchaser may be liable for other unpaid federal taxes, though, as discussed below.

<u>Section 3505 - Liability Of Third Parties Who Pay Wages</u>

Under Section 3505, third parties are liable for TFRP if they paid wages on an employer's behalf. A common situation in which this arises is when employees are wrongly classified as "independent contractors," so the employer does no withholding. There are two kinds of Section 3505 liability - full and partial. Section 3505(a), full liability, requires that a lender, surety or other third party make payment of wages directly to employees or to an agent for the employees' benefit. Under Section 3505(b), a lender, surety or other third party is only partially liable if the following can be shown: funds were advanced for the specific purpose of paying wages; and the third party actually knew that the employer did not intend, or would be unable, to make timely payment or deposit of employment taxes. Liability is limited to 25% of the amount advanced to the employer.

Transferee Liability Generally

Section 6901 is the IRS's primary method of pursuing assets subject to federal tax liabilities which have been transferred to third parties. However, there are several other significant ways in which transferee liability attaches.

Fraudulent Transfer - State and Federal Law

The IRS can bring suit in either state or federal court as a creditor to set aside a fraudulent transfer. State law and federal law requirements for fraudulent transfer differ slightly.

State law - Uniform Fraudulent Transfer Act (UFTA)

Most states (including Texas) have adopted the UFTA.[20] There are two types of fraudulent transfer, actual and constructive. A constructive "fraudulent transfer" under the act is any transfer made (a) without "receiving a reasonably equivalent value in exchange for the transfer" and (b) by a person who is insolvent or who will be rendered insolvent by the transfer. An actual "fraudulent transfer" is any transfer made with the actual intent to hinder, delay or defraud a creditor, regardless of the financial status of the debtor.

Section 4(a)(1) of UFTA requires the IRS to demonstrate actual fraud to set aside a fraudulent transfer. Thus, UFTA requires the IRS to show that the taxpayer actually intended to hinder, delay or defraud the IRS in its collection efforts. The IRS usually proves this by showing one or more "badges of fraud," for example, inadequate consideration; continued retention or use of the property by the taxpayer; transfers to close family members or friends; insolvency of the taxpayer; or transfer of all or nearly all of the property just prior to litigation.

Insolvency: Courts will look beyond the transfer at issue to determine whether the transfer was one of several liquidating transfers which rendered the taxpayer insolvent. Insolvency is measured either by the "equity test" or the "bankruptcy test" (more commonly followed). The "equity test" finds insolvency when a debtor is unable to meet his/her obligations as they become due. The "bankruptcy test" measures whether the debtor's liabilities exceed his/her assets. Texas uses both tests, and satisfaction of either of them means the debtor is insolvent.[21] Not all assets are taken into account in measuring insolvency. If the IRS could not reach the assets or would not have priority over them, they are not considered.

To succeed in an UFTA claim, the IRS must show that it would be futile to proceed against the taxpayer, and that it has exhausted its legal remedies against the taxpayer. In addition, transferees have also prevailed by showing that they paid full and adequate consideration for the property at issue, and that the transfer was in the ordinary course of the taxpayer's business.[22] For a thorough discussion of transferee liability under the Texas UFTA, see *U.S. v. Evans*, 513 F.Supp.2d 825 (W.D. Tex. 2007) (holding against the taxpayer).

Federal law - Federal Debt Collections Procedures Act (FDCPA)

Under 28 U.S.C. §§ 3304 and 3306, the IRS can avoid transfers which are "fraudulent as to a debt of the United States[.]" Transfers can be fraudulent in either of two ways. The taxpayer can be liable if he/she makes a transfer without receiving a reasonably equivalent value in exchange, and the taxpayer is insolvent at the time of the transfer. Alternatively, the taxpayer can be liable if he/she makes a transfer to an "insider," if the taxpayer is insolvent at the time of the transfer, and if the insider had reasonable cause to believe that the taxpayer was insolvent.

Similar to UFTA, a taxpayer-debtor is deemed to be insolvent if he/she is not paying debts as they become due or if the sum of his/her debts exceeds the fair value of all assets. The statute of limitations is either six years from the date of the transfer or two years from discovery of the transfer, depending on the presence of actual fraud. For transfers to insiders, the statute is two years. Federal law usually provides the IRS with a longer statute of limitations period than under UFTA, since the IRS takes the position that it is not bound by state statutes of limitations.[23]

Trust Fund Doctrine

This is an equitable doctrine that was the IRS's primary method of imposing transferee liability prior to the enactment of Section 6901. This method is still available to the IRS but is less commonly used now. Basically, the IRS files a suit in equity as a creditor against a transferee to set aside a transfer. The assets transferred constitute a "trust fund" for the creditor (the IRS), and each transferee is jointly and severally liable to the extent of the value of the assets received. The IRS must prove the following: a transfer of assets occurred; the transferor was insolvent at time of transfer, or the transfer was part of a series of transactions which made the transferor insolvent; the value of the transferred property; and that a proceeding against the transferor would be pointless. The IRS is not required to issue a notice of deficiency to the transferee prior to bringing suit.

Transferee also a creditor of the transferor: In at least one case, a transferee was able to limit her liability to the IRS by showing that she was a creditor of the transferor, and the transferred assets were allocated among her and the IRS based on the size of all creditors' claims.[24]

Nominee or Alter Ego Liability

When a transferee is proved to be a taxpayer's "nominee" or "alter ego," the IRS can proceed as if there had been no transfer. The IRS can use a lien properly filed on the taxpayer to collect on transferred assets, even though they are no longer in the taxpayer's name. In dicta, the U.S. Supreme Court approved the use of the alter ego concept in the collections context in *G.M. Leasing Corp. v. United States*, 429 U.S. 338 (1977).

Factors previously considered by courts in determining whether a transferee is a nominee include the following: the taxpayer continued to use the transferred property; the taxpayer continued to maintain insurance on the property; the taxpayer continued to manage the property; the taxpayer paid the upkeep and the mortgage; a close relationship between the transferor and transferee; the transfer was in anticipation of a lawsuit; and the transfer was unrecorded.

Some courts also look to state law concepts of "piercing the corporate veil" to determine whether a transferee is an alter ego of the taxpayer. These factors include the level of control asserted over the transferee, the use of the transferee for the taxpayer's benefit or to shield the taxpayer from liability, and commingling of assets, among others.

Fiduciary Liability

Any fiduciary who pays other debts before paying a claim of the government is personally liable to the full extent of the debts paid.[25] This is a particularly harsh form of liability, and courts have narrowly construed it for this reason.[26]

A "fiduciary" is defined as any "guardian, trustee, executor, administrator, receiver, conservator, or any person acting in a fiduciary capacity for any person."[27] A "debt" includes a beneficiary's distribution from an estate.[28]

This form of liability is narrowly construed, and is imposed only where a fiduciary, in the exercise of his free choice, has chosen to pay a debt due from the person or estate for whom he acted in preference to the latter's liability to the United States.[29]

A fiduciary may raise the defense of lack of knowledge that the debt was due to the United States. The fiduciary must have had either (a) actual knowledge, or (b) knowledge of enough facts to put a reasonably prudent person on notice of the tax liability.

Transferee Liability In Equity

The IRS can proceed in equity against a transferee under either of two theories, the "trust fund" theory (described above), and fraudulent transfer (also described above).

Transferee Liability At Law

There are three types of transferee liability at law — contractual liability, statutory liability, and liability for estate and gift taxes.

Contractual liability: Use of this theory is fairly rare. Along with a transfer of assets, the transferee must expressly assume liability for payment of the transferor's federal taxes. The IRS must show: a transfer of property; liability for taxes at time of the transfer and at time the IRS seeks to collect; a valid contract between the taxpayer and transferee; and express assumption of liability by transferee.

The theory is that the IRS is a third-party beneficiary of the contract under state law. Thus, if state law does not have a theory of recovery for third-party beneficiaries, the IRS cannot use contractual liability but must resort to other methods of collection. A contract to assume "all liabilities" or "all existing liabilities" of a successor is sufficient, but this contract has to be accompanied by a transfer of property. The tax liability must be enforceable at the time of the contract, e.g., it cannot be barred by the statute of limitations. Under this theory of liability, the IRS does not have to prove insolvency of the taxpayer, exhaustion of remedies against the taxpayer, or the value of the transferred assets. Contractual liability is not limited to the value of the assets the transferee receives.

Statutory liability: This is triggered by state bulk sales acts and state corporation laws. A transferee who purchases all or most assets of a business may incur transferee liability for unpaid federal taxes. Depending on the state statute, a corporation which merges with a taxpayer with outstanding tax liabilities may be directly liable as standing in the shoes of the taxpayer, rather than liable through Section 6901. Although no cases have addressed it, direct liability appears to be the rule in Texas.[30] In addition, bulk sales/transfer laws can give rise to transferee liability. Texas has no bulk sales/transfers law. (Article 6 of the UCC was repealed in the early 1990s.)

Liability for Estate and Gift Taxes: Under Section 6324(a)(2), transferees who receive property from an estate are liable for unpaid estate taxes to the extent of the value of the property received. Value is determined as of the date of death. Federal courts currently disagree whether the IRS must assess against the transferee under Section 6901 or may rely on the original assessment against the estate.[31]

In addition, Section 6324(b) imposes a 10-year lien, running from the date of the gift, on any gift to the extent of the gift's value. Essentially the same rules as for gift taxes apply to generation-skipping taxes.

Under Section 2056A, trustees of Qualified Domestic Trusts (QDOTs) may be personally liable for estate taxes if a trust distribution is made before the death of the surviving spouse and if any property remains in the trust on the death of the surviving spouse.

Section 6901

Section 6901 is only an enforcement mechanism, not an independent source of taxpayer liability.[32] The IRS may assess the liability of the taxpayer against the transferee in the same manner and to the same extent as the IRS could against the taxpayer. Under Rev. Proc. 2009-03, the IRS will no longer issue rulings or determination letters on whether a transferee is liable under Section 6901.

Liability under Section 6901 is either in law or in equity, and is generally determined by state law principles.[33] There are two overarching requirements: a transfer of property to a third party; and the taxpayer-transferor is liable for the tax at the time of the transfer and at the time the IRS asserts transferee liability.

There are exceptions to the principle that state law governs. This includes liability under the FDCPA (see above), transfers of property from an estate (Section 6324(a)), and donees of taxable gifts (Section 6324(b)).

Transfer of property - Section 6901(a)(1): The requirement of a "transfer" of property is loosely construed, and courts look to state law to determine whether a transfer has occurred. Passing of title is not determinative; rather, any transaction which makes the transferee liable at law or in equity to the government as a creditor of the taxpayer is considered a transfer. Some examples include: discharge by the taxpayer of obligations of another person; corporate dividend paid to a sole shareholder in the form of cancellation of indebtedness of the taxpayer to the corporation; corporate liquidating distributions paid for a taxpayer's benefit or for any personal reason of the taxpayer; payment of excessive or unreasonable salaries; lease arrangements in which the payments are treated as distributions of corporate assets.

Liability of the taxpayer: Under 6901, the taxpayer must have been liable for the tax both at the time the property is transferred and at the time the IRS seeks to enforce liability against the transferee. For example, if an estate has valuation issues, there is no transferee liability until those issues are resolved. Judicial determinations of the liability of the taxpayer are also binding on the transferee, even if those decisions were by stipulation or consent. Payment by the taxpayer extinguishes liability for transferees, and payment by one transferee extinguishes liability against others.

Retransfers: If state law provides for it, the retransfer of property subject to a federal tax liability back to the taxpayer will extinguish transferee liability. The retransfer must occur before the IRS commences collection actions against the transferee.

Who Is A Transferee Under Section 6901?

An often-cited definition of a transferee is "[o]ne who takes the property of another without full, fair and adequate consideration to the prejudice of creditors."[34] Donees, heirs, legatees, devisees, distributees, and all of those liable under Section 6324 for estate and gift taxes are transferees.[35] Also, distributees of an estate, shareholders of a dissolved corporation, and parties to a Section 368 reorganization are transferees.[36]

Beneficial use of property required: If a transferee receives "bare legal title" without beneficial use of property, transferee liability is not applicable. The agency relationship must be clearly established.

Sale and purchase of corporate stock and assets:

Stockholders: Stockholders who receive liquidating distributions from a corporation which has not made adequate provisions to pay federal taxes are usually liable as transferees under Section 6901. Where a corporation liquidates its assets and then distributes the proceeds to the stockholders, the stockholders are transferees under Section 6901. The time of the stock acquisition has been held irrelevant for transferee liability purposes.[37] Generally stockholders are considered "transferees" rather than "fiduciaries" subject to broader liability (see above).

"Distributions" for this purpose also include constructive distributions. Thus, if an stockholder is also an officer or director who receives an excessive salary, the stockholder can be treated as a transferee. Another common situation giving rise to transferee liability is a lease arrangement where the lessee is obligated to make payments to the stockholders directly. Also, where a controlling stockholder directs the corporation to satisfy his/her obligations before tax liabilities, that stockholder is a transferee.

Stock sales: When stockholders sell their stock to a third party who then liquidates the corporation, the stockholders are not transferees. The third-party purchaser is a transferee, though.

It is often difficult to distinguish between a stock sale to a third party followed by a liquidation and a sale of corporate assets followed by a liquidating distribution.[38] Because the form of the liquidating transactions is so important for transferee status under Section 6901, buyers and sellers should carefully review their agreements. Courts generally will respect the form of the agreements if the transaction is not a sham.[39]

Corporate successors/asset sales: When a person purchases all of the assets of a corporation for full value, the purchaser is not a transferee. This should be compared to a stock sale, in which the purchaser usually incurs transferee liability.

There are six exceptions to the rule that corporate successors are not transferees: the purchaser assumes "all liabilities" of the predecessor corporation; the transaction is a merger or consolidation under state law, and state law provides for assumption of all liabilities of predecessor; the transaction is a de-facto merger under state law, and state law provides for assumption of all liabilities of predecessor; the successor corporation is merely a name change or a continuation of the predecessor; the acquisition of assets is a fraud on creditors of the predecessor; the consideration for the sale flows directly to predecessor's stockholders.

Creditors and borrowers: A creditor is not a transferee if the payment discharges a valid debt. This is true even if the creditor is also a stockholder, so long as the stockholder can prove the debt was bona fide and the payment was not intended to prejudice the rights of other creditors. A debtor is not a transferee so long as the promise to repay is fair consideration.

Fiduciaries: Estates, executors of estates, trustees of testamentary trusts, and bankruptcy trustees all can be transferees. These relationships also can trigger fiduciary liability (see above).

Life insurance beneficiaries: In the Fifth Circuit, a life insurance beneficiary is liable as a transferee up to the amount of premiums, if any, which were fraudulently paid by the insured.[40]

Pension beneficiaries: The IRS has taken the position that pension benefits are not subject to transferee liability to the extent they are exempt from creditors' claims under state law.[41] Pension benefits are exempt property in Texas.[42]

Partners and partnerships: Partners are liable as transferees if a partnership receives assets subject to federal tax liability.[43] Transferees of partnership interests may be transferees if state law provides that partnership interests are property.

Transferees of transferees: Subsequent transferees are also liable under Section 6901, but a special statute of limitations applies.[44] Their liability is limited to the value of the assets received from the first transferee.

Intermediary Transaction Tax Shelters and Transferee Liability

Currently, the IRS is examining the gain resulting from intermediary asset/stock sale transactions. Participation in one of these transactions does not result in transferee liability *per se*; the IRS must establish the elements of transferee liability.

Notice 2008-111 describes the basic transaction. A seller owns certain stock of a corporation, and desires to sell the stock. The corporation has assets with large built-in gains. A buyer desires to buy the assets and receive a stepped-up basis. The seller sells all of its stock to an intermediary, which is the parent of a consolidated group which anticipates a loss for the year. The corporation now is part of the consolidated group. The corporation transfers the relevant assets to the buyer, who receives the stepped-up basis. The seller recognizes no gain because the capital gains are offset by the group's losses.

Essentially, the issue for transferee liability is whether the transactions should be characterized as an asset sale (triggering liability for the seller) or a stock sale (potentially triggering liability for the buyer). It is possible that the transaction could qualify as a Section 332 liquidation. This would allow the buyer to avoid transferee liability, but the buyer would lose the stepped-up basis.

IRS CC-2001-023 discusses the IRS's considerations for characterizing a transaction like the one above as either an asset sale or a stock sale. Much depends on who is viewed as the shareholder of the corporation immediately preceding the corporation's liquidation. The following factors are considered important by the IRS: how the transaction was originally negotiated and characterized; who introduced the intermediary to the transaction; who was responsible for compensating and indemnifying the intermediary; if either buyer or seller arranged financing for the intermediary; and who received the primary benefit from the transaction. Other IRS guidance on this issue can be found in Notice 2001-16, Coordinated Issue Paper (Dec. 19, 2002), and Industry Directive (Jan. 12, 2006).

Extent of Transferee Liability

Under any theory, a transferee's liability is limited to either the amount of the tax shown on the return or to any deficiency or underpayment of any tax. Liability is also limited to the unpaid tax liability of the taxpayer for the tax year during which the transfer took place, plus the taxpayer's unpaid tax liabilities for prior years. The transferee is only liable for taxes which accrued until the time of the transfer and is not liable for taxes that are unpaid after that date. Also, the transferee's liability is reduced by the consideration paid for the asset.

Transferee's liability in equity: This is limited to the value of the assets received from the taxpayer. "Value" is measured by the value of the assets on the date of transfer, and later sales prices are irrelevant.[45] The value is further reduced by any fixed liabilities like mortgages encumbering the transferred property. In addition, value is determined by the fair market price of the asset on the date of the transfer. Thus, if the transferee paid a bargain price, the transferee is liable only to the extent of the excess of the fair market value of the property over the consideration paid.

The IRS has unsuccessfully argued that the transferee should be liable for the amount by which he/she rendered the taxpayer insolvent. Also, if the taxpayer is not insolvent and has assets available to the IRS at the time the IRS pursues transferee liability in equity, the transferee's liability is reduced by the value of the taxpayer's assets.

Transferee's liability at law: This is determined by the scope of the transferee's express agreement with the taxpayer.

Penalties and interest: A transferee generally is liable for penalties and interest on the tax due. A transferee cannot be liable for more than the value of the assets transferred. But a transferee is liable for the full amount of the deficiency until it is paid, including penalties and interest.[46]

When the value of the assets is less than the liability, the transferee may still be liable for interest accruing until the date of the notice of deficiency to the transferee, depending on state law.[47] Texas does not specifically provide for payment of interest, but a creditor is entitled to "any other relief" as well as avoidance of the transfer.[48] Although no cases have addressed this issue, it appears the IRS could seek payment of interest from a transferee.

Interest accruing after the date of the notice of deficiency to the transferee is a matter of federal law, and the transferee is liable for this regardless of the value of the property. (There is some debate about this in the estate and gift tax context.)

Defenses to Transferee Liability

While the availability of these defenses depends on what theory of liability the IRS is pursuing, transferees have used the following defenses to transferee liability:

- ∑ expiration of the statute of limitations;
- ∑ return of all or part of the transferred property;
- there was no transfer;
- ∑ the tax has been paid by or on behalf of the transferor;
- ∑ the transfer occurred before the tax year of the transferor for which the income tax liability was assessed;
- ∑ the transferor was not liable for the tax;
- ∑ the transfer was made for full and adequate consideration; or
- ∑ the IRS has not exhausted its remedies against the transferor.

The innocent spouse defense is not available in the transferee liability context.[49]

Section 6901 Assessment Procedure

Section 6901 does not create liability but gives the IRS a summary procedure for collection of unpaid taxes against transferees. Section 6901(a) provides that a transferee is subject to the same assessment, payment and collection procedures and the same limitations, as apply to a transferor. This means that the IRS must issue a notice of deficiency to the transferee under Section 6212. (No notice of deficiency is required prior to enforcement of a gift and estate tax lien under Section 6324, however.) The notice must determine that the individual is liable as a transferee and notify the individual that the IRS proposes to assess a liability against him/her. The notice is valid if it goes to the "last known address" of the transferee.

Statute of limitations on assessment: Because Section 6901(a) provides that the same rules apply to assessment and collection against the transferee as against the transferor, the initial transferee is subject to the Section 6501 statute of limitations. Section 6501 generally requires assessment within three years from the date on which the return was filed, but is subject to numerous exceptions. Section 6901(c)(1) extends the three-year statute by one additional year beyond the expiration of the period of assessment against the taxpayer.

Where the transferor requests a prompt assessment

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under Section 6501(d), the period for assessment against the transferor ends 18 months after the written request is filed, or three years from the date of filing of the return, whichever period expires first.

Transferees of transferees are subject to a special rule: the IRS must assess liability against the transferee of a transferee within one year from the expiration of the period of limitations against the preceding transferee, but not later than three years from expiration of the period of limitations for assessment against the initial transferor.[50]

Any agreement to extend the statute of limitations made by the taxpayer may also bind the transferee, depending on the terms of the agreement. Moreover, the death of the taxpayer is immaterial for purposes of transferee assessments, and the statute is measured as if the taxpayer had not passed away.[51] Also, the assessment statute is suspended after a notice of deficiency is issued and during the pendency of any court proceeding.[52]

Filing suit to challenge the notice of deficiency: The same rules apply for a transferee as for a regular taxpayer. The transferee may bring suit in Tax Court within 90 days of the notice without paying the underlying deficiency. The transferee may also pay the liability and file a suit for refund in district court.

The transferee also has the option to seek an injunction against collection in district court. The Anti-Injunction Act, Section 7421, does not prohibit this type of suit, but it is rare. The burden is on the transferee to demonstrate that he/she is not, in fact, a transferee. The transferee must also show that (1) it is clear that under no circumstances can the government prevail; and (2) equity jurisdiction otherwise exists (the plaintiff shows that he would otherwise suffer irreparable injury). This option apparently has never been used in the Fifth Circuit.[53]

IRS collection actions: The IRS has all of its usual methods of collection available, including levy, lien, suit to enforce a lien, or suit to reduce amount to judgment under Section 7402. As discussed above, the IRS also has equitable remedies available under state law. Under Section 6502, IRS collection suits are subject to a 10-year statute of limitations running from the date of assessment. If the IRS brings suit against the transferee, the IRS bears the burden of proof.

Bankruptcy issues

Release of the taxpayer's liability in bankruptcy does not release the transferee, and does not release any lien imposed on the property prior to the transfer. On the other hand, if the transferee is in bankruptcy, the liability can be released under certain limited conditions.

Conclusion

The challenges and opportunities presented by the current economic environment can trigger complex tax problems. In advising your clients who are thinking of closing down or purchasing a business, it is important to be aware of the contours of responsible person liability and transferee liability under the Internal Revenue Code.

ENDNOTES

1 Sonnenschein Nath & Rosenthal LLP, 2000 McKinney Avenue, Dallas, Texas 75201, 214-259-0900
2 Section 7501(a); Treas. Reg. §§ 31.6011(a)-1(a) and 301.6070(a)-1(a).
3 Section 31.
4 All references to "Sections" in this article refer to provisions of the Internal Revenue Code of 1986, 26 U.S.C, *et. seq.*
5 *Stewart v. U.S.*, 19 Cl. Ct. 1 (1989).
6 *Brinskele v. U.S.*, 73 Fed. Cl. 277 (2006).
7 *Cash v. Campbell*, 346 F.2d 670 (5th Cir. 1965).
8 Section 6672(a).
9 *Commonwealth Nat'l Bank of Dallas v. U.S.*, 665 F,2d 742 (5th Cir. 1982),
10 *Bean. v. U.S.*, 103 AFTR 2d 2009-420 (S.D. Tex. 2009).
11 *Id.*
12 *Mazo v. U.S.*, 591 F.2d 1151 (5th Cir. 1979).
13 *Howard v. U.S.*, 711 F.2d 729 (5th Cir. 1983).
14 *Id.*
15 *Newsome v U.S.*, 431 F.2d 742 (5th Cir. 1970).
16 *U.S. v. Rineer*, 03 AFTR 2d 2009-334 (N.D. Tex.)(internal quotations omitted).
17 *See Newsome v U.S.*, 431 F.2d 742 (5th Cir. 1970)
18 *Haslett v. U.S.*, 103 AFTR 2d 2009-796 (D. AK.).
19 *Young v. U.S.*, 609 F. Supp. 512, 518 (N.D. Tex. 1985).
20 *See* Tex. Bus. & Com. Code §§ 24.001 *et seq.* ("TUFTA").
21 Tex. Bus. & Com. Code § 24.003(a-b).
22 *See Johnson v. Commissioner*, 118 T.C. 74 (2002) (Texas case involving a transfer to an insider/creditor).
23 *See U.S. v. Summerlin*, 310 U.S. 414 (1940). Texas courts have agreed. *See U.S. v. Evans*, 513 F.Supp.2d 825, 837-38 (W.D. Tex. 2007).
24 *See Albert v. Commissioner*, 56 T.C. 447 (1971) (Texas case).
25 31 U.S.C. § 3713(b).
26 *See, e.g., U.S. v. Evans*, 513 F.Supp.2d 825 (W.D. Tex. 2007) (finding issue of fiduciary liability was res judicata because of prior agreed judgments on transferee liability).
27 Section 7701(a)(6).
28 Treas. Reg. § 20.2002-1.
29 PLR 9306011.
30 *See* Tex. Bus. Corp. Act § 5.06(A)(3) (stating that "all liabilities" of the predecessor corporations survive a merger).
31 *See U.S. v. Davenport*, 327 F.Supp.2d 725 (S.D. Tex. 2004), *rev'd on other grounds* 484 F.3d 321 (5th Cir. 2007) (holding that no Section 6901 assessment was required).
32 *See Streber v. Hunter*, 221 F.3d 701, 716 n.18 (5th Cir. 2000).
33 *U.S. v. Stern*, 357 U.S. 39 (1958).
34 *First Nat'l Bank of Chicago v. Comm'r*, 255 F.2d 759 (7th Cir. 1958).
35 Section 6901(h).
36 Treas. Reg. § 301.6901-1(b).
37 *Miller v. Commissioner*, T.C. Memo 1975-356.
38 *See Bates Motor Trans. Lines v. Comm'r*, 200 F.2d 20 (7th Cir. 1952); *Vendig v. Comm'r*, 229 F.2d 93 (2d Cir. 1956).
39 *See Pittsburgh Realty Inv. Trust v. Comm'r*, 67 T.C. 260 (1976) (purchaser unsuccessfully asked court to disregard the form of the sale and impose transferee liability on the sellers/stockholders).
40 *U.S. v. Truax*, 223 F.2d 229 (5th Cir. 1955).
41 PLR 7825086; PLR 8125045.
42 Tex. Prop. Code § 42.0021.
43 *See Comm'r v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962).
44 Section 6901(c)(2).
45 *See U.S. v. Estes*, 450 F.2d 62 (5th Cir. 1971).
46 *See Lowy v. Commissioner*, 35 T.C. 393 (1960).
47 *See Stanbury v. Commissioner*, 104 T.C. 486 (1995) (holding that a transferee is liable for interest from the date of the transfer if the IRS would be entitled to interest during such period as a creditor under state law).
48 Tex. Bus. & Comm. Code § 24.008.
49 *See United States v. Shanbaum*, 10 F.3d 305 (5th Cir. 1994).
50 Section 6901(c)(2).
51 Section 6901(e).
52 Section 6901(f).
53 *See Brittingham v. Commissioner*, 451 F.2d 315, 318-19 (5th Cir. 1971) (declining to consider whether injunction would be available because IRS has not asserted transferee liability against plaintiff).

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PUBLIC OR PRIVATE? HOW THE DISTINCTION MAY AFFECT YOUR COMPANY'S EXECUTIVE COMPENSATION PRACTICES

Katy B. Zarolia1

Is your company public or private? The answer may not be as simple as whether the company's stock is traded on a national securities exchange, such as the New York Stock Exchange ("NYSE"). The terms "publicly held corporation," "publicly traded" and "readily tradable" are scattered throughout the Code[2] and a determination that a company is a "publicly held corporation" for one purpose does not necessarily mean that it is "publicly traded" for another. This article takes a look at how these terms are defined in some of the key executive compensation provisions of the Code, including sections 162(m), 280G, and 409A, and how the determination of whether a company is public or private can affect the application of those sections. While this article provides a general overview of Code sections 162(m), 280G, 409A, and the other Code sections discussed herein, it assumes that the reader is somewhat familiar with the general requirements of these Code sections, and thus, does not provide an in-depth discussion of all of the requirements of each Code section discussed.

THIS ARTICLE MAY ANSWER GENERAL QUESTIONS THAT MAY ARISE WITH REGARD TO CODE SECTIONS 162(m), 280G, AND 409A AND THE OTHER GUIDANCE ISSUED THEREUNDER, BUT SHOULD NOT BE RELIED UPON TO ANSWER SPECIFIC QUESTIONS. THIS ARTICLE IS FOR EDUCATIONAL PURPOSES ONLY. NOTHING HEREIN SHALL CONSTITUTE LEGAL ADVICE BY THE AUTHOR OR THE LAW OFFICES OF HAYNES AND BOONE, L.L.P. ANY TAX ADVICE CONTAINED IN THIS OUTLINE 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 OTHER MATTER ADDRESSED HEREIN. EACH CASE VARIES DEPENDING UPON ITS FACTS AND CIRCUMSTANCES. ANYONE SEEKING TAX ADVICE SHOULD CONSULT WITH HIS, HER, OR ITS TAX ADVISOR.

Introduction

In today's challenging economic times, many public companies may find themselves faced with the possibility of being de-listed from the national securities exchange on which their stock is traded for failure to maintain the listing requirements of the exchange, such as minimum stock price and market capitalization. While the NASDAQ and NYSE have temporarily suspended or loosened these listing requirements in response to the market's volatility and the current economic hardships facing many companies, such modifications in the listing requirements cannot be expected to continue indefinitely. Consequently, a company that once was considered a "publicly held corporation" for purposes of Code section 162(m), or that had stock that was "readily tradable on an established securities market" for purposes of Code sections 280G and 409A, may find that, after it has become de-listed, it is no longer a "publicly held corporation" or has stock that is "readily tradable," even if the stock is traded on an over-the-counter market, such as the pink sheets. Additionally, as companies look to potential mergers as a method of surviving the current financial crisis, private companies may find that, as a result of a merger or acquisition, they are now considered "publicly held" for purposes of Code section 162(m) or have stock that is "readily tradable on an established securities market" for purposes of Code sections 280G and 409A.

Whatever the reason for it, a change in a company's status as public or private can have repercussions under the Code. This article takes an in-depth look at how the terms "publicly held corporation," "publicly traded" and "readily tradable" are defined in the various Code sections governing executive compensation and provides practical tips for interpreting these sections in today's economy. Companies considering a merger or acquisition, or facing de-listing, should consider the potentially adverse, and perhaps unexpected, tax consequences that may result from such transactions.

Code Section 162(m)

Code section 162(m) generally prohibits "publicly held corporations" from taking a federal income tax deduction for the compensation of the chief executive officer and the three highest compensated officers (other than the chief executive officer and chief financial officer) that exceeds $1 million in any tax year. <u>See</u> I.R.C. §162(m)(1) and IRS Notice 2007-49. If a company is subject to the limits of Code section 162(m), it may exempt certain compensation, such as performance-based compensation, from the $1 million cap if specific requirements outlined in the Treasury Regulations are met. <u>See</u> I.R.C. §162(m)(4).

For purposes of Code section 162(m), the term "publicly held corporation" means "any corporation issuing any class of common equity securities *required to be registered* under section 12 of the Securities Exchange Act of 1934" (the "Exchange Act"). I.R.C. §162(m)(2). (emphasis added) The legislative history for the Revenue Reconciliation Act of 1993, under which section 162(m) was added to the Code, sheds some light on what it means for equity securities to be "required to be registered." "In general, the [Exchange Act] requires a corporation to register its common equity securities under section 12 if: (1) the securities are listed on a national securities exchange, or (2) the corporation has $5 million or more of assets and 500 or more holders of such securities." H.R. Rep. No. 103-213, at 93 (1993). The same rule applies today, except that the requirement that the corporation has assets of $5 million or more has been increased to $10 million or more. <u>See</u> SEC Release No. 34-37157.

While a company may voluntarily register its equity securities with the Securities and Exchange Commission (the "SEC"), it will not be considered a "publicly held corporation" for purposes of Code section 162(m) if such registration is voluntary. <u>See</u> Treas. Reg. §1.162-27(c)(1)(i). The legislative history provides the following example of a voluntary registration: "Such a voluntary registration might occur, for example, if a corporation that otherwise is not required to register its equity securities does so in order to take advantage of other procedures with regard to public offerings of debt securities." H.R. Rep. No. 103-213, at 93 (1993).

When determining whether a corporation is required to be registered under the Exchange Act, it is important to consider all corporations which are part of the same affiliated group. "A publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b))." Treas. Reg. §1.162-27(c)(1)(ii). Generally, corporations will be included in an affiliated group if each corporation owns at least 80% of the voting power of the stock and has a value equal to at least 80% of the total value of the stock of the corporation directly below it. See I.R.C. §1504(a). "However, an affiliated group of corporations does not include any subsidiary that is itself a publicly held corporation. Such a publicly held subsidiary, and its subsidiaries (if any), are separately subject to [Code section 162(m)]." Treas. Reg. §1.162-27(c)(1)(ii).

"Whether a corporation is publicly held is determined based solely on whether, as of the last day of its taxable year, the corporation is subject to the reporting obligations of section 12 of the Exchange Act." Treas. Reg. §1.162-27(c)(1)(i). The examples in the Treasury Regulations suggest that a corporation is subject to the reporting obligations of section 12 of the Exchange Act as of the date it is required to file a registration statement.

The following two examples were taken from the Treasury Regulations, but have been modified to incorporate changes to the Exchange Act and use more recent dates:

Example 1: Private Company Goes Public

> Corporation W, a calendar year taxpayer, has total assets equal to or exceeding $10 million and a class of equity security held of record by 500 or more persons on December 31, 2008. However, under the Exchange Act, Corporation W is not required to file a registration statement with respect to that security until April 30, 2009. Thus, Corporation W is not a publicly held corporation on December 31, 2008, but is a publicly held corporation on December 31, 2009. Treas. Reg. §1.162-27(c)(6), Ex. 3.

Example 2: Public Company Goes Private

The preamble to the proposed Treasury Regulations under Code section 162(m) addressed the situation of a publicly held corporation that "goes private." "If a corporation reports income on a calendar-year basis, the corporation is subject to section 162(m) only if its common equity securities are required to be registered under the Exchange Act on December 31. Thus, a corporation that 'goes private' during the year is not subject to section 162(m) for that year." 58 Fed. Reg. 66310. The following example illustrates this point:

> The facts are the same as in the previous example, except that on December 15, 2008, Corporation W files with the Securities and Exchange Commission to disclose that Corporation W is no longer required to be registered under section 12 of the Exchange Act and to terminate its registration of securities under that provision. Because Corporation W is no longer subject to Exchange Act reporting obligations as of December 31, 2008, Corporation W is not a publicly held corporation for taxable year 2008, even though the registration of Corporation W's securities does not terminate until 90 days after Corporation W files with the Securities and Exchange Commission. Treas. Reg. §1.162-27(c)(6). Ex. 4.

Example 3: Two Private Companies Merge

Corporation A and Corporation B, each with no common equity securities required to be registered under section 12 of the Exchange Act, merge on December 31, 2008. Upon completion of the merger, the total assets and number of equity security holders of the surviving corporation exceeds the limits set forth in section 12 of the Exchange Act. The surviving corporation is subject to the reporting obligations of section 12 of the Exchange Act and is considered a "publicly held corporation" for purposes of Code section 162(m). Because the surviving corporation is not required to file its registration statement until April 30, 2009, the surviving corporation is not considered a "publicly held corporation" for purposes of Code section 162(m) until December 31, 2009.

The determination that a private company is now "publicly held" for purposes of Code section 162(m) can have adverse tax consequences. However, the Treasury Regulations provide some transitional relief.

Under the Treasury Regulations, the $1 million deduction limit does not apply to "any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held." Treas. Reg. §1.162-27(f)(1). The publicly held corporation may rely on this transitional relief until the earliest of:

(i) "the expiration of the plan or arrangement;

(ii) the 'material modification' of the plan or arrangement;

(iii) the issuance of all employer stock and other compensation that has been allocated under the plan; or

(iv) the first meeting of shareholders at which directors are to be elected that occurs after the close of third calendar year following the calendar year in which the initial public offering occurs or, in the case of a privately held corporation that becomes publicly held without an initial public offering, the first calendar year following the calendar year in which the corporation becomes publicly held." Treas. Reg. §1.162-27(f)(2).

The transitional relief applies to any compensation received pursuant to the exercise of a stock option or stock appreciation right or the substantial vesting of restricted stock granted under a plan in existence prior to the time the corporation became publicly held, if the grant occurs on or before the earliest of the events specified in the prior paragraph. See Treas. Reg. §1.162-27(f)(3).

"A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee." Treas. Reg. §1.162-27(h)(1)(iii). "A modification of the contract that accelerates the payment of compensation will be treated as a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on either a reasonable rate of interest or one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of the specific investment (including any decrease as well as any increase in the value of the investment)." Treas. Reg. §1.162-27(h)(1)(iii)(B).

Private companies considering a merger should give careful consideration to Code section 162(m) when conducting their due diligence of each other's employee benefit plans. Despite the fact that the companies may not intend to have the surviving corporation's securities publicly traded on a national securities exchange, the surviving corporation will be considered a "publicly held corporation" for purposes of Code section 162(m) if the asset and shareholder thresholds of section 12 of the Exchange Act are surpassed, as illustrated by Example 3 above. While the Treasury Regulations provide some relief from the application of Code section 162(m) for corporations that become "publicly held," the surviving corporation should be cognizant of the application of Code section 162(m) so that it may consider whether structuring new compensation arrangements in bonus plans and employment agreements in a way to fit within one of the exceptions under Code section 162(m), such as the exception for performance-based compensation, would be in the best interest of the surviving corporation.

Code Section 280G

Code section 280G was added to the Code as part of the Deficit Reduction Act of 1984, in part, because Congress viewed golden parachute payments as hindering "acquisition activity in the marketplace and, as a matter of policy, should be strongly discouraged." Joint Comm. on Int. Rev. Tax., 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 199 (1984). Today, critics of golden parachutes find fault in such payments, not because they hinder mergers and acquisitions, but because they often reward executives for failure. RiskMetrics Group, a leading proxy advisor, recently stated, "severance provisions should not be so appealing that they become an incentive for the executive to be terminated." RiskMetrics Group, U.S. Corporate Governance Policy, 2009 Updates, Nov. 25, 2008. Despite the criticism, golden parachutes remain a common fixture in executive employment agreements.

A parachute payment is generally any payment in the nature of compensation that is (i) contingent on a "change in control" of the corporation, (ii) payable to an officer, highly compensated employee, or more than one-percent shareholder of the corporation (i.e. a "disqualified individual"), and (iii) in excess of a safe harbor amount. See I.R.C. §280G(b)(2). A "change in control" generally means any change in the ownership of the corporation, the effective control of the corporation, or the ownership of a substantial portion of the assets of the corporation. Id. Code section 280G generally disallows a federal income tax deduction for any "excess parachute payment" (i.e., parachute payments in excess of the disqualified individual's five-year average compensation). See I.R.C. §280G(a). In addition, the individual who receives the excess parachute payment in connection with a change in control is subject to a 20% excise tax under Code section 4999. See I.R.C. §4999(a).

In its original form, Code section 280G applied to all corporations that underwent a change in control. However, two years after its initial enactment, Congress passed the Tax Reform Act of 1986, limiting the scope of Code section 280G by adding an exemption for corporations which do not have any stock that is "readily tradable on an established securities market." See I.R.C. §280G(b)(5).

Code section 280G exempts from the definition of "parachute payment" any payment to a disqualified individual with respect to a corporation (other than a small business corporation) if immediately before the change in control, "no stock in such corporation was readily tradable on an established securities market or otherwise" and the shareholders approve the payment. See I.R.C. §280G(b)(5)(A)(ii). In order to meet the requirements of the exemption, the shareholders must receive adequate disclosure of all material facts concerning the payments that would be "parachute payments" but for the exemption, and the payments must be approved by a vote of the shareholders who, immediately before the change in control, owned more than 75 percent of the voting power of all outstanding stock of the corporation. See I.R.C. §280G(b)(5)(B).

The exemption is not available with respect to a corporation if "a substantial portion of the assets of any entity consist (directly or indirectly of stock in such corporation and any ownership interest in such entity is readily tradable on an established securities market or otherwise." Treas. Reg. §1.280G-1 Q&A-6. Further, if a corporation is a member of an affiliated group, the exemption is not available "if any stock in any member of such group is readily tradable on an established securities market or otherwise." Id.

"Stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock." Id. The phrase "readily tradable" is used in various sections of the Code and is consistently defined to mean "regularly quoted by brokers or dealers making a market" in such stock. See I.R.C. §§453, 897, 367, 3406, among others. However, the Code and Treasury Regulations do not offer any guidance on what "regularly" means, and the Internal Revenue Service ("IRS") has not issued any other guidance in the form of Private Letter Rulings ("PLRs"), Revenue Rulings, etc. on the issue.

"The term *established securities market* means an established securities market as defined in §1.897-1(m)." Treas. Reg. §1.280G-1 Q&A-6.

Treas. Reg. §1.897-1(m) defines an "established securities market" as:

(i) "a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f),

(ii) a foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and

(iii) any over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer." Treas. Reg. §1.897-1(m).

In 2004, the IRS issued Revenue Ruling 2004-87, which addressed whether a corporation whose stock is de-listed, but traded on an over-the-counter market (such as the pink sheets), is a corporation whose stock is "readily tradable" for purposes of Code section 280G. While the Revenue Ruling is set in the context of a corporation in bankruptcy, it sheds light on how the IRS might view similar corporations in a non-bankruptcy context. The Revenue Ruling held that stock of a corporation that is de-listed from an established securities market and for which no trading occurred on any market (including any over-the-counter market) was considered not readily tradable on an established securities market for purposes of Code section 280G. See Rev. Rul. 2004-87. However, the answer is not quite as clear with respect to stock of a corporation that is de-listed but traded on an over-the-counter market (such as the pink sheets). The Revenue Ruling held that "the trading of stock on an over-the-counter market (e.g. the pink sheets, the OTCBB, the ACT, or any similar market) when the corporation is a debtor in a case under the Bankruptcy Code is *impaired*, and therefore, the stock is not considered "readily tradable" for purposes of section 280G." Id. (emphasis added)

Would it be reasonable to conclude, therefore, that the trading of a corporation's stock on the pink sheets, where such trading is not "impaired" due to bankruptcy, would result in the stock being treated as "readily tradable"? As discussed below, the IRS has issued guidance under other sections of the Code that finds a company's stock that is traded on the pink sheets does not constitute stock that is "readily tradable on an established securities market." However, because Revenue Ruling 2004-87 qualifies its holding by making reference to the fact that the trading on the pink sheets was "impaired," it appears that the IRS has not closed the door on whether trading on the pink sheets in non-bankruptcy contexts will constitute stock that is "readily tradable" for purposes of Code section 280G.

If a corporation determines that it has no stock that is readily tradable on an established securities market, it is not automatically exempt from the requirements of Code section 280G, as is the case with a finding that a corporation is not a "publicly held corporation" for purposes of Code section 162(m). Rather, the corporation must meet the shareholder approval requirements set forth in the Treasury Regulations in order to exempt the payments from treatment as parachute payments. Such determination shall be made early in the merger or acquisition process so that the corporation can ensure that it provides its shareholders with adequate time to review and approve the parachute payments.

Code Section 409A

Section 409A was added to the Code by the American Jobs Creation Act of 2004 in an effort to regulate the payment of "non-qualified deferred compensation." The Code and the related Treasury Regulations impose restrictions on the form and operation of non-qualified deferred compensation plans, such as employment agreements, severance plans, and supplemental executive retirement plans ("SERPs"), just to name a few. The applicability of some of these restrictions depends on whether the service recipient (generally, the employer) is "publicly traded" or has stock that is "readily tradable on an established securities market."

One of the most important provisions of Code section 409A is the 6-month delay in payments upon the separation from service of a specified employee. "The term 'specified employee' means a service provider who, as of the date of the service provider's separation from service, is a key employee of a service recipient any stock of which is *publicly traded on an established securities market or otherwise*." Treas. Reg. §1.409A-1(i)(1). (emphasis added)

Just like in the Treasury Regulations under Code section 280G, the term "established securities market" means an established securities market within the meaning of Code §1.897-1(m). But, the term "publicly traded" is not defined in the Code or Treasury Regulations under Code section 409A.

The applicability of the provision exempting nonqualified stock options from Code section 409A also depends on whether the service recipient is public or private. Nonqualified stock options are exempt from section 409A of the Code if the exercise price of the option is at least equal to the fair market value of the stock on the date of grant. How "fair market value" is determined depends on whether the stock is "*readily tradable on an established securities market*." See Treas. Reg. §1.409A-1(b)(5)(iv). (emphasis added)

The preamble to the final Treasury Regulations under Code section 409A states that, in response to requests for additional guidance with respect to when a stock will be treated as readily tradable, "the final regulations adopt the same standard as that set forth in §1.280G-1, Q&A-6(e), that stock is treated as 'readily tradable' if it is regularly quoted by brokers or dealers making a market in such stock." 73 Fed. Reg. 19234.

Why did Congress use the term "publicly traded" for purposes of the definition of "specified employee" but "readily tradable" for the provision governing the valuation of stock? Unfortunately, the Treasury Regulations and legislative history do not offer any answers.

Because "publicly traded" is not defined in Code section 409A or the Treasury Regulations issued thereunder, we must look to other sections of the Code for guidance. Code section 401(a)(35), which requires defined contribution plans that hold publicly traded employer securities to meet certain diversification requirements, defines the term "publicly traded employer securities" to mean "employer securities which are readily tradable on an established securities market." I.R.C. §401(a)(35)(G)(v). Thus, it appears that "publicly traded," as used in the context of Code section 401(a)(35), has the same meaning as "readily tradable."

In at least two PLRs issued in the context of Code section 409 (dealing with employee stock ownership plans), the IRS has stated: "The Service has previously ruled that until regulations are issued defining 'readily tradable on an established securities market' under section 409(l), this term would be considered to have the same general meaning as 'publicly traded' under section 54-4975-7(b)(1)(iv) of the Excise Tax Regulations. Section 54-4975-7(b)(1)(iv) states that the term 'publicly traded' refers to a security that is listed on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) or that is quoted on a system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act (15 U.S.C. 780)." PLR 9036039 and PLR 200052014. While PLRs are specific to the taxpayer to whom they are issued and cannot be relied upon as providing authoritative guidance to other taxpayers, they may shed light on how the IRS would interpret "publicly traded" and "readily tradable" in other contexts.

Because Code sections 401(a)(35) and 409 define the terms "publicly traded" and "readily tradable" with reference to each other, it appears that such terms could be used interchangeably and have the same meaning. Therefore, it may be reasonable to interpret "publicly traded" and "readily tradable" also to have the same meaning for purposes of Code section 409A. Because Code section 409A defines the term "readily tradable," it may be reasonable to assume that "publicly traded," as used in the context of specified employees, also means "regularly quoted by brokers or dealers making a market."

Over-the-Counter Markets: No Bright Line Rule

Both the NYSE and NASDAQ require the companies listed on their exchanges to maintain a stock price of at least $1 per share and a minimum market capitalization. If the average closing stock price over a consecutive 30 trading day period is less than $1 per share, or the minimum market capitalization requirement is not met, the company could face the possibility of being de-listed. See NYSE Listed Company Manual and NASDAQ Listing Standards and Fees.

When the stock of a company becomes de-listed from the national securities exchange on which it was traded, the company may become privately-held, or it may become traded on an over-the-counter market, such as the pink sheets, which is a market for trading stock of companies that are not registered with the Securities Exchange and Commission and are not traded on NASDAQ, the NYSE or any other market.

As more companies face the prospect of being de-listed, it is likely that we will see a surge in companies trading on over-the-counter markets, such as the pink sheets. Therefore, it will be critical for the IRS to issue definitive guidance on whether trading on the pink sheets falls within the definition of trading on an "established securities market" for purposes of Code sections 280G and 409A.

The IRS has not addressed the issue of whether trading on the pink sheets constitutes trading on an "established securities market" for purposes of Code sections 280G and 409A, other than Revenue Ruling 2004-87, discussed above. However, the IRS has provided guidance on the issue in the context of other sections of the Code.

In PLR 9036039, discussed above, the IRS held that "unlike NASDAQ, the 'pink sheets' are not a system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act." PLR 9036039. Therefore, for purposes of the ESOP rules under Code section 409, trading on the pink sheets does not constitute trading on an "established securities market." However, before applying the guidance of this PLR to Code sections 280G or 409A, an important distinction should be made. The definition of "established securities market" for purposes of Code section 409 does not include "over-the-counter markets" as the definition of "established securities market" for purposes of Code sections 280G and 409A does. Therefore, notwithstanding the fact that trading on the pink sheets will not result in the stock being "readily tradable" for Code section 409 purposes, the same may not hold true for purposes of Code sections 280G or 409A.

In 2003, the IRS issued Notice 2003-71, which interpreted the term "readily tradable on an established securities market" for purposes of Code section 1(h)(11)(C)(ii). While this Code section does not specifically relate to executive compensation matters, it may be useful to consider because it uses the same phrase – "readily tradable on an established securities market" – as Code sections 280G and 409A. The Notice stated that for purposes of this Code section, stock is "considered readily tradable on an established securities market in the United States if it is listed on a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 or on the Nasdaq Stock Market." IRS Notice 2003-71. The Notice went on to state that the issue of stock traded on the pink sheets was left unanswered. See Notice 2003-71. However, Code section 1(h) does not define the term "established securities market," and therefore, perhaps the guidance issued under this Notice may also be distinguished.

While the guidance that the IRS has issued regarding trading on the pink sheets tends to conclude that such trading will not result in the stock being treated as "readily tradable on an established securities market" or "publicly traded," this does not appear to require the same result in the context of Code sections 280G and 409A because the definition of "established securities market" in Code sections 280G and 409A specifically includes "over-the-counter markets" whereas the definitions in the guidance issued does not. Therefore, until further guidance is issued with respect to the pink sheets, there does not appear to be a clear answer as to whether trading of stock on the pink sheets will result in such stock being treated as "readily tradable" or "publicly traded."

Looking Forward

Recent legislation has raised the question of whether the distinction between public and private companies may soon become a moot point for purposes of the Code sections discussed herein. The Emergency Economic Stabilization Act of 2008 ("EESA") and the American Recovery and Reinvestment Act of 2009 ("ARRA") amended Code sections 162(m) and 280G with respect to financial institutions receiving federal assistance through the Troubled Assets Relief Program ("TARP recipients"). See Emergency Economic Stabilization Act of 2008, P.L. 110-343, §302 and American Recovery and Reinvestment Act of 2009, P.L. 111-5, §7001. While these new provisions currently apply only to TARP recipients, it is not unreasonable to believe that they could one day apply to all companies.

Under section 302 of EESA, the $1 million cap on deductible compensation under Code section 162(m) is reduced to $500,000. As amended, the limits of Code section 162(m) apply regardless of whether the TARP recipient is a "publicly held corporation." Additionally, section 302 of EESA broadly expanded the scope of Code section 280G with respect to TARP recipients. As amended, Code section 280G is no longer limited to payments made in connection with a change in control. Rather, any severance payments to a "covered executive" made upon an involuntary termination, or in connection with a bankruptcy, liquidation, or receivership of the financial institution shall be subject to a potential lost tax deduction and imposition of the 20% golden parachute excise tax on the executive, regardless of whether a change in control has occurred. Further, the exemption for corporations in which no stock is readily tradable on an established securities market is not applicable. Section 7001 of the ARRA took the golden parachute rules even further by treating payments made upon a termination of employment for *any reason* as potential golden parachutes.

The changes implemented by EESA and ARRA are likely just the beginning. The new administration has made it clear that executive compensation will be a priority and current limits will be reconsidered. For now, companies that undergo corporate changes, such as mergers, acquisitions, or de-listing of their stock from national securities exchanges, must closely evaluate whether they are subject to the requirements of Code sections 162(m), 280G, and 409A, among others, which apply to "publicly held corporations" and corporations with stock that is "readily tradable on an established securities market."

ENDNOTES

1 Katy B. Zarolia, Haynes and Boone, LLP, 2323 Victory Ave., Suite 700, Dallas, Texas 75219-7673, katy.zarolia@haynesboone.com

2 All references to the "Code" shall be references to the Internal Revenue Code of 1986, as amended.

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BONUS RETURNS AND TAX DEDUCTIONS

By Robert W. Wood[1]

The newspapers are full of stories about executives repaying bonuses. In fact, there is so much of it under discussion today, that it is difficult to know who is repaying what and why. There are calls for super-taxing bonuses, for new caps on bonuses, for mandatory bonus repayments, for voluntary bonus repayments, and for various combinations of all of these things. In a climate of near (but understandable) hysteria, few seem to be discussing tax law, which seems downright ironic. Some feel-good news comes as New York's Attorney General Andrew Cuomo announced that 15 of the top 20 recipients of AIG retention bonuses (about $50 million worth in all) have agreed to give back their bonuses.[2] Press coverage isn't clear how voluntary or compulsory that was, though Mr. Cuomo's comments suggest that the givebacks were entirely voluntary. Interestingly, the Wall Street Journal noted that in making the decision whether to remit, some of these individuals were concerned about the potential tax implications of returning money received.[3] Tax practitioners won't find that surprising.

In fact, what is surprising is that amidst all the hubbub, there's been so little mention of this issue. After all, much of the brouhaha started with the payment of bonuses that everyone knows are tax deductible. The biggest catalyst for the bonus repayment mess was the discovery that many companies on the receiving end of enormous government bailout money were, at around the same time, paying out bonuses to some of the same people who caused the problems requiring the bailout. Of course, the bailout money was all tax dollars.

There were even tax rules released by the IRS on the heels of the bailout money. The IRS issued rules (incredibly quickly, mind you, which is no mean feat for the IRS) addressing how bailed out companies would be treated for purposes of net operating losses on the receipt of bail out money. And much of the focus about how to prevent this sort of thing from ever happening again has been centered on the tax code. We turn to the tax code, it seems, to change behavior.

With all this considerable focus on the tax law in this context, it therefore seems a little strange that few seem to be considering exactly what happens from a federal income tax perspective when someone returns compensation they received. Like so much else in the tax law, it is a far more complex problem than one might think. Dollars in and dollars out sounds simple, but untangling the mess for the executives involved who return money is going to be a doosey.

Voluntary Payback

Whatever the factual setting, a repayment of cash compensation raises interesting and fundamental tax questions. For example, does the Internal Revenue Code allow the undoing of a prior transaction? If so, how does this square with annual accounting, which is one of the underpinnings of our tax system? If you give back compensation (voluntarily or not), can one be made whole via a tax deduction? If a deduction is warranted, what is its timing and character?

Suppose an executive received a $10 million cash bonus in 2008, on which state and federal income taxes have been withheld, along with Social Security and other payroll taxes. Suppose the executive gives it back in 2009, either voluntarily or under some kind of program. Does he just give back his net check after all those deductions?

If you were repaying compensation, that might seem a reasonable approach, for that is all you received. Yet withheld income taxes were credited to your account with the IRS. If a court or administrative order directs the repayment, or even if a contract provision is triggered to do so, the true payment to the executive was $10 million. Actually, the payment was more than that when you consider the employer's portion of payroll taxes. The taxes withheld are credited to the executive's income tax obligations and Social Security account, and it may be his problem to get them back. The company may offset tax amounts, but it is probably not obligated to.

The easiest setting to address is where the cash bonus and the giveback occur in the same year. However, this seems rare. The majority of bonus repayments do not occur in the year of payment. That means the repaying executive, whether he must return the entire bonus, or only some net number after deductions, has a tax problem. He has previously included in income (probably as wages) an amount he is now returning and wants to deduct.

It is probably necessary to know whether the repayment is or is not voluntary. As we shall see, a repayment motivated by altruism, shame, or patriotism may be more admirable, but it may yield a bleaker tax outlook. An executive who gives back a bonus when a law, court order, or administrative decree requires it runs an easier tax gauntlet, although even that does not guarantee a rosy (or even just) tax posture. For the most part, we'll assume the executive can make a case that he had to give back a bonus, though that may not be a reasonable assumption in some cases.

Claim of Right Issues

In considering the tax ramifications of paying back compensation, there are several possibilities. It may be possible for the payor to claim a deduction under Section 1341 for restoring an amount held under claim of right. The claim of right doctrine requires a taxpayer to pay tax on an item of income in the year in which he received it under a claim of right, even if it is later determined that his right to the item was not absolute, and he is required to return it.[4] This rule is based on the proposition that if a taxpayer has free and unfettered use of funds from the time of receipt, the taxable year of receipt is the appropriate time to fix the tax liability. This is but one manifestation of the annual accounting principle upon which our tax system is based.

The claim of right doctrine allows the taxpayer to deduct a repayment from his income in the year of repayment (as opposed to deducting the amount in a prior year). This result was mandated by the Supreme Court, because income and deductions are determined on an annual basis.[5] Of course, annual accounting often results in a mismatch. The taxpayer may benefit less from the deduction in the year of repayment than he would benefit if he had been able to deduct the amount repaid in the year of receipt. This may occur, for example, where the taxpayer was in a higher tax bracket in the year of receipt than in the year of repayment.

Theoretically, this sounds quite nice, but Section 1341 is not simple. Under it, a taxpayer who has previously reported income under a claim of right may be able to later deduct the repayment (which must be more than $3,000) in a subsequent year. Section 1341 usually provides a better result than a deduction under other Code sections, since it attempts to place the taxpayer back in the position he would have been in had he never received the income. Frequently, other deductions can be subject to limitations, phase outs, floors, etc.

Taxpayers must meet a number of requirements to claim a deduction under Section 1341. First, the taxpayer must have included the item in gross income in the prior year because he had an unrestricted right to the item. Do most executives today meet this first requirement? Presumably yes. At the time the now tarnished bonuses were awarded and paid, the executives probably had no knowledge or belief they might have to return them.

Second, a deduction must be allowed under another Code section. Section 1341 is not a deduction-granting section.[6] As discussed in more detail below, executives embroiled in the current scandal might be allowed a deduction under Section 162 as an ordinary and necessary business expense. If so, they would appear to meet this requirement too.

<u>What is Voluntary</u>

A third requirement for a deduction under Section 1341 is that the taxpayer must learn in a subsequent year that he did not actually have an unrestricted right to the item. Courts have frequently interpreted this to mean that taxpayers were compelled by law to repay the amounts. In other words, the taxpayer's repayment must be involuntary. Here we return to the awkward question of just how and why an executive today returns a bonus.

If an executive is embarrassed by publicity or ashamed and gives back a bonus, is that involuntary? Probably not. If the executive faces pressure at work, with a ìsuggestionî that feels almost mandatory, is that involuntary? Does it take legal process? What about threatened legal process that ends in a settlement?

There is a dearth of authority on arrangements of this sort. Clearly, anyone returning compensation would have an easier time from a tax position if he had actually been ordered to pay back money. Legal compulsion seems an absolute standard. However, a settlement, with execution of legal releases, presumably operates in the same way as a judgment. It is simply not clear what else might suffice.

If a taxpayer meets the three tests of Section 1341 and therefore qualifies for the deduction, he can obtain the superior benefits of Section 1341, compared to the inferior deduction he would receive under the underlying Code section (let's say Section 162) on which the Section 1341 deduction is based. The explanation for Section 1341's superiority is that a non-Section 1341 deduction in the year of repayment often will not reduce the taxpayer's tax liability by the amount paid as a result of the initial inclusion. For example, if the taxpayer's tax rates are lower in the year of repayment than in the year of inclusion, the taxpayer would not derive a benefit from the deduction equivalent to the tax burden in the year of receipt. Part of Section 1341's superiority stems from its providing the taxpayer the greater benefit of either (1) deducting the repayment in the year of repayment, or (2) reducing his tax liability by taking a credit (in the year of repayment) for the amount of tax he could have avoided if he had excluded the item from income in the year of inclusion. Furthermore, unlike an ordinary and necessary business expense deduction the executive might claim under Section 162, the deduction provided by Section 1341 is not a miscellaneous itemized deduction.

Section 1341 can actually make a taxpayer whole, effectively as if the prior transaction hadn't occurred. For example, in Revenue Ruling 58-456,[7] a corporation distributed excess mortgage payments to its shareholders, violating its corporate charter. Under threat of legal action, the shareholders later repaid the dividend and were able to restore their basis in their stock to the extent the prior distribution affected their basis.

Suppose the taxpayer had a basis of $1,000 in his stock and received a distribution of $10,000 when the corporation had no earnings and profits. The first $1,000 would constitute a return of basis and the remaining $9,000 would constitute income. If later the taxpayer were required to repay the entire $10,000, only $9,000 could qualify as a deduction under Section 1341, and the remaining $1,000 would constitute a restoration of the basis of the stock.

<u>Setting Precedent</u>

There is little authority regarding the application of the claim of right doctrine to repayments of compensation. Perhaps this is because compensation has historically rarely been repaid. Most of the existing authority involves closely-held private corporations, and repayments by controlling shareholders who are also either officers, directors or employees.

Nevertheless, one of the seminal cases involves an officer who only owned approximately 25% of the corporation. In George Blanton,[8] the taxpayer repaid his corporate employer a portion of his director's fees. The IRS determined that portion of his fees to be excessive, so it denied the corporation a deduction for that portion of his fees.

The taxpayer made the repayment pursuant to a contract (entered into after he received the fees, and possibly after the IRS determined them to be excessive) which called for the repayment of amounts the corporation could not deduct. This kind of savings clause is often triggered by golden parachute payments. There, the executive generally has to give back the portion of any payment that triggers the double whammy of non-deductibility and the excise tax on excess parachute payments. However, savings clauses are cropping up in other contract provisions too.

According to the court in *Blanton*, for purposes of obtaining a deduction by restoring amounts held under a claim of right, it was irrelevant whether the taxpayer was legally bound by the later contract to return the salary. Furthermore, it was irrelevant whether the taxpayer and the corporation entered into the contract before or after the start of the IRS audit. Under the claim of right doctrine, the requisite lack of an unrestricted right to an item of income must arise out of the circumstances, terms, and conditions of the original payment. It cannot arise from a <u>subsequent</u> agreement.

Thus, the *Blanton* court disallowed a deduction under Section 1341, since the circumstances, terms and conditions surrounding the original payment did not reflect the fact that the taxpayer lacked an unrestricted right to such amount. Later courts have softened the rigid stance that the repayment must come from the circumstances, terms and conditions surrounding the original payment. Indeed, a deduction for restoring an amount held under claim of right may be possible if, prior to the IRS disallowing the corporate deduction, the corporation's board enacts a resolution requiring repayment if the corporation cannot deduct it and the taxpayer executes an agreement to reimburse it.[9]

In *Van Cleeves*, the board adopted a bylaw in 1969 that payments to officers later disallowed by the IRS must be reimbursed by the officer. In addition to the bylaw change, the taxpayer entered into a separate contract with his controlled corporation requiring him to return his salary if the corporation could not deduct it. In 1974, Van Cleeves received compensation which the IRS later deemed to be excessive, such that the corporation could not deduct a portion of it.

Upon demand from the board of directors, Van Cleeves returned the portion of his salary which the corporation could not deduct. On his own tax return, Van Cleeves deducted the repayment under Section 1341. Since he was in a higher tax bracket in the year of repayment, Section 1341 (versus Section 162) had more than an immaterial effect.

The IRS contested the application of Section 1341, and the trial court agreed, characterizing Van Cleeve's return of his salary as "voluntary." Since he controlled the corporation, the power to enforce and compel repayment was entirely in his hands. The court saw no sound policy in allowing this deduction, since there would be no downside to a taxpayer who received an excessive salary if there was a pre-existing requirement to repay the non-deductible portion. Nevertheless, the Sixth Circuit disagreed, allowing the taxpayer's deduction under Section 1341.

The appellate court held that the fact a restriction on a taxpayer's right to income does not arise until a year subsequent to receipt does not affect the availability of a Section 1341 tax adjustment. The court expressly noted that Congress designed Section 1341 to alleviate this problem. A deduction from another Code section (aside from Section 1341) may leave the taxpayer less than whole, and Section 1341 is to remedy that.

Interestingly, the court did not comment on whether the requirement to return the salary imposed by the bylaws, and the similar requirement in the contract between the corporation and the officer, were equally compelling. Was one alone sufficient, and which one? The court didn't say. Careful practice may suggest that we should provide for repayment both in organizational documents (such as bylaws) and in employment and consulting contracts. A payment that is not supported by such provisions and that is truly voluntary, may be problematic.

<u>Out of Luck?</u>

The requirement that the repayment must be involuntary may be easy with a court or administrative order, or perhaps even in a bitterly negotiated settlement. But there are many possibilities under which a repayment may be advisable. Even aside from lawsuits, contract giveback provisions are becoming common in executive compensation agreements, and the current economic and political climate is unheralded.

In any case, the focus on a legal mandate does suggest an ironic result. A fired executive could obtain a deduction under the claim of right doctrine if he loses a legal battle and has to pay. A more altruistic executive – who gives back the money because it's the right thing to do – may not be able to. Of course, it may not be necessary for the repayment to be made pursuant to a judgment to be characterized as involuntary.[10]

However, the payment must be made under circumstances entitling someone to enforce the demand for payment by legal action in the absence of compliance. In Revenue Ruling 58-456, the preferred shareholder (who was the Commissioner of the Federal Housing Administration) could, under the corporation's charter, enforce the return of a dividend on the common stock. Thus, five years after the dividend, upon demand by the preferred shareholder, the common shareholders returned the dividend, and the common shareholders were able to deduct the payment under Section 1341.

<u>Second Best</u>

Let's suppose there is no compulsory repayment. In lieu of obtaining a deduction for restoring amounts previously received under a claim of right, the next best thing would be an ordinary and necessary business expense deduction under Section 162. As compared with a deduction under Section 1341, Section 162 only provides a current year deduction, and does not necessarily make the taxpayer whole. Section 162 provides only a miscellaneous itemized deduction, subject to the 2% adjusted gross income floor. Worse still, since deductions under Section 162 are below-the-line, the deduction is subject to phase out, and the taxpayer may face the AMT.

Of course, it is axiomatic that Section 162 provides a deduction for ordinary and necessary business expenses. While Section 162 has almost infinite nuances, to be deductible an expense must generally be (1) ordinary, (2) necessary, and (3) a business expense.

The requirement that the bonus repayment constitutes a business expense merits examination. Although there is no statutory or regulatory definition of what constitutes a business expense for an executive, the regulations acknowledge that services performed as an employee can constitute a trade or business.[11] Some courts have come to the rescue of corporate officers, providing that their services also constitutes a trade or business. Yet it isn't clear that a repayment of compensation could remotely further that business.

To be deductible, a bonus repayment would also have to be ordinary. The determination whether an expense is ordinary depends on the facts and circumstances of a particular taxpayer. Indeed, the Supreme Court noted over 75 years ago that whether an expense is ordinary is determined by its time, place and circumstance.[12] Generally speaking, an expense is ordinary if a business would commonly incur it in the particular circumstances involved.

To be ordinary, an expense need not be recurrent. In fact, a one-time expense can be ordinary. A once-in-a-lifetime piece of litigation does not fail to be "ordinary" just because it is unusual, unexpected, or unlikely to reoccur. If a company is suing a former executive for fraudulent financial statement manipulation, it would seem that a one-time payment by other executives to bring prior bonuses in line with restated financial statements should be an ordinary expense.

Determining whether an expense is necessary is far less clear. The key to the necessary determination is whether the payment was voluntarily made or legally required.[13] A voluntary repayment of compensation in a subsequent tax year does not allow the taxpayer to take a Section 162 deduction. In the *Blanton* case,[14] the IRS audited the taxpayer in 1963 regarding salary received in 1959 through 1961. While Blanton had a contract to repay any portion of his salary that was not allowed as a deduction to the corporation, the court determined that his repayment contract was entered into no earlier than 1962.

In rejecting Blanton's Section 162 deduction, the court said there was nothing in the record to establish that the repayment rendered the taxpayer any business benefit or was in any sense ordinary and necessary to his position at the company. Unfortunately, the court's opinion regarding the Section 162 deduction is contained in precisely one sentence (unlike its lucid Section 1341 discussion noted above). Over time, other courts have expanded upon *Blanton's* laconic analysis.

Although the effect of a retroactive repayment contract was unclear under *Blanton*, in *U.S. v. Simon*,[15] on facts substantially similar to *Blanton*, the taxpayer did make his contract with his controlled corporation retroactive. Not surprisingly, the court did not find this additional fact convincing, since the agreement was still entered into after the year in which the original salary had been paid. Indeed, the court found no business purpose, only tax advantages, in the retroactive nature of the contract. When an executive gives back compensation, there should surely be some business purpose, not a tax incentive.

The situation seems markedly different where a preexisting legal obligation requires the taxpayer to return money. For example, in *Oswald v. Commissioner*,[16] the taxpayer's controlled corporation included in its original bylaws a requirement that any compensation not deductible by the corporation must be repaid. Later, when the taxpayer repaid the nondeductible amount, the court allowed the taxpayer's Section 162 deduction. Since the corporation's bylaws were enforceable, repayment was necessary.

In rejecting the IRS' argument, the court noted that the repayment bylaw served a valid business purpose, to help the company pay its increased tax bill caused by the denial of the compensation deduction. The purpose of the repayment bylaw was not to provide the taxpayer a deduction. A deduction, if allowed, reduces the taxpayer's tax.

Yet no one would argue that the taxpayer would be better off financially if he did not have to repay the corporation. The rationale of the courts in this line of cases becomes even more clear in *Pahl v. Commissioner*.[17] In *Pahl*, the taxpayer's controlled corporation paid the taxpayer an excessive salary. The original bylaws did not provide for repayment of nondeductible compensation, but the board later amended the bylaws to so provide.

Although the board enacted the amendment prior to being audited, the amendment was made in the middle of a tax year which was later audited. Not surprisingly, the court denied the taxpayer's deduction for salary paid *prior* to the amendment, but allowed a deduction for salary repaid *after* the amendment. Payments prior to the bylaw amendment were deemed voluntary.

In the brouhaha over public company compensation, just how pertinent these cases are is debatable. Almost all of this case law deals with controlled privately-held corporations, where the majority shareholder was either a director, officer or employee – in some cases, all three. There don't seem to be any cases in which the director, officer or employee was not a significant or majority shareholder. In this closely-held context, a latent issue is whether the excessive compensation is really a disguised dividend.

<u>Employment Taxes</u>

Repayment of a bonus upon which an executive (and the company) have already paid employment taxes makes it possible that executive and company end up paying extra employment taxes.[18] FICA has two components: old-age, survivors and disability insurance ("OASDI") and hospital insurance. Generally speaking, both the employer and the employee pay 6.2% of an employee's wages in OASDI, but only up to the maximum wage base, which for 2007 is $97,500. Neither employers nor employees pay OASDI on wages in excess of the maximum wage base. While both an employer and employee pay the hospital insurance at 1.45% of an employee's wages, there is no maximum wage base.

Thus, a $10 million bonus incurs the hospital insurance tax. If after a bonus repayment, an executive's prior year salary is less than the $97,500 OASDI maximum wage base, the executive would have overpaid both OASDI and the hospital insurance. In the more likely scenario where the executive's post-repayment wages exceed the OASDI maximum wage base, the executive would not have overpaid any OASDI, but would have overpaid hospital insurance tax.

It is possible for an executive to be made whole regarding the overpayment of prior year's employment tax. For example, if a bonus is repaid within the statute of limitations, the company must either repay the executive for the employment tax overpayment or reduce his future employment tax withholding.[19] The company would then be able to claim a credit on a subsequent employment tax filing for overpayment of both its portion and the employee's portion of the prior overpayment. If the statute of limitations has expired (unlikely in the current bonus scandals), however, it would seem that the company would not be required to repay an executive the overpaid employment tax. In addition, the company could evidently not claim a credit for any overpaid employment tax. In this scenario, the executive could get stuck with paying employment tax on the returned bonus.

Amending Prior Year Returns

Amending a prior year return might seem to be the cleanest method to effectuate a bonus repayment, and perhaps to entirely avoid the issues surrounding a later deduction. Most executives now returning bonuses have probably not yet filed their 2008 returns, which may make this unnecessary. For those who have filed, however, the IRS generally will not allow taxpayers to amend returns under repayment circumstances such as these.[20]

Amending a prior year return is generally allowed only to correct a mistake on the return. Here, an amendment would not seek to correct a mistake. Rather, it would be changing the nature of the prior bonus transaction by netting it with the current repayment transaction.

Netting across several tax years goes against our tax system's annual accounting concept. It also goes to the heart of the claim of right doctrine. Since the executive originally received the income under a claim of right, and without restriction as to its disposition, the taxpayer cannot later amend his original return.

Salary Reduction?

Another potential method to effectuate a repayment may be for the company to reduce the executive's current year salary. Of course, this works only for current employees, and many repaying persons may be former executives. Besides, the math may not work if the executives salary is $500,000 and they need to return $10 million. Plus, it isn't clear if an executive's giveback would achieve the same public relations coup (or the same legal effect) if he agrees to an offsetting salary reduction, even though simple math suggests that he has, in fact, paid the money back.

As with amending a prior year return, this method may appear to avoid some of the sticky issues associated with repayment. There does not appear to be any direct authority disallowing this arrangement, although it does seem to circumvent much of the above discussion. The IRS might argue that in fact two transactions (a current salary and a repayment of a prior year's salary) are being netted, and each must be reported separately.[21] However, it isn't yet clear how this particular possibility for handling executive paybacks will play out.

Conclusion

The pressures of public opinion and litigation are probably far more frightening than the prospect of losing a tax deduction for having to return compensation. Still, the tax impact to this kind of mismatch adds enormously to the executive's overall cost of the payback. It is always puzzling when the tax treatment of a transaction seems at odds with its economics.

Indeed, on a fundamental level, this is the kind of tax issue that one can imagine an otherwise sophisticated client not understanding at all. The headaches an executive would face on having to not only give back a bonus, but to then find he's been tax disadvantaged too, will be palpable. And the precise details of the repayment, whether prompted by law, regulation, public or shareholder outrage – or an executive's general sense that it's the right thing to do – are going to matter.

Whatever the tax result, we may see more such pay give-backs, not only in settlements of lawsuits, but perhaps also in more early stage investigations. We are also seeing overtly voluntary payments, where issues of the voluntary versus mandatory character of the repayment are likely to arise.

Fortunately, in our hurly burly world, most of the bonus flap is occurring at quite a rapid pace.

That fact may portend that the tax problems for the executives involved may be smaller than if this drama were unfolding over several years as opposed to several weeks. Nevertheless, there are surely at least some tax year mismatches, where monies were paid in 2008 and repaid in 2009. A few tax returns may also already be filed. Moreover, there are clearly some "voluntary" payments being made, at least under the IRS's traditional view of what is and is not voluntary.

Of course, it's quite possible that I'm overreacting to this, and that everyone has this little issue solved. Indeed, it's also quite possible that Congress will dash off a new tweak to the Spartan tax code to make sure there are no tax laws standing in the way of bonus givebacks. If this occurs, I've been mulling over several suggestions for titles to such a law, but my current favorite is: "The American Patriotism Tax Neutral Pay Your Fair Share Bonus Giveback for the Good of America Act."

ENDNOTES

1 Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco. He is the author of ***Taxation of Damage Awards and Settlement Payments*** (3d Ed. 2008) and ***Qualified Settlement Funds and Section 468B*** (2009), both published by Tax Institute and available at www.taxinstitute.com.

2 See Rappaport and Pleven, "AIG Employees Will Return About $50 Million of Bonuses," Wall Street Journal, March 24, 2009, p. C1.

3 Id.

4 *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).

5 *U.S. v. Skelly Oil Co.*, 394 U.S. 678, 681 (1969).

6 *Skelly Oil*, 394 U.S. 678.

7 1958-2 CB 415.

8 *George Blanton v. Commissioner*, 46 T.C. 527 (1966), aff'd per curium 379 F. 2d 558 (5th Cir. 1967).

9 *Van Cleeves v. U.S.*, 718 F.2d 193 (6th Cir. 1983).

10 See Rev. Rul 58-456, 1958-2 CB 415.

11 Treas. Reg. § 1.162-17.

12 *Welch v. Helvering*, 290 U.S. 111 (1933).

13 See Revenue Ruling 69-115, 1969-1 CB 50.

14 46 TC 527 (1966), *aff'd per curiam* 379 F.2d 558 (5th Cir. 1967).

15 281 F.2d 520 (6th Cir. 1960).

16 49 TC 645 (1968).

17 67 TC 286 (1976).

18 See SCA 1998026 and Rev. Rul. 79-311, 1979-2 CB 25.

19 Treas. Reg. 31.6413(a)-1(b)(1).

20 See *United States v. Lewis*, 340 US 590 (1951).

21 See SCA 1998026 and Rev. Rul. 79-311, 1979-2 CB 25.

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PUBLIC CHARITIES, PRIVATE FOUNDATIONS, AND SUPPORTING ORGANIZATIONS FOR THE NON-EXEMPT ORGANIZATIONS SPECIALIST

Part I: Public Charities and Private Foundations - A Statutory Roadmap

Albert Lin1

I. <u>Introduction</u>.

A rare bright spot to emerge in the midst of the worst recession in decades is an increased interest in benevolent, altruistic enterprises, with a resulting increase in the establishment of tax-exempt nonprofit corporations. The deceptively simple nonprofit corporation process can quickly escalate into expensive and time-consuming headaches during the tax-exempt application process status via Form 1023 (Application for Recognition of Exemption from Federal Income Tax) if prepared by one inexperienced in the process. In light of the media and regulatory focus on nonprofit organizations, this two-part Article attempts to assist the tax practitioner by reviewing essential formation issues for the nonprofit organization, tax-exempt under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended ("Code"), and hopefully unshackle altruism from the burdens of Code complexity. Part I will examine the essential decision made when creating a new Section 501(c)(3) organization – whether the entity will be a public charity or private foundation – and reviews the exhaustively complex subcategories of these types of Section 501(c)(3) organizations. The second Part, to be published later this year, will discuss the new "supporting organization" rules passed under the Pension Protection Act of 2006 ("PPA '06") and decipher the Type I-II-III distinctions now relevant to major corporate and individual donors.

II. <u>All Section 501(c)(3) Organizations Must Address Public Charity Versus Private Foundation Distinction</u>.

The statutory framework governing Section 501(c)(3) organizations seems simple enough – Section 501(c)(3) simply identifies the tax-exempt charitable organization as one which is:

> *organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.*[2]

Yet once the basic Section 501(c)(3) statute is satisfied – the organizational and operational tests, the prohibition against private inurement and public benefit, the prohibition against political campaign activities and such as provided therein – the practitioner must still refer to the less-familiar Section 508(a)("Special rules for 501(c)(3) organizations"), which reminds us that (i) the hopeful Section 501(c)(3) organization *must* apply for recognition of exemption (unlike other tax-exempt organizations); and (ii) all Section 501(c)(3) organizations are *automatically private foundations* unless the IRS is notified otherwise in their required application for recognition of exemption.[3]

The private foundation rules confuse many in part because the term "private foundation" is a specific tax term as opposed to the generic "charitable foundation" term, and in part because the specific tax statutes themselves are migraine-inducing by lacking some essential (i.e. helpful) cross-referencing, or include cross-referencing which nobody really wants to track down.[4] Rather than containing a useful mention of private foundation rules within Section 501(c)(3) (so tax lawyers in more profitable practices might actually notice), the Code requires tax lawyers to magically discover Section 508 ("Special Rules with Respect to Section 501(c)(3) Organizations) and Section 509 ("Private Foundation Defined") on their own.[5] These sections remind us that (1) all Section 501(c)(3) organizations are automatically "private foundations" unless the IRS is told and convinced otherwise; and (2) Section 509 gets its jollies by defining "private foundation" as a bunch of things they are actually not (which is about as useful as telling a grocer an apple is anything not an orange, a pear, a cantaloupe, or a mangosteen).

A. What's a Private Foundation?

The client-understandable answer to this question is that a "private foundation" is a Section 501(c)(3) organization that relies upon a handful of wealthy donors for its money and can afford to navigate the plethora of legal restrictions and filing requirements therewith. Ideally, the creators and governing body of a private foundation will actually be advised of the consequences of being one because the consequences, as discussed in Section III of this Article, are kind of annoying. The long and tax-oriented answer to "What's a private foundation?" requires parsing Section 509(a), which, while titled "Private Foundation Defined," might better be titled "How to Get Out of Private Foundation Status By Reviewing the Most Excruciatingly Complex Code Provisions Ever Devised."6

1. <u>It's Not a Private Foundation if it Is Described in Section 509(a)(1)</u>.

The first categories (yes, there are categories) of Section 501(c)(3) organization that automatically avoid private foundation classification, all described under Section 509(a)(1), are actually those which are listed in clauses (i) through (vi) of Section 170(b)(1)(A).[7] Tax nerds call these Section 501(c)(3) organizations "Section 509(a)(1) organizations," which is pretty annoying because all Section 509(a)(1) does is cross-refer to Section 170(b)(1)(A). What is Section 170(b)(1)(A)? Section 170(b)(1)(A) deals with the actual charitable deduction rules that authorize charitable contributions to certain specifically-defined entities (obviously it would be too easy to have these rules in the rules governing Section 501(c)(3) organizations), and, depending on the organization's classification, also limits the actual charitable contribution deduction to 50 percent or 30 percent of the donor's "contribution base," which is defined as the donor's adjusted gross income ("AGI").[8] So, Section 170(b)(1)(A) lists what we can call "50 percent deductibility charities;" Section(b)(1)(B) provides the rule for "30 percent deductibility charities," which include most private foundations.

Types of Section 501(c)(3) organizations that "get out of private foundation jail" under Section 170(b)(1)(A) include:

(i) *churches;*[9]

(ii) *educational institutions* with regular faculties and curriculum and regular enrollment;[10]

(iii) *hospitals or medical education or research institutions* (provided certain parameters are met);[11]

(iv) Section 501(c)(3) organizations that both meet a "substantial support test" by receiving substantial support from Section 170(c)(1) governmental units or the general public and makes distributions to educational institutions owned or operated by a governmental unit or agency thereof (i.e. *public university foundations*);[12]

(v) governmental units (as specified in Section 170(c)(1);[13] and

(vi) a Section 501(c)(3) organization which receives a "substantial part of its support," "exclusive of income" received in its exercise or performance of activities, from a governmental unit or from direct or indirect contributions from the general public; called *publicly supported organizations*.[14]

This last organization, the publicly supported organization classification, creates a lot of confusion (okay, *more* confusion if you actually got this far). The primary reason for such confusion is the annoying fact that under the Code, there are actually *two* types of "publicly supported organizations." Section 170(b)(1)(A)(vi) is the first type (which is discussed right here), and Section 509(a)(2) is the other type (and will be discussed in more detail later). The main difference is that under Section 170(b)(1)(A)(vi), support from performance of activities (such as performance of medical services for the indigent, performance of plays, admission fees, etc.) is NOT included.[15] In contrast, under Section 509(a)(2), a publicly supported organization may include in the income from exempt activities in satisfying the tests.[16] Section 170(b)(1)(A)(vi) was effective for tax years after December 31, 1963; Section 509(a)(2) was passed in 1969 to extend the same benefits to organizations in which receipts from performance of the exempt function was a major source of revenue and the public support test for Section 170(b)(1)(A)(vi) could not be met.[17]

Under both types of publicly supported organizations, the support test is met if the publicly supported organization either receives at least 1/3rd of its support from governmental or general public sources; however, Section 170(b)(1)(A)(vi) publicly supported organizations may in the alternative meet a facts and circumstances test that is satisfied if the hopeful organization normally receives at least 10 percent of all its support from government or public sources, has a bona fide program for solicitation of funds from the government or public sources, and (by looking at all facts and circumstances) the activities are actually going to appeal to persons with broad common interests or purposes.[18] Meeting these tests can be difficult if the funds primarily come from a few key sources with no real fundraising or grant solicitations.

Organizations described in clauses (vii) and (viii) of Section 170(b)(1)(A) are purposely left out as automatic non-private foundations.[19] Under clause (vii), such organizations qualify for some, but not all, non-private foundation advantages separately (though they are still private foundations, technically). Section 170(b)(1)(A)(vii) cross-refers to recently amended Section 170(b)(1)(F) (which was moved to (F) under PPA '06 to make room for new (E), now dealing with qualified conservation contributions). Clause (vii) therefore describes three types of private foundations that are "*not so-bad*" private foundations. Thus, Section 170(b)(1)(F) covers *private operating foundations* (which are subject to separate rules that give them the same advantages of private foundations), *conduit foundations*, and *common fund foundations*. Under Clause (viii), Section 509(a)(2) and (3) organizations are covered and these are also not private foundations. First covered will be clause (vii) "not so bad" private foundations.

A *private operating foundation* actively conducts its own tax-exempt activities rather than simply distributing funds to other organizations. The cross-referencing fun continues as the meat of the definition of a "private operating foundation" is found not in Section 170 or in Section 509, but in Section 4942(j)("Taxes on Failure to Distribute Income; Other Definitions") and the accompanying Treasury regulations. Part of the reason the definition is here is because private operating foundations aren't subject to the Section 4942 taxes on failure to distribute its income[20] and also get the benefits of "50 percent deductibility charities."[21] To understand private operating foundations, the tax practitioner has to leave the safe confines of Section 170 and jump to Section 4942. A private operating foundation must satisfy (i) an income test and (ii) either an assets test, an endowment test, or a support test for its current tax year.[22] Through these tests, the IRS ensures the private operating foundation directly and actively carries out its exempt purposes through its own programs.

(i) The *income test* for a private operating foundation is met if it spends substantially all of the lesser of its adjusted net income or its minimum investment return (generally, 5 percent of the fair market value of all assets less acquisition indebtedness) directly for the active conduct of the activities or purpose for which it was organized and operated. "Substantially all" means 85 percent or more of either adjusted net income or minimum investment return.[23]

(ii) The *assets test* is met if the private operating foundation devotes substantially more than half of its assets (defined as 65 percent or more of the fair market value of the organization's assets) to its charitable activities or to functionally related businesses.

(iii) The *endowment test* is met if it has an endowment based on 2/3rds of its minimum investment return;[24] in other words, if the foundation normally makes qualifying distributions directly for the active conduct of the activities for which it is organized and operated in an amount not less than two thirds of its minimum investment return, it meets the endowment test.

(iv) The *support test* is met if it derives substantially all (at least 85 percent) of its support from the general public and five or more exempt organizations, and not more than 25 percent of its support is received from any one such exempt organization, and not more than half is received from gross investment income (such as interest and dividends).[25]

A *common fund foundation* is a private foundation that pools its contributions into a common fund.[26] The organization's common fund must be a fund that would be a supporting organization but for the right of any substantial contributor or his spouse to designate annually the recipient organizations of the income attributable to the donor's contribution to the fund, and to direct by deed or will the payment to a charitable organization of the corpus in the common fund attributable to the donor's contribution.[27] Assuming this classification applies, contributions made to a common fund foundation are treated as if made to a public charity.

A common fund foundation must contain provisions in its governing instrument requiring it to:

(i) distribute all of the adjusted net income of the common fund to one or more charitable organizations not later than the 15th day of the third month after the close of the tax year in which the income is realized by the fund; and

(ii) distribute all of the corpus attributable to any substantial contributor's contribution to the fund to one or more charitable organizations not later than one year after the substantial contributor's death, or the death of his surviving spouse if she has the right to designate the recipients of the corpus.

A *conduit, nonoperating foundation* is a private foundation that distributes an amount equal in value to 100 percent of all contributions received in a tax year by the 15th day of the third month following the close of its tax year.[28]

The contributions must be "qualifying distributions" which are amounts paid to accomplish charitable purposes, amounts paid to acquire an asset used or held for use directly in carrying out one or more of such charitable purposes, or qualified set-asides for these purposes.[29] Amounts paid to a private foundation (that is not a private operating foundation) or to an organization controlled by the foundation are not qualifying distributions.

Now that the deceptively exhaustive Section 509(a)(1) rules have been covered; the supporting organization rules follow.

2. <u>It's Not a Private Foundation if it is Described in Section 509(a)(2).</u>

Section 501(c)(3) organizations that "get out of jail" under Section 509(a)(2) are also called "publicly supported organizations," but as mentioned earlier, include "exempt function income" in the one-third support test. The one-third support test for a Section 509(a)(2) organization differs in additional ways and is a bit more stringent than in a Section 170(b)(1)(A)(vi) organization.

Section 509(a)(2) classification becomes necessary where donations from the general public are not sufficient (i.e. no major fundraising campaigns are planned or doable), but the organization expects to generate revenues through its activities (such as an artistic organization's performance of plays, or an exempt healthcare organization's fees for services). Such an organization may obtain much of its funding through a few wealthy donors and might consider Section 509(a)(2) classification as Section 170(a)(1)(A)(vi) requirements are unlikely to be met.

Hence, a simple walkthrough for Section 509(a)(2) status (which should be reviewed only when the easier Section 170(a)(1)(A)(vi) tests cannot be met) works as follows.

(i) *The organization must normally receive more than one-third of its support in each taxable year from "permitted sources" listed below.*[30] This requires consideration of a fraction; the denominator is "total support" as defined in Section 509(d);[31] the numerator is taken from amounts as described below.

(a) Gifts, grants, contributions, or membership fees from "permitted sources," and such "permitted sources" include persons *other* than "disqualified persons," from governmental units, or from organizations described in Section 170(b)(1)(A)(other than from clauses (vii) and (viii) therein). The text of the statute itself is confusing; to restate it differently, permitted sources include support from governmental units and from most Section 170(b)(1)(A) sources and anybody that is not a disqualified person.

(b) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business, and such receipts must be from permitted sources, including persons *other* than "disqualified persons," from governmental units, or from organizations described in Section 170(b)(1)(A)(other than from clauses (vii) and (viii) therein).

(ii) *In calculating the one-third test, receipts from any single permitted source are excluded to the extent that such receipts exceed the greater of $5,000 or 1 percent of the organization's support in such taxable year*.

(iii) *A Section 509(a)(2) organization must also meet both the gross investment income and unrelated business income test set forth in Section 509(a)(2)(B). An organization will meet this test only if it normally receives not more than one-third of its total support in each taxable year from gross investment income,*[32] *and from the excess of unrelated business taxable income over any unrelated business income tax imposed.*[33]

3. <u>It's Not a Private Foundation if it is Described in Section 509(a)(3)</u>.

The other way to "get out of jail" (i.e. get out of private foundation status) is Section 509(a)(3), which covers "supporting organizations." The rules here are quite extensive, so this Article will delay the discussion until later this year.

B. By the Way, the IRS Eliminated the Advance Ruling Period (But Hasn't Updated Form 1023).

The one-third tests are computed based on "normal" sources of support, which must look to complex testing rules over a five year period.[34] Prior to new temporary regulations under Section 170, applications for Section 501(c)(3) status needed either to use at least eight months of activity to determine if it met the tests or to apply for an "advance ruling," whereby the organization needed to file Form 8754 (Support Schedule for Advance Ruling Period) five years later. Effective September 8, 2008, the IRS changed that process. Applicants now automatically qualify for public charity status if they can reasonably expect that they will meet the tests during the first five years.[35] Whether or not such reasonable expectation exists is based on a facts and circumstances test, depending on whether "its organizational structure, current or proposed programs or activities, and actual or intended method of operation are such as can reasonably be expected to attract the type of broadly based support from the general public, public charities, and governmental units that is necessary to meet such tests."[36]

Form 1023, however, has not been revised to take out the Advance Ruling language on Page 11 of Form 1023. The IRS has published an "Errata Sheet" which tells the tax practitioner to basically ignore the outdated provisions in Form 1023 and follow instead the instructions in the Errata Sheet itself.[37]

III. Private Foundation Disadvantages – Dance with Who Brung Ya.

Assuming, after all attempts at parsing the mess of rules described above, an organization is left with no choice but to be a private foundation, what are the consequences? First, donors on average will be less likely to contribute to a private foundation; second, private foundations are far more high-maintenance than public charities, subject to a host of excise taxes not applicable to public charities. Major donors are more hesitant to contribute to private foundations because donations of cash or capital gain property to private foundations are more limited. Donations of cash to a private foundation are capped at 30 percent of the donor's contribution base and donations of capital gain property are capped at 20 percent of such base. [38]

The distinctions arise throughout the rarely-seen Sections 4940 through 4948 and are "simply" summarized here.

(i) Private foundations (that aren't private operating foundations) are subject to a 2 percent tax on their "net investment income" under Section 4940 (Excise Tax Based on Investment Income).[39]

(ii) Private foundations are subject to potential penalty taxes under Section 4941(a)("Taxes on Self-Dealing"), a fairly lengthy section. This section imposes a tax on *each* instance of "self-dealing," which is any transaction between a "disqualified person" and the private foundation itself. The tax is potentially severe; it amounts to 10 percent of the amount of the "self-dealing" transaction (paid by the disqualified person, along with another 5 percent tax paid by a "foundation manager" who cannot show that the self-dealing transaction was not willful or had reasonable cause). There is another 200 percent tax on the disqualified person, and a 50 percent tax on the foundation manager, if they don't correct the self dealing transaction after a certain amount of time (generally, if the practitioner notices it, fix it soon; if the IRS actually notices it, fix now!).[40]

This requires a bit more parsing of defined terms. The definition of "disqualified person" isn't cross-referenced early enough in Section 4941, but once it is "helpfully" cross-referenced in Section 4941(d)(2), we learn that a disqualified person is defined in Section 4946 (Definitions and Special Rules). Section 4946 is actually an entire section dedicated towards defining what a "disqualified person" is, at least for purposes of the Section 4941 tax. A disqualified person is basically any substantial contributor[41] or foundation manager.[42] And lest this is too simple, the IRS provides that a disqualified person also includes:

(a) an owner of 20 percent or more of the interest (or control) of any substantial entity contributor;

(b) any individual related (other than siblings) to such substantial contributor or foundation manager; or

(c) a corporation, partnership, or trust in which the substantial contributor or foundation manager owns or controls at least 35 percent of a substantial contributor, a foundation manager, or a 20 percent owner or an individual as described above.[43]

How the average individual preparing Form 990s or establishing a nonprofit is supposed to worm through these rules to determine if there is a disqualified person in the mix is anyone's guess.

What, then, is self-dealing? The practitioner goes back to Section 4941(d), which defines "self-dealing" as director or indirect:

(a) sale or exchange or leasing of property between a private foundation and a disqualified person (unless the property is made available to the public on terms at least as favorable as the terms made to the disqualified person and such property is functionally related to the organization's purpose)[44];

(b) lending of money or extension of credit between a private foundation and a disqualified person (unless the loan is without interest or other charges);

(c) furnishing of goods, services, or facilities between a private foundation and a disqualified person (excepted are furnishings such goods or services where the general public receives similar terms for goods, services, or facilities);[45]

(d) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a qualified person (unless such compensation is reasonable and necessary);[46] or

(e) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation (excepting incidental benefits);[47] and

(f) any agreement by a private foundation to make any payment of money or other property to a government official (other than an agreement to employ the government official after termination of government service within 90 days).[48]

(iii). Private foundations are also subject to an excise tax under Section 4942 (Taxes on Failure to Distribute Income). This is yet another mind-bogglingly complex section; the dumbed-down (i.e. to-the-point) purpose is to make sure private foundations do not hoard net income. The tax is 30 percent of a private foundation's "undistributed income," which is then defined as the difference between its "distributable amount" and any "qualifying distributions."[49] The "distributable amount" is generally a 5 percent minimum investment return on a private foundation's assets. "Qualifying distributions" are basically distributions for actual charitable purpose.[50] Naturally, this is all a huge oversimplification of what the rules actually are (since there are all sorts of funky adjustments to what makes up the distributable amount and what is a qualifying distribution), but hopefully the practitioners won't have to actually make this calculation anytime soon.

(iv). Under Section 4943 (Taxes on Excess Business Holdings), private foundations are subject to yet another 10 percent excise tax on any excess business interest holdings relating to businesses owned by disqualified persons. Another scarily long section, Section 4943, is directed at prohibiting rich folks from setting up tax-exempt charities that hold their own corporation's stock and basically doing whatever with that stock (and avoiding taxes on it at the same time). Generally (but of course with lots of exceptions), private foundations can only hold up to 20 percent of the voting stock in a corporation, reduced by the amount of any stock held by disqualified persons.[51] The difference between the high amount (i.e. 50 percent) and the permitted amount (i.e. 20 percent) is the "excess business holding." Like the Section 4941 self-dealing penalty taxes, if the IRS finds out about excess business holdings and the private foundation doesn't give or sell it back somehow, there is a potential 200 percent penalty on the private foundation on top of the 10 percent tax.[52]

(v). Section 4944 (Tax on Investments Which Jeopardize Charitable Purpose) is a catch-all 10 percent excise tax assess on the value of investments which jeopardize the carrying out of any of the private foundation's exempt purposes. Uncorrected, an additional 25 percent tax is assessed on the private foundation, and a 10 percent tax is imposed on a knowing foundation manager. This is a fairly broad-based, discretionary penalty since, after all, what jeopardizes a charitable purpose? Generally where the foundations managers have failed to exercise ordinary business care and prudence.[53]

(vi). Finally, Section 4945 (unhelpfully titled "Taxes on Taxable Expenditures") imposes a 20 percent tax on the private foundation and a 5 percent tax on a knowing foundation manager on amounts expended for the purpose of influencing legislation or for study/scholarships which do not meet nondiscriminatory requirements in terms of selection.[54] Also under Section 4945, private foundations are required to exercise "expenditure responsibility," meaning that upon receipt of a grant, the private foundation must make reasonable and adequate efforts to:

(a) see that the grant is spent solely for the purpose for which made,

(b) obtain full and complete reports from the grantee on how the funds are spent, and

(c) make full and detailed reports with respect to such expenditures to the IRS.[55]

IV. Conclusion (For Now).

There are plenty of helpful articles and web-based materials on the issue of public charities versus private foundations, but many are geared towards the layperson. Hopefully this Article presents it in a different manner that enables the tax practitioner not entirely familiar with the tax-exempt Code provisions to better follow the Code and thus more effectively advise clients when creating a charitable organization. Part I of this Article summarized the public charity versus private foundation distinction and explained the relationship between Section 501(c)(3) and Section 509, and all the Code branches growing haywire thereof.

Part II: Supporting Organizations will discuss the supporting organization rules in Section 509(a)(3) and the PPA '06 provisions that require heightened compliance and due diligence with respect to the three different "Types" of Section 509(a)(3) organizations.

ENDNOTES

1 Partner, Brown McCarroll, L.L.P., 111 Congress Avenue, Suite 1400, Austin, Texas 78701, (512) 703-5726, alin@mailbmc.com

2 I.R.C. §501(c)(3)(italics added). The italicized language, as a good drafting principle, is typically incorporated in the purposes clause of the Certificate of Formation.

3 Id. §508(e).

4 And since these questions are usually for nonprofits with limited legal fee budgets, it's hard to track down every possible Code branch when evaluating classification decisions.

5 To appreciate how complex the public charity/private foundation distinction truly is, the Internal Revenue Service's ("IRS's") own internal continuing professional education ("CPE") on the topic, entitled "Public Charity or Private Foundation Status," can be downloaded at http://www.irs.gov/pub/irs-tege/eotopicb03.pdf. All 236 pages of it cover the topic in exhaustive detail – glumly quoting a district court's description of the private foundation rules as "fantastically intricate and detailed" in order to "thwart the fantastically intricate and detailed efforts of taxpayers to obtain private benefits from foundations while avoiding the imposition of taxes." Windsor Foundation v. U.S., 77-2 U.S.T.C. 9709 (E.D. Va. 1977)).

6 Employee benefits and corporate consolidated return specialists may take dispute with this allegation.

7 The author admits this is clear as mud. Section 509(a)(1) states that a private foundation does not include "an organization described in section 170(b)(1)(A) (*other than in clauses (vii) and (viii)*)."

8 I.R.C. §170(b) is entitled "Percentage Limitations." The deductibility limitations are shown in §170(b)(1)(B). Nobody ever gets that far because they get stuck on §170(b)(1)(A) and their eyes just glaze over (as such describing the types of entities is demanding enough).

9 I.R.C. §170(b)(1)(A)(i).

10 Id. §170(b)(1)(A)(ii).

11 Id. §170(b)(1)(A)(iii). The author has actually had to read this section in real life. In creating a medical research organization, note that medical research organization must be operated in connection with a hospital in order to automatically avoid private foundation classification under Section 170(b)(1)(A). Absent the hospital agreement, however, similar benefits may be offered as a private operating foundation under Section 170(b)(1)(F).

12 Id. §170(b)(1)(A)(iv).

13 Id. §170(b)(1)(A)(v). What is considered a governmental unit raises its own mess of questions that fortunately won't be covered in this Article (but which the author would be happy to discuss over a fine single-malt).

14 Id. §170(b)(1)(A)(vi).

15 Bruce Hopkins, a tax-exempt organization Grand Pooh-Bah, calls these "Donative Publicly Supported Charities." If you spend any significant time in this area, buy his book (even though the current edition is about 1300 pages long). No, the author of this Article does not get a kickback. See Bruce R. Hopkins, The Law of Tax-Exempt Organizations §12.3(b)(ii)(9th ed. 2007).

16 The Grand Pooh-Bah calls these "Service Provider Publicly Supported Charities." Hopkins §12.3(b)(iv).

17 1980 IRS EO CPE Text, Publicly Supported Organizations p. 4, available at http://www.irs.gov/pub/irs-tege/eotopicm80.pdf.

18 Treas. Reg. §1.170A-9(e)(10).

19 Remember the author mentioned this supra n. .

20 See supra n. .

21 See infra n. and accompanying text.

22 I.R.C. §4942(j)(3).

23 Treas. Reg. §53.4942(b)-1(c).

24 I.R.C.§4942(j)(3)(B)(ii); Treas. Reg. §53.4942(b)-2(b)(1).

25 I.R.C. §4942(j)(3)(B)(iii); Treas. Reg. §53.4942(b)-2(c)(1).

26 §170(b)(1)(A)(vii); §170(b)(1)(F)(iii); Treas. Reg. §1.170A-9(h).

27 This might make more sense later, because supporting organizations, discussed later, don't let contributors have that much say.

28 §170(b)(1)(A)(vii); §170(b)(1)(F)(ii); Treas. Reg. §1.170A-9(g). This one is easy; obviously if all a private foundation does is pay out all its monies each year to charitable purposes by its governing documents, the IRS has less to worry about.

29 §4942(g)(1), (2).

30 I.R.C. §509(a)(2)(A); Treas. Reg. §1.509-3(a)(2). Treasury regulations give the name "permitted sources" to the sources specified in the actual Code. Treas. Reg. §1.509(a)–3(d)(2)("Broadly, publicly supported organizations").

31 "Total support" includes gifts, grants, contributions, or membership fees, gross receipts from admissions, sales of merchan-

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dise, performance of services, or furnishing of facilities in any activity which is not an unrelated trade or business net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business, gross investment income, tax revenues levied for the benefit of an organization and either paid to or expended on behalf of such organization, and the value of services or facilities (exclusive of services or facilities generally furnished to the public without charge) furnished by a governmental unit to an organization without charge. I.R.C. §509(d). Capital gains are specifically excluded.

32 Generally, gross investment income includes interest, dividends, royalties, and rents. I.R.C. §509(e). Where, however, rents are received in connection with the organization's exempt purposes (i.e. rent from low-income housing), such rents are applied towards support from a related activity. Treas. Reg. §1.509(a)–3(m)(1); I.R.M. 7.26.4.3.2 (04-01-1999).

33 I.R.C. §509(a)(2)(B); Treas. Reg. §1.509-3(a)(3); I.R.M. 7.26.4.3.1 (04-01-1999).

34 Normal sources exclude unusual grants from disinterested parties. Temp Reg. §1.509(a)-3T(c)(3) (outlining rules for determination whether grants are unusual).

35 Temp. Reg. §1.170A–9T(f)(4)(v).

36 Id.

37 See Errata Sheet for Form 1023 - To Be Used to Complete Parts IX and X, available at http://www.irs.gov/pub/irs-tege/errata_sheet_for_form_1023_final.pdf.

38 I.R.C. §170(b)(1)(B); 170(b)(1)(D).

39 I.R.C. §4940(c). Of course, "net investment income" has to be defined as "gross investment income" less "allowable expenses." Gross investment income is simply dividends, interest, royalties, and the like, and "allowable expenses" are investment-type expenses. Id. §4940(c)(1)-(4).

40 I.R.C. §4941(b); 4941(e).

41 Guess what? "Substantial contributor" is defined by yet another cross-reference to §507 (Termination of Private Foundation Status). This section defines a substantial contributor as any person who contributed more than $5,000 to the private foundation, if such amount is more than 2 percent of the total contributions received by the foundation before the close of the taxable year of the foundation. I.R.C.§507(d)(2).

42 A "foundation manager" is at least still defined in §4946(b), and includes any officer, director, or trustee of a foundation as well as any employee with authority or responsibility to act with respect to the transaction in question. I.R.C. §4946(b).

43 I.R.C. §4946.

44 Also excepted are no-charge leases between the disqualified person and the private foundation. I.R.C. §4942

45 Leases of office space between the private foundation and the disqualified person are permitted without charge, even where the private foundation pays for maintenance and expenses so long as the payment is not made directly or indirectly to the disqualified person. Treas. Reg. §1.4391(d)-2(d)(3).

46 Treas. Reg. §1.4391(d)-2(e).

47 Treas. Reg. §53.4941(d)-2(f).

48 I.R.C. §4942(d)(1)(a)-(f).

49 I.R.C. §4942(c).

50 Id. §4942(g).

51 I.R.C. §4943(c). If an unrelated third party has effective control of the corporation and the private foundation and disqualified persons do not together own more than 35 percent of the corporation, the permitted holdings is 35 percent. The author doesn't make these rules up.

52 I.R.C. §4943(a), (b).

53 Investments that Jeopardize Charitable Purposes, IRS 1988 EO CPE Text, *available at* http://www.irs.gov/pub/irs-tege/eotopick88.pdf.

54 I.R.C. §4945(a), (b).

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PENDING LEGISLATION TO CHANGE THE FEDERAL TRANSFER TAXES

James V. Roberts, Esq.[1]

In 2001, Congress passed and the President signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). That statute contained a number of transfer tax provisions which were designed to eliminate the estate tax through a phase-in of increases in the amount of the credit a taxpayer could use against estate tax obligations in his or her estate. Congress capped the amount that could be given away during life at $1,000,000, while the estate tax so-called "applicable exclusion amount" was increased to $1 million, then $1.5 million, then $2 million and, for 2009, $3.5 million. EGTRRA provided that no estate tax would be due for decedents dying after December 31, 2009. But the Act did not have the requisite number of votes to clear the Senate. As a result, EGTRRA had a sunset provision that repealed all of the foregoing changes for tax years after December 31, 2010, thus creating a situation where the estate and gift tax credits would re-unify in 2011 at $1 million.

Over the intervening years, numerous pieces of legislation have been introduced to change the outcome of EGTRRA. Many bills sought to make the repeal of the estate tax permanent. Others sought to keep the estate tax but in a modified form. With the success of the Democratic Party in the Congressional elections in 2006, most hopes for repeal faded away. And during the 2008 presidential campaign, then candidate, and now President, Barrack Obama promised to work toward freezing the estate tax applicable exclusion amount at $3.5 million.

Significant problems with the economy, the desire to implement sweeping changes in health care, the massive 2009-2010 budget, the wars in Iraq and Afghanistan, other problems abroad as well as pressing needs concerning Social Security reform and many other matters have dictated that estate and gift tax reform legislation take a back seat to more pressing problems. But nonetheless, a year without an estate tax has been a predictable motivator for many in Congress and beyond. At the same time, the discussions concerning estate tax repeal or reform have impressed upon many at least some of the complexities of the existing system, and even of the one before EGTRRA. At the same time, perceived abuses with family limited partnerships have been a motivating factor for change of valuation rules.

As a result of the foregoing, 14 bills (not counting companion bills) have been introduced, some following the path laid out by President Obama, some attempting to rekindle dreams of estate tax repeal, some using estate tax reform as a means to another end, and some seeking specialized relief of one form or another. This paper seeks to report on those, examine proposed portability and valuation rules, and, at the same time, make some predictions on where the entire process is going.

Budget Resolutions

Trying to answer the question, "What do you think will happen with the estate tax?" can be answered in part by examining the budget resolutions working their way through Congress. While the individual bills certainly testify to the objectives of the legislators who have proposed them, or perhaps to the legislators' perceptions of their constituents, the budget resolutions may give some idea of where Congress as a whole may go.

On March 27, 2009, budget resolutions were filed in both the House[2] and Senate.[3] The Senate resolution proposed raising the applicable exclusion amount to $5,000,000 indexed to inflation, with a maximum rate of 35%, a reunification of the estate and gift tax credits, and portability of the exemption among spouses. The House version addressed transfer taxes only globally in terms of a "policy reserve fund" to pay for legislation related to Medicare improvements, middle-class tax relief, AMT reform and transfer tax matters. The resolution called for changes related to estate and gift tax to be limited so that reductions in revenues would not exceed $72 billion for fiscal years 2010 through 2014 and reductions in revenue would not exceed $256 billion for 2010 through 2019. Within those fiscal guidelines was the stated objective that the transfer taxes should apply only to "a minute fraction of estates" and that that could be accomplished "by extending the law as in effect in 2009

The nearly final version, in the form of **S.Con.Res. 13**, which passed the Senate on **April 2, 2009**, and was subject to several amendments in the House which approved the amended version on **April 22, 2009**, has been in conference negotiations since then. As of the final draft of this paper (Wednesday, April 29, 2009), after agreement on pay-go rules just before midnight April 27, the final votes by the House and Senate on the budget resolution are expected shortly, possibly as early as April 28, except that "House Majority Leader Steny H. Hoyer, D-Md., told reporters that he wanted to honor a pledge to make the budget available to the public for at least 24 hours before debate on the resolution is finished."[4] The final version of the budget resolution, as of April 27 before the final agreements on pay-go, adopted the House's language concerning estate and gift tax by setting budget limitations and calling for the "elimination of estate taxes on all but a minute fraction of estates by reforming and substantially increasing the unified tax credit by extending the law as in effect in 2009 for Estate and Gift Tax."

On April 28, 2009, Senate Budget Committee Chair Kent Conrad, D-N.D. reported that Senate and House negotiators had reached agreement on a final budget. In his statement posted on his website, he said, "It matches the President's estate tax reform proposal, which would permanently extend the 2009 level of a $7 million exemption for couples and $3.5 million for individuals." Rep. John Spratt, D-S.C. echoed that announcement in one of his own on his website, and added that the exemptions would be indexed to inflation. Tax Notes Today reported that the day before "House Majority Leader Steny H. Hoyer, D-Md., said a House vote on the budget was likely within the next 48 hours."[5]

In other words, it appears that in large part Congress will keep the applicable exclusion amount for estate taxes at $3,500,000 and the maximum tax rate at 45%. Whether the applicable exclusion for gift taxes will remain at $1,000,000 and the GST exemption at $3,500,000 remains to be seen. And while the budget resolution says nothing about portability, certainly pronouncements from those involved in the process indicate that it will be part of the package. What is certain is that except for what may be found in one bill, valuation matters are not within the universe of the things considered in the budget process, at least so far. Valuation may either become an add-on at some point in the process, perhaps as part of attempts to achieve the fiscal goals set out in the budget resolution, or it may be addressed entirely outside of the legislative process by the Internal Revenue Service which might attempt to craft regulations to address perceived valuation abuses.

Pending Legislation

If the budget resolutions are any indication of where Congress might go, then perhaps the best method of addressing the various bills touching transfer tax issues is to take those which have no basis in the budget, and progress from there to those that are more in line with the budget and the goals of the President, and perhaps ultimately may be the heart of any legislation that makes it to the President's desk. With that in mind, the following listing starts with the Religious Freedom Peace Tax Fund Act which mentions transfer taxes, but changes nothing in terms of estate planning or probate. The list then moves through issues of the day which touch on or directly involve transfer tax issues, including relief for donors who used part of their lifetime exclusion on gifts of Madoff-style fraudulent accounts, and also including ABLE accounts that can be cast as part of health care reform. From there, the list goes through farm and small business bills, such endeavors often being the poster child(ren) for estate tax reform or repeal. Brief mention is made of the outright repeal legislation. This section on Pending Legislation ends with those bills that bear some semblance of what Congress' budget indicates where it all may go in the end.

<u>Peace Fund</u>.

H.R. 2085 introduced **April 23, 2009** by Rep. John Lewis [D-GA][6] titled the "**Religious Freedom Peace Tax Fund Act of 2009**" would require that all income, estate and gift tax revenues be segregated into a separate fund by Treasury to be used only for non-military purposes.

<u>Madoff Type Relief with Transfer Tax Provisions</u>.

H.R. 1159 introduced **February 24, 2009** by Rep. Kendrick Meek [D-FL][7] (the bill has no title) is designed to provide relief from Madoff-style Ponzi schemes. Most of its provisions deal with income tax issues. But the bill does provide for relief for those who made gifts of such accounts at a time when the balances in those accounts were believed to be larger than they actually were. If a taxpayer filed a gift tax return with respect to such gifts and used a part of the gift tax applicable exclusion, the bill provides a means by which that portion of the applicable exclusion can be set aside and thus restored to the donor.

<u>Accounts for the Disabled with 529 College Savings Account Provisions</u>.

Companion bills **H.R. 1205** introduced by Rep. Ander Crenshaw [R-FL] with 62 cosponsors[8], and **S. 493** introduced by Sen. Robert Casey [D-PA] with co-sponsors[9] including Sen. Edward Kennedy [D-MA], Sen. Orrin Hatch [R-UT], Sen. Arlen Specter [R-PA (or maybe that is "D-PA")], Sen. Samuel Brownback [R-KS], and Sen. Christopher Dodd [D-CT] titled "**ABLE Act of 2009**" would create "Achieving a Better Life Experience" accounts for disabled beneficiaries. Basically, the bill would allow the creation of one (and only one) IRA–type account for its disabled beneficiary. Rules in Section 529(c)(2), (4) and (5)[10] related to 529 college savings accounts are incorporated by reference without modification. Unfortunately, no effort was made to examine those adopted provision, which, as many noted authors including Susan Bart and Christopher Houston have often proclaimed are confusing, incomplete and ripe for abuse[11]

<u>Farm and Small Business Bills</u>.

H.R. 96 introduced **January 6, 2009**, by Rep. Michael Conaway [R-TX][12] titled the "**Save Family-Owned Farms and Small Businesses Act of 2009**" would: (a) increase the amount of the reduction allowed under Section 2032A from $750,000 to $1,850,000; (b) repeal the repeal of Section 2057 which provided for a deduction for family owned businesses; and (c) increase that maximum amount of that deduction from $650,000 to $2,000,000.

H.R. 173 introduced **January 6, 2009** by Rep. John Salazar [D-CO][13] (bearing no title) would create a new Section 2033A which would defer and perhaps exempt under certain circumstances from estate taxation the "adjusted value" of "qualified farmland." "Adjusted value" means the value of the farmland reduced by the debt against it. Thus that deduction in combination with the one for the debt itself could serve to pass the qualified farmland estate tax free.

To qualify for the deduction, the decedent must have been a resident or US citizen, and more than 50% of the decedent's income for 3 of the 5 years prior to death must have come from the trade or business of farming. In addition, for 5 of the 8 years prior to the decedent's death, the farmland must have been owned by decedent or a member of the decedent's family, and, during that same period there must have been material participation by the decedent or a member of the decedent's family in farming operations.

The farmland itself must be in the United States, used for farming purposes within the meaning of Section 2032A(e)[14], which was acquired from or passed from the decedent to a qualified heir, and, on the date of death was being so used by the decedent or a member of the decedent's family. Like H.R. 1328 discussed below, there are draconian provisions dealing with the disposition of the qualified heir or the cessation of its use for farming purposes at any time after the decedent's death and before the death of the heir. Rules similar to 2032A will apply.

H.R. 1328 was introduced **March 5, 2009** by Rep. Timothy Bishop [D-New York][15] titled the "**Farmland Preservation and Land Conservation Act of 2009**" would add a new Code Section 2059 that provides for a election by which the executor for a decedent who is a US citizen or resident may take a deduction, which, in effect, causes the value of "qualified farm or conservation land" to be excluded from the estate. The deduction is equal to the "adjusted value" which is defined as the value of the land for estate tax purposes, reduced by any mortgage, i.e the equity. "Qualified farm or conservation land" means land located in the United States, which on the date of death was being used for farming purposes (adopting the definition in 2032A(e)) or exclusively for conservation purposes (adopting the definition in Section 170(h)[16]), with respect to which there is a recorded covenant restricting use of the land to only those purposes, and as to which each person having any interest in the land (including the estate) executes an agreement with the Internal Revenue Service.

That agreement, both in H.R. 1328 and H.R. 173 discussed above, and in the new proposed code section would provide for the imposition of estate tax on the value of the land as of the decedent's date of death, if the heir, before the heir's death, either disposes of (other than by granting a qualified conservation easement) to someone who is not subject to the recorded covenant, or the heir uses the land in a manner inconsistent with the restrictive covenant. In addition to the estate tax imposed, interest must be paid as though the obligation were owed from the initial due date of estate taxes.

As if the lifetime ownership and use requirement were not enough when combined with the imposition of the estate tax with interest, the new section treats the land as being sold, thus creating the possibility of triggering income tax on the gain from the deemed sale. The deemed sales price would be the land's fair market value when the improper disposition or use occurs. The basis in the land is its adjusted basis on the date of decedent's death (this provision is unclear whether it means the decedent's adjusted basis carries over, or a new basis is intended under Section 2014). There is nothing in the language which indicates the party responsible for the payment of the income tax, and further nothing to indicate whether a misuse could be corrected, or how far back in time Treasury could reach to examine changes in use in order to impose the tax. The statute is silent about interest and penalties, but presumably claims for interest and penalties would follow the assessment of the tax. There is an exception to the deemed sale, and that is that if there is an actual disposition where gain is recognized, the foregoing income tax provision does not apply.

In addition, to provide parity between testamentary and lifetime transfers, a new section 2524 (renumbering the existing 2524 as 2525) is proposed that would provide a comparable deduction for gifts of qualified farmland and an election by the donee, apparently without the joinder or consent of the donor which would be presumed at least at that point since it would be donor who would benefit from the deduction. As with the estate tax deduction there must be an agreement with the Service. Additional gift tax is imposed if the donee transfers or disposes of the land, and income tax is payable as though the land were sold (unless the land was actually sold in a transaction in which gain was recognized). Nothing is said about which party, the donor or the donee, is to be responsible for the payment of the taxes.

Section 2611(b) relating to exclusions from the generation skipping transfer tax would be amended by adding a new subsection that conforms to the new proposed gift tax section. Presumably, gifts to skip persons could be the most dangerous of all since there exists the possibility of gift, generation skipping and income tax all being imposed on the same disposition or as a result of the disqualifying use.

And, finally, the proposed statute would add a new section 6324C which would impose a lien on the land, thus heading off the question of whether the Service can have a lien or other security. The lien would continue until the earlier of the land being transferred to a qualified organization under Section 170(h)(3), or the liability for tax has been satisfied or has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise under the new sections.

This bill has significant problems as proposed, in addition to those mentioned above. First, it imposes an unending tax liability until the qualified heir dies. Second, it's not clear if two or more qualified heirs inherit whether the death of one or all is meant by the phrase "the death of the heir" for purposes of determining when the tax liability ends. Third, the gift tax liability appears to apply only with respect to property includable in an estate of a decedent, the reason behind the preamble that makes that link being unknown. Fourth, where the farmland has been given by the donor to the donee, it is the donee alone who controls whether an election and agreement is made, not the donor, and it would appear that the donee's actions alone control whether the donor will have additional gift tax liability and interest thereon.

Repeal Bills.

H.R. 99 introduced on **January 6, 2009**, by Rep. David Dreier [R-CA][17] titled the "Fair and Simple Tax Act of 2009" would repeal all transfer taxes while making a number of income tax changes.

H.R. 533 was introduced **January 14, 2009**, by Rep. Randy Neugebauer [R-TX][18] titled "**Opportunity for Family Farms and Small Businesses Act of 2009**" and proposed making EGTRRA's repeal of estate tax permanent as well as providing some income tax changes primarily applicable to small businesses.

H.R. 1763 was introduced **March 26, 2009** by Rep. Robert Latta [R-OH][19] titled "**Responsible Reinvestment Act of 2009**" and proposes to make EGTRRA's repeal of estate tax permanent as well as provide some income tax changes.

H.R. 1960 introduced **April 2, 2009**, by Rep. Joseph Pitts [R-PA][20] titled "**Permanent Death Tax Repeal Act of 2009**" proposes to do exactly what its name implies, i.e. make the repeal of the estate tax in EGTRRA permanent.

Repeal Legislation with a Twist – The Fair Tax Act.

Companion bills **S. 296** introduced **January 22, 2009** by Sen. Saxby Chambliss [R-GA][21] and **H.R. 25** introduced **January 6, 2009** by Rep. John Linder [R-GA][22], both titled the "**Fair Tax Act of 2009**," would repeal all income, transfer, and employment taxes, and impose a new national sales tax that would cover almost all government obligations.

Five Million Dollar Applicable Exclusion.

H.R. 498 introduced **January 14, 2009** by Rep. Harry Mitchell [D-AZ][23] titled "**Capital Gains and Estate Tax Relief Act of 2009**" would (a) restore the unified credit for estate and gift taxes; (b) ultimately raise the applicable exclusion amount to $5,000,000 through a series of $250,000 increments starting in 2010 ($3,750,000 for 2010, $4,000,000; (c) index that to inflation in $10,000 increments; (d) use the capital gains tax rate for the first $25,000,000 of an estate, and two times the capital gains rate for amounts in estates that over $25,000,000, with the $25,000,000 figure indexed to inflation in $50,000 increments; (e) make the rates retroactive for prior gifts; (f) repeal the deduction for state death taxes; (g) make changes to EGTRRA in conformity with the foregoing (repealing the repeal, eliminating carryover basis, unifying the credit, eliminating the $1,000,000 gift tax exclusion, and repealing related deadwood in the statutes); (h) providing for portability of the estate tax applicable exclusion amount from one spouse to another (this provision, like the ones in HR 2023 and S 722, requires the timely filing of an estate tax return on the estate of the prior decedent with an election to allow the surviving spouse to received the unused applicable exclusion amount and eliminating any statute of limitations for the examination of the prior estate tax return).

Four Million Dollar Applicable Exclusion.

H.R. 1986 introduced **April 21, 2009** by Rep. Travis Childress [D-MS][24] (no title) would: (a) repeal of the provisions in EGTRRA which would repeal the estate tax; (b) repeal the special gift tax rate (in 2010); (c) repeal the provision in EGTRRA related to transfers to non-grantor trusts; (d) repeal the $1,000,000 gift tax applicable exclusion thus reunifying the estate and gift tax credits; (e) eliminate the sunset provisions of EGTRRA as they apply to transfer taxes; (f) increase the unified credit to cover an applicable exclusion amount of $4,000,000; and (g) reduce the maximum tax rate to 40%.

Two Million Dollar Applicable Exclusion.

H.R. 2023 introduced **April 22, 2009** by Rep. James McDermott [D-WA] (no co-sponsors) titled the "**Sensible Estate Tax Act of 2009**" provides for: (a) repeal of the repeal of the estate tax in EGTRRA; (b) eliminates carryover basis for decedents; (c) eliminates the 35% rate for gifts, thus reunifying the rates; (e) re-unifies the estate and gift tax credits; (f) sets the unified credit equal to an exclusion of $2,000,000; (g) indexes the exclusion to inflation after 2010 in increments of $10,000; (h) restores the credit for state death taxes; (i) provides for portability of the exclusion to the surviving spouse (unlike S 722 discussed elsewhere herein, the language here does not appear to contemplate portability to more than one surviving spouse).

Serious Estate Tax Reform Bills in Line with the Budget Resolutions.

S. 722 introduced **March 26, 2009** by Sen., Max Baucus, Sen. Charles Schumer [D-NY] and Sen. John Rockefeller [D-WV] titled the "**Taxpayer Certainty and Relief Act of 2009**" has three sections to it, one of which deals with AMT relief, another which deals with other so-called middle class tax relief, and a third section dealing with transfer tax matters. That third section: (a) restores the unified credit for estate and gift taxes; (b) freezes the credit for both so that the exclusion amount is $3,500,000; (c) indexes that amount to inflation in $10,000 increments; (d) sets the maximum estate tax rate at 45%; (e) sets the exclusion amount for non-resident non-citizens at $175,000; (f) for estate tax return purposes and computation of how much of the credit has been used, the tax rates for prior gifts are deemed to be the same rates as are applicable on the date of death; (g) the applicable credit amount for any calendar year before 1998 is the amount which would be determined under 2010(c) if the applicable exclusion amount were the dollar amount under section 6018(a)(1)[25]; (h) increases the amount of the deduction under Section 2032A to $3,500,000 (from its current $750,000); (i) in line with the above, it repeals parts of EGTRRA including the repeal of the estate tax, and the carryover basis at death, the 35% rate for gifts, thus re-unifying the rates and re-unifies the estate and gift tax credits. In addition, it provides for portability of the exclusion to surviving spouses (however many there may be, unlike HR 2023 which appears to contemplate only one surviving spouse). All of the foregoing will be effective for decedents dying after December 31, 2009.

H.R. 436 was introduced **January 9, 2009** by Rep. Earl Pomeroy [D-ND][26]. The bill: (a) repeals the repeal in EGTRRA; (b) eliminates carryover basis; (c) re-unifies the gift and estate tax credits; (d) sets $3,500,000 as the applicable exclusion amount and indexes it to inflation; (e) sets the transfer tax rate at 45%; and (f) modifies the surtax rate for estates over $10 million by increasing the cap an amount equal to the "maximum rate less tax computed at the graduated rate structure" plus "the sum of the applicable credit amount under section 2010(c) and $119,200" (that would appear to be $1,455,800 + $119,200 = $1,575,000),]. In addition, and perhaps the most famous part of this proposed bill is its new valuation rules for passive assets inside entities and for family controlled entities (discussed below).

Problems with Portability and Valuation Provisions

Portability.

H.R. 498, H.R. 2023 and S. 722 contain so-called "portability" provisions that are designed to provide for a mechanism whereby the surviving spouse can make use of the predeceasing spouse's unused unified credit. One goal in such legislation may be to eliminate the need for tax-planning in estates that, combined, would exceed the applicable exclusion amount, but which would not exceed the combined applicable exclusion amounts of both spouses. A part of that goal may be to simplify the tax system so that tax planning with a credit shelter bypass trust would be unnecessary. And perhaps also the intent is to make the law conform to many people's expectations about how the law works (or should work). A side effect of the above would be the reduction of estate taxes on a married couple who have accumulated estates in excess of twice the exemption.

Part and parcel of the foregoing may be the concern that many American do not seek competent legal and tax planning advice in time to make use of mechanisms such as credit-shelter bypass trusts. But if simplification is a goal, the mechanism created in the proposed statutes suffers from a fundamental flaw. All of the bills require that the predeceasing spouse's estate must file timely an estate tax return, and, in that return, elect to pass on to the surviving spouse the balance of the predeceasing spouse's unified credit. **************Two problems present themselves.

First, it's not that easy or inexpensive to prepare and file a federal estate tax return, even on a "simple" estate. If the proponents of portability are trying to reduce the costs of estate planning to the predeceasing spouse, the added cost to the estate caused by the preparation of an estate tax return both may serve simply to create a replacement cost to the cost of planning, and, more significantly, create a serious obstacle to the use of the portability provisions.

The pending legislation does not present any method for overcoming that hurdle. Dennis Belcher, at the American Bar Association Spring Symposium in Washington, D.C., said on April 30, 2009, that a possible solution, assuming a return had to be filed, was to create a short, one-page form, which would only identify and provide the values of assets passing to those other than the surviving spouse, and the filing of the return would be, itself, an election. Another possible solution would be for Treasury to provide a revenue procedure creating a method for granting Section 9100 relief for late filing. But regardless, all agree that a fix is needed.

Second, the requirement for filing an estate tax return presupposes that the taxpayer's executor and heirs know about and understand the need to file one. In addition, it presupposes that they will somehow gain an understanding of the time limitations, and likewise gain an appreciation of the consequences for failing to file the return in a timely manner. For those unsophisticated taxpayers who would not plan, or who did not understand the need to plan, or who simply did not know to ask, these new mechanisms may be just as unknown and confusing as the laws that currently exist.

Those first two factors may result in little or no positive impact by any portability provisions. If the return and the election thereon are not timely made, there is nothing in the proposed legislation that would allow late filing. As noted above, perhaps Treasury can craft a procedure for making late filings as it does in other cases. But if Treasury must do that, the legislation certainly misses the point, assuming the goals set out above.

Beyond the impact on taxpayers, professionals and especially estate planning attorneys will have an added burden imposed upon them. When a client does seek professional planning advice in advance of the death of either spouse, the planning attorney is going to have to explain to the clients a new choice, and that is to forego the traditional credit shelter bypass trust in favor of using the portability provisions. The implications of that would have to be explained as well. For example, the unused credit of the first to die may carry over to the surviving spouse, but that does not appear to be indexed to inflation the way the surviving spouse's credit would continue to be. If a bypass trust were used, and assuming the assets placed in the trust were to grow only with the rate of inflation, then the credit of the predeceasing spouse would be used, and the credit, now in the form of real assets, could continue to grow. Of course, the reverse is true as well, that improperly invested, the bypass trust could lose value.

Another issue of significant concern is the provision in each of the bills that would allow the Service to examine and change the return of the first to die without regard to the time between death and review. In other words, the predeceasing spouse's return filed in 2010 might be subject to examination when the surviving spouse dies 20 years later in 2030. It can be argued that both the taxpayer and the Service may be on a level playing field in terms of challenging values after many of those who could have testified have passed away.

What should concern most tax professionals is the statute of limitation on malpractice, which, in many states, does not commence to run until discovery of the wrong, in this case the discovery of the tax professional's mistakes in preparation of the tax return concerning the estate of the predeceased spouse. Keep in mind that judges and juries may find it hard to place themselves in the mindset of the tax professional at an earlier time. Intervening court decisions, legislative enactments and administrative rulings, with the passage of time, may create a hindsight view of the earlier work that seems obviously right, or more worrisome, obviously wrong. Being open to a malpractice claim 20 years after the return was filed may cause professionals to consider advising clients to follow the more traditional route of incorporating a bypass trust in their planning. And yet they may also be open to a malpractice claim if the advice is to use the bypass trust approach if the portability approach works out to provide a more easily administered outcome.

Valuation Rules.

The proposed new valuation rules in H.R. 436 have caused considerable concern since that bill was filed earlier this year. They would eliminate most if not all valuation discounts for entities, such as family limited partnerships, to the extent those entities have "non-business" assets. Passive assets are defined in the bill and are presumed to be non-business assets, unless they are part of the working capital of the business. And lack of control would no longer be considered for discounting purposes in many cases.

These provisions are an obvious attempt to attack discounts in family limited partnerships and similar entities.

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Business interests that are actively traded[27] are excluded from the scope of the bill. The bill seems aimed at eliminating discounts for non-actively traded entities to the extent to which the entity owns "non-business" assets.

The language spelling out the mechanical application of the statute is not artfully worded, but its intent is probably clear enough to give the statute effect. The key provision (in this regard) mandates only how the value of the non-business assets will be determined, i.e. as though they were owned and transferred by the transferor directly. Who owns and who transfers the assets probably has no effect whatsoever on their value, but that is what the statute commands. In other words, it does not mandate that the transferor will be deemed to have owned and transferred the non-business assets, and then the entity interests (without the assets) as another part of the gift. If it had done the latter, then clearly the statute would make a considerable difference in valuation. Yet this unfortunate wording probably will not prevent its enforcement to achieve the perceived goal.

Non-business assets are defined as those which are not used in the active conduct of one or more trades or businesses. Passive assets, which may be part of what might otherwise be considered to be business assets, are treated as though they were not, with some exceptions. The interests in the entity that are transferred are then valued as though the entity did not own the passive assets.

Passive assets are defined to include cash, cash equivalents, corporate stock, ownership interests in other kinds of entities, debt instruments, trading devices (options, forward and future contracts, notional principal contracts and derivatives), foreign currency, interests in REITs and RICs, publicly traded partnerships, precious metals, annuities, real property (with some exceptions), assets which pay royalties (other than patents and trademarks), commodities, collectibles and "any other asset specified in regulations prescribed by the Secretary."

One important asset is real property, which although used in an active trade or business, is a passive, non-business asset if the transferor does not materially participate within the meaning of Section 469(c)(7)(C)[28] and with respect to which the transferor meets the requirements of Section 469(c)(7)(B)(ii)[29] which require that the transferor works more than 750 hours per year in the business. The new statute goes on to say that material participation is determined under the rules of Section 469(h) which says that except as provided in the regulations, no interest in a limited partnership shall be treated as an interest with respect to which the taxpayer materially participates. In the case of a family limited partnership, that statutory rule could work to require that all assets in the partnership be treated as owned directly by the partners.

Pass-through rules add to the above by saying that if the entity in which an interest is transferred in turns owns at least a 10-percent of another entity, then the assets of the second entity are treated as though they are owned by the entity being transferred, up to the percentage of ownership. In other words, if A transfers an interest in FLP to B, and FLP owns a 10% interest in BigCo which owns \$100 in assets, then \$10 of BigCo's assets will be treated as though the FLP owned them directly. If some or all of those are passive assets, the transferor will be treated as owning a portion of that \$10 directly.

And finally, discounts for lack of control are eliminated entirely if the interest is not actively traded and the transferor and members of the family (as defined under section 2032A(e)(2)) have control of the entity. It is interesting to note that the definition of family members referred to is very restricted, and so a wide variety of people normally considered family members in common parlance are not included in the foregoing, such as aunts and uncles.

Whether valuation rules of some sort ought, or ought not, be adopted is a policy issue beyond the scope of this paper. The problem these rules create goes far beyond addressing concerns about FLPs. The wording of the statute could be read to say that some part of the real estate owned by an operating company could be considered passive assets. In denying discounts to transferors who are part of a family which owns a majority of a business entity, the statute ignores reality.

The language of the proposed bill presents an

Beyond those points, the statute's most significant problems may be in what it does not address. For example, the statute does not address how the valuation rules would interact with other existing statutes where value is an issue, such as the marital deduction. The statute leaves open the possible argument that the value being transferred to the spouse for purposes of Section 2056 is the discounted value of the ownership interests in the entity, determined under traditional valuation principles, while the amount included in the decedent's estate is determined by the above rules. Hardest hit may be those taxpayers in the real estate business who have significant holdings in real estate through entities. The older taxpayer who may have scaled back participation in the business may not be active enough. As a result, that donor or decedent, as the case may be, would be penalized by having the real estate included directly in the estate or gift tax computation.

Another issue not addressed is basis. Section 1014 would provide for a change in basis for assets owned by the decedent at death. The proposed bill does not indicate whether assets deemed owned directly by a decedent for the purpose of computing values, and thus estate taxes, are going to be deemed to be owned directly for basis purposes.

The interplay of the new statute with partnership tax provisions applicable to transfers is unclear. Sections 734, 743(b) and 754 set forth a mechanism to allocate to partnership assets new basis of a transferee.

Finally, the valuation methods with which most estate planning practitioners are familiar are not all that there is. Within the text of the statute is enough room for valuation experts to provide the same low values for ownership interest as they might have previously referred to as "discounted values." In the end, the lack of knowledge about appraisal as a profession may prove to make the valuation provisions unenforceable.

ENDNOTES

1 Glast, Phillips & Murray, 2200 One Galleria Tower, 13355 Noel Road LB48, Dallas, Texas 75240, (214) 528-2822, Jim@jamesVRoberts.com
2 H.R.Con.Res. 85
3 S.Con.Res. 13
4 Tax Analysts, Tax Notes Today, 2009 TNT 80-2, by Sam Goldfarb.
5 *Tax Analysts, Tax Notes Today*, 2009 TNT 79-1
6 co-sponsors Rep. Fortney Stark[D-CA], Rep. Keith Ellison [D-MN], Rep. Rush Holt [D-NJ], Rep. Tammy Baldwin [D-WI], Rep.

James McDermott [D-WA], Rep. Chaka Fattah [D-PA], Rep. Bobby Rush [D-IL], Rep. Donald Payne [D-NJ], Rep. James Oberstar [D-MN], and Rep. James McGovern [D-MA].

7 co-sponsors Rep. James McGovern [D-MA] and Rep. Richard Neal [D-MA])

8 Del. Madeleine Bordallo [D-GU], Rep. John Mica [R-FL], Rep. Bob Filner [D-CA], Rep. Mark Kirk [R-IL], Rep. Roy Blunt [R-MO], Rep. Dean Heller [R-NV], Rep. Peter King [R-NY], Rep. Peter Sessions [R-TX], Rep. Cathy McMorris Rodgers [R-WA], Rep. Eric Cantor [R-VA], Rep. Barton Gordon [D-TN], Rep. Tim Holden [D-PA], Rep. Dennis Moore [D-KS], Rep. Christopher Smith [R-NJ], Rep. Michael Thompson [D-CA], Rep. Pete Olson [R-TX], Del. Eleanor Norton [D-DC], Rep. Randy Neugebauer [R-TX], Rep. Geoff Davis [R-KY], Rep. Devin Nunes [R-CA], Rep. Ileana Ros-Lehtinen [R-FL], Rep. John Boozman [R-AR], Rep. James Marshall [D-GA], Rep. Thomas Rooney [R-FL], Rep. Ellen Tauscher [D-CA], Rep. Rush Holt [D-NJ], Rep. Dan Burton [R-IN], Rep. Spencer Bachus [R-AL], Rep. Timothy Ryan [D-OH], Rep. AndrÈ Carson [D-IN], Rep. Robert Andrews [D-NJ], Rep. Erik Paulsen [R-MN], Rep. Corrine Brown [D-FL], Rep. Ronald Paul [R-TX], Rep. Virginia Brown-Waite [R-FL], Rep. Melissa Bean [D-IL], Rep. Gregg Harper [R-MS], Rep. Kendrick Meek [D-FL], Rep. Samuel Graves [R-MO], Rep. David Dreier [R-CA], Rep. Steven Rothman [D-NJ], Rep. Barney Frank [D-MA], Rep. Phil Hare [D-IL], Rep. Bill Young [R-FL], Rep. Lincoln Diaz-Balart [R-FL], Rep. Jean Schmidt [R-OH], Rep. Steve Cohen [D-TN], Rep. Todd Akin [R-MO], Rep. David Roe [R-TN], Rep. Vernon Ehlers [R-MI], Rep. Marsha Blackburn [R-TN], Rep. James Moran [D-VA], Rep. Mike Pence [R-IN], Rep. Kevin Brady [R-TX], Rep. Patrick Kennedy [D-RI], Rep. Shelley Berkley [D-NV], Rep. Brad Ellsworth [D-IN], Rep. Todd Platts [R-PA], Rep. John Campbell [R-CA], Rep. Frank Wolf [R-VA], Rep. Connie Mack [R-FL], Rep. Peter Roskam [R-IL]

9 : Sen. Robert Casey [D-PA], Sen. Edward Kennedy [D-MA], Sen. Orrin Hatch [R-UT], Sen. Arlen Specter [R (or maybe "D")-PA], Sen. Samuel Brownback [R-KS], Sen. Christopher Dodd [D-CT], Sen. Roger Wicker [R-MS] and Sen. Richard Burr [R-NC])

10 Section 529(c)(2), (4) and (5) provide, "(c) Tax treatment of designated beneficiaries and contributors. ***
(2) Gift tax treatment of contributions. For purposes of chapters 12 and 13 —
(A) In general. Any contribution to a qualified tuition program on behalf of any designated beneficiary-
(i) shall be treated as a completed gift to such beneficiary which is not a future interest in property, and
(ii) shall not be treated as a qualified transfer under section 2503(e).
(B) Treatment of excess contributions. If the aggregate amount of contributions described in subparagraph (A) during the calendar year by a donor exceeds the limitation for such year under section 2503(b), such aggregate amount shall, at the election of the donor, be taken into account for purposes of such section ratably over the 5-year period beginning with such calendar year. ***
(4) Estate tax treatment.
(A) In general. No amount shall be includible in the gross estate of any individual for purposes of chapter 11 by reason of an interest in a qualified tuition program.
(B) Amounts includible in estate of designated beneficiary in certain cases. Subparagraph (A) shall not apply to amounts distributed on account of the death of a beneficiary.
(C) Amounts includible in estate of donor making excess contributions. In the case of a donor who makes the election described in paragraph (2)(B) and who dies before the close of the 5-year period referred to in such paragraph, notwithstanding subparagraph (A), the gross estate of the donor shall include the portion of such contributions properly allocable to periods after the date of death of the donor.
(5) Other gift tax rules. For purposes of chapters 12 and 13 —
(A) Treatment of distributions. Except as provided in subparagraph (B), in no event shall a distribution from a qualified tuition program be treated as a taxable gift.
(B) Treatment of designation of new beneficiary. The taxes imposed by chapters 12 and 13 shall apply to a transfer by reason of a change in the designated beneficiary under the program (or a rollover to the account of a new beneficiary) unless the new beneficiary is—
(i) assigned to the same generation as (or a higher generation than) the old beneficiary (determined in accordance with section 2651), and
(ii) a member of the family of the old beneficiary.

11 When Congress adopted the Pension Protection Act of 2006, it modified Section 529 by adding language requiring Treasury to craft regulations to prevent abuse. The legislative history includes an example of the kind of abuse possible. Treasury issued a Notice of Propsoed Rulemaking, 73 Fed. Reg. 3441 (Jan. 18, 2008) calling for comments on issues raised by the statute and Treasury's proposals for addressing the issues. The author, along with notable commentators on 529 accounts, Susan Bart and Christopher Houston, in cooperation with others, crafted responses which were used and submitted by the American College of Trust and Estate Counsel, the Tax Section of the American Bar Association and, with some reservations, the Real Property, Trust and Estates Section of the ABA as well. Those comments catalogues the issues remaining to be addressed. A quick review of those would serve to provide a foreshadowing of the types of problems that might be experienced with ABLE accounts.

12 no co-sponsors

13 co-sponsors Rep. Ciro Rodriguez [D-TX], Rep. Walter Minnick [D-ID], Rep. Baron Hill [D-IN], Rep. Joe Donnelly [D-IN], Rep. Betsy Markey [D-CO], Rep. Michael Simpson [R-ID], Rep. Travis Childers [D-MS], Rep. Leonard Boswell [D-IA] and Rep. Brad Ellsworth [D-IN]

14 Section 2032A(e) provides (e) Definitions; special rules. For purposes of this section—
(1) Qualified heir. The term "qualified heir" means, with respect to any property, a member of the decedent's family who acquired such property (or to whom such property passed) from the decedent. If a qualified heir disposes of any interest in qualified real property to any member of his family, such member shall thereafter be treated as the qualified heir with respect to such interest.
(2) Member of family. The term "member of the family" means, with respect to any individual, only—
(A) an ancestor of such individual,
(B) the spouse of such individual,
(C) a lineal descendant of such individual, of such individual's spouse, or of a parent of such individual, or
(D) the spouse of any lineal descendant described in subparagraph (C).
For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as the child of such individual by blood.
(3) Certain real property included. In the case of real property which meets the requirements of subparagraph (C) of subsection (b)(1), residential buildings and related improvements on such real property occupied on a regular basis by the owner or lessee of such real property or by persons employed by such owner or lessee for the purpose of operating or maintaining such real property, and roads, buildings, and other structures and improvements functionally related to the qualified use shall be treated as real property devoted to the qualified use.
(4) Farm. The term "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.
(5) Farming purposes. The term "farming purposes" means
(A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;
(B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and
(C) (i) the planting, cultivating, caring for, or cutting of trees, or
(ii) the preparation (other than milling) of trees for market.
(6) Material participation. Material participation shall be determined in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a) (relating to net earnings from self-employment).
(7) Method of valuing farms.
(A) In general. Except as provided in subparagraph (B), the value of a farm for farming purposes shall be determined by dividing—

(i) the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual State and local real estate taxes for such comparable land, by
(ii) the average annual effective interest rate for all new Federal Land Bank loans.
For purposes of the preceding sentence, each average annual computation shall be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death.
(B) Value based on net share rental in certain cases.
(i) In general. If there is no comparable land from which the average annual gross cash rental may be determined but there is comparable land from which the average net share rental may be determined, subparagraph (A)(i) shall be applied by substituting "average annual net share rental" for "average annual gross cash rental".
(ii) Net share rental. For purposes of this paragraph, the term "net share rental" means the excess of—
(I) the value of the produce received by the lessor of the land on which such produce is grown, over
(II) the cash operating expenses of growing such produce which, under the lease, are paid by the lessor.
(C) Exception. The formula provided by subparagraph (A) shall not be used—
(i) where it is established that there is no comparable land from which the average annual gross cash rental may be determined, or
(ii) where the executor elects to have the value of the farm for farming purposes determined and that there is no comparable land from which the average net share rental may be determined under paragraph (8).
(8) Method of valuing closely held business interests, etc. In any case to which paragraph (7)(A) does not apply, the following factors shall apply in determining the value of any qualified real property:
(A) The capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors,
(B) The capitalization of the fair rental value of the land for farm land or closely held business purposes,
(C) Assessed land values in a State which provides a differential or use value assessment law for farmland or closely held business,
(D) Comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price, and
(E) Any other factor which fairly values the farm or closely held business value of the property.
(9) Property acquired from decedent. Property shall be considered to have been acquired from or to have passed from the decedent if—
(A) such property is so considered under section 1014(b) (relating to basis of property acquired from a decedent),
(B) such property is acquired by any person from the estate, or
(C) such property is acquired by any person from a trust (to the extent such property is includible in the gross estate of the decedent).
(10) Community property. If the decedent and his surviving spouse at any time held qualified real property as community property, the interest of the surviving spouse in such property shall be taken into account under this section to the extent necessary to provide a result under this section with respect to such property which is consistent with the result which would have obtained under this section if such property had not been community property.
(11) Bond in lieu of personal liability. If the qualified heir makes written application to the Secretary for determination of the maximum amount of the additional tax which may be imposed by subsection (c) with respect to the qualified heir's interest, the Secretary (as soon as possible, and in any event within 1 year after the making of such application) shall notify the heir of such maximum amount. The qualified heir, on furnishing a bond in such amount and for such period as may be required, shall be discharged from personal liability for any additional tax imposed by subsection (c) and shall be entitled to a receipt or writing showing such discharge.
(12) Active management. The term "active management" means the making of the management decisions of a business (other than the daily operating decisions).
(13) Special rules for woodlands.
(A) In general. In the case of any qualified woodland with respect to which the executor elects to have this subparagraph apply, trees growing on such woodland shall not be treated as a crop.
(B) Qualified woodland. The term "qualified woodland" means any real property which—
(i) is used in timber operations, and
(ii) is an identifiable area of land such as an acre or other area for which records are normally maintained in conducting timber operations.
(C) Timber operations. The term "timber operations" means—
(i) the planting, cultivating, caring for, or cutting of trees, or
(ii) the preparation (other than milling) of trees for market.
(D) Election. An election under subparagraph (A) shall be made on the return of the tax imposed by section 2001. Such election shall be made in such manner as the Secretary shall by regulations prescribe. Such an election, once made, shall be irrevocable.
(14) Treatment of replacement property acquired in section 1031 or 1033 transactions.
(A) In general. In the case of any qualified replacement property, any period during which there was ownership, qualified use, or material participation with respect to the replaced property by the decedent or any member of his family shall be treated as a period during which there was such ownership, use, or material participation (as the case may be) with respect to the qualified replacement property.
(B) Limitation. Subparagraph (A) shall not apply to the extent that the fair market value of the qualified replacement property (as of the date of its acquisition) exceeds the fair market value of the replaced property (as of the date of its disposition).
(C) Definitions. For purposes of this paragraph—
(i) Qualified replacement property. The term "qualified replacement property" means any real property which is—
(I) acquired in an exchange which qualifies under section 1031, or
(II) the acquisition of which results in the nonrecognition of gain under section 1033.
Such term shall only include property which is used for the same qualified use as the replaced property was being used before the exchange.
(ii) Replaced property. The term "replaced property" means—
(I) the property transferred in the exchange which qualifies under section 1031, or
(II) the property compulsorily or involuntarily converted (within the meaning of section 1033).

15 co-sponsors Rep. Carolyn Maloney [D-NY] and Rep. Maurice Hinchey [D-NY]

16 Section 170(h) provides" (h) Qualified conservation contribution.
(1) In general. For purposes of subsection (f)(3)(B)(iii), the term "qualified conservation contribution" means a contribution—
(A) of a qualified real property interest,
(B) to a qualified organization,
(C) exclusively for conservation purposes.
(2) Qualified real property interest. For purposes of this subsection, the term "qualified real property interest" means any of the following interests in real property:
(A) the entire interest of the donor other than a qualified mineral interest,
(B) a remainder interest, and
(C) a restriction (granted in perpetuity) on the use which may be made of the real property.
(3) Qualified organization. For purposes of paragraph (1), the term "qualified organization" means an organization which—
(A) is described in clause (v) or (vi) of subsection (b)(1)(A), or
(B) is described in section 501(c)(3) and—
(i) meets the requirements of section 509(a)(2), or
(ii) meets the requirements of section 509(a)(3) and is controlled by an organization described in subparagraph (A) or in clause (i) of this subparagraph.
(4) Conservation purpose defined.
(A) In general. For purposes of this subsection, the term "conservation purpose" means—
(i) the preservation of land areas for outdoor recreation by, or the education of, the general public,
(ii) the protection of a relatively natural habitat of fish, wildlife,

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or plants, or similar ecosystem,
(iii) the preservation of open space (including farmland and forest land) where such preservation is—
(I) for the scenic enjoyment of the general public, or
(II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy,
and will yield a significant public benefit, or
(iv) the preservation of an historically important land area or a certified historic structure.
(B) Special rules with respect to buildings in registered historic districts. In the case of any contribution of a qualified real property interest which is a restriction with respect to the exterior of a building described in subparagraph (C)(ii), such contribution shall not be considered to be exclusively for conservation purposes unless—
(i) such interest—
(I) includes a restriction which preserves the entire exterior of the building (including the front, sides, rear, and height of the building), and
(II) prohibits any change in the exterior of the building which is inconsistent with the historical character of such exterior,
(ii) the donor and donee enter into a written agreement certifying, under penalty of perjury, that the donee—
(I) is a qualified organization (as defined in paragraph (3)) with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and
(II) has the resources to manage and enforce the restriction and a commitment to do so, and
(iii) in the case of any contribution made in a taxable year beginning after the date of the enactment of this subparagraph [enacted Aug. 17, 2006], the taxpayer includes with the taxpayer's return for the taxable year of the contribution—
(I) a qualified appraisal (within the meaning of subsection (f)(11)(E)) of the qualified property interest,
(II) photographs of the entire exterior of the building, and
(III) a description of all restrictions on the development of the building.
(C) Certified historic structure. For purposes of subparagraph (A)(iv), the term "certified historic structure" means—
(i) any building, structure, or land area which is listed in the National Register, or
(ii) any building which is located in a registered historic district (as defined in section 47(c)(3)(B) and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.
A building, structure, or land area satisfies the preceding sentence if it satisfies such sentence either at the time of the transfer or on the due date (including extensions) for filing the transferor's return under this chapter for the taxable year in which the transfer is made.
(5) Exclusively for conservation purposes. For purposes of this subsection—
(A) Conservation purpose must be protected. A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.
(B) No surface mining permitted.
(i) In general. Except as provided in clause (ii), in the case of a contribution of any interest where there is a retention of a qualified mineral interest, subparagraph (A) shall not be treated as met if at any time there may be extraction or removal of minerals by any surface mining method.
(ii) Special rule. With respect to any contribution of property in which the ownership of the surface estate and mineral interests has been and remains separated, subparagraph (A) shall be treated as met if the probability of surface mining occurring on such property is so remote as to be negligible.
(6) Qualified mineral interest. For purposes of this subsection, the term "qualified mineral interest" means—
(A) subsurface oil, gas, or other minerals, and
(B) the right to access to such minerals.

17 co-sponsor Rep. Charles Dent [R-PA]

18 no co-sponsors

19 co-sponsor Rep. Eric Cantor [R-VA]

20 co-sponsors Rep. Lynn Westmoreland [R-GA], Rep. Roy Blunt [R-MO], Rep. Paul Broun [R-GA], Rep. Walter Jones [R-NC], Rep. Ileana Ros-Lehtinen [R-FL], Rep. Thomas Rooney [R-FL], Rep. Addison Wilson [R-SC], Rep. Dan Burton [R-IN], Rep. Rodney Alexander [R-LA], Rep. Marsha Blackburn [R-TN] and Rep. Trent Franks [R-AZ]

21 co-sponsors Sen. Thomas Coburn [R-OK], Sen. John Cornyn [R-TX] and Sen. John Isakson [R-GA]

22 co-sponsors Rep. John Kline [R-MN], Rep. Ander Crenshaw [R-FL], Rep. Jeff Miller [R-FL], Rep. Lynn Jenkins [R-KS], Rep. Lynn Westmoreland [R-GA], Rep. Rodney Alexander [R-LA], Rep. John Mica [R-FL], Rep. John Carter [R-TX], Rep. Roscoe Bartlett [R-MD], Rep. Gary Miller [R-CA], Rep. Bill Posey [R-FL], Rep. Virginia Brown-Waite [R-FL], Rep. Steve King [R-IA], Rep. Paul Broun [R-GA], Rep. Nathan Deal [R-GA], Rep. Samuel Graves [R-MO], Rep. Tom Price [R-GA], Rep. Brian Bilbray [R-CA], Rep. Michael Conaway [R-TX], Rep. John Culberson [R-TX], Rep. Jeb Hensarling [R-TX], Rep. William Thornberry [R-TX], Rep. Pete Olson [R-TX], Rep. John Gingrey [R-GA], Rep. Randy Neugebauer [R-TX], Rep. Jerry Moran [R-KS], Rep. Mary Fallin [R-OK], Rep. Frank Lucas [R-OK], Rep. John Fleming [R-LA], Rep. Zach Wamp [R-TN], Rep. Todd Akin [R-MO], Rep. Clifford Stearns [R-FL], Rep. Jack Kingston [R-GA], Rep. Darrell Issa [R-CA], Rep. Donald Young [R-AK], Rep. John Duncan [R-TN], Rep. Henry Brown [R-SC], Rep. Mike Pence [R-IN], Rep. Edward Whitfield [R-KY], Rep. Kevin Brady [R-TX], Rep. Rob Bishop [R-UT], Rep. Ted Poe [R-TX], Rep. Todd Tiahrt [R-KS], Rep. Michael McCaul [R-TX], Rep. Sue Myrick [R-NC], Rep. Dan Burton [R-IN], Rep. Trent Franks [R-AZ], Rep. Spencer Bachus [R-AL], Rep. Doug Lamborn [R-CO], Rep. John Sullivan [R-OK] and Rep. Rob Wittman [R-VA]

23 co-sponsors Rep. Mark Kirk [R-IL], Rep. Sue Myrick [R-NC], Rep. Michael Conaway [R-TX], Rep. Joseph Pitts [R-PA], Rep. Donald Young [R-AK] and Rep. Glenn Nye [D-VA]

24 no cosponors

25 Section 6018(a)(1) provides, "In all cases where the gross estate at the death of a citizen or resident exceeds the applicable exclusion amount in effect under section 2010(c) for the calendar year which includes the date of death, the executor shall make a return with respect to the estate tax imposed by subtitle B et seq."

26 no cosponsors

27 H.R. 436 cross-references Section 1092, one of the wash-sales provisions dealing with straddles, for a definition of actively traded. That section does not include a definition of that term, except in the context of foreign currency transactions where there is an active interbank market.

28 Section 469(c)(7)(C) provides: "For purposes of this paragraph, the term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

29 Section 469(c)(7)(B)(ii) provides, "This paragraph shall apply to a taxpayer for a taxable year if— … (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates."

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THE NEW AND IMPROVED FBAR: BROADER IN SCOPE WITH ENHANCED ENFORCEMENT BUT NOT MORE CLARITY

Joseph M. Erwin1

I. Introduction

Tax lawyers and other tax practitioners are generally aware of the requirement that U.S. persons file a form reporting ownership in foreign financial accounts. This awareness is now certainly extended to the general public with the onset of the UBS affair. The IRS indicates approximately 322,000 FBARs were filed for 2007, up 60% since 2003.[2] The FBAR is the centerpiece for the current embroglio between the United States, Switzerland, UBS AG, and thousands of yet unnamed U.S. taxpayers over non-compliance with the FBAR filing requirements on the part of U.S. citizens and non-compliance by UBS AG in its role as a participant in the Qualified Intermediary[3] scheme.

The current climate of enhanced U.S. investigation and enforcement of penalties for failure to comply with this requirement made the promulgation of a new form for reporting foreign financial accounts seem inevitable. Nevertheless, while the enforcement effort has been gathering momentum for the last decade or so,[4] it was not until late in 2008 that the modest reporting form was revised and its scope expanded.

A Report of Foreign Bank and Financial Accounts (Treasury Form TD F 90.22-1) (colloquially, and herein, the "FBAR") is required to be filed by U.S. persons who have "a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country . . . ."[5] The requirement to report an interest in a foreign financial account is administered in two steps. The U.S. income tax return for U.S. resident persons asks if the taxpayer has an interest in a foreign financial account.[6] If the answer is affirmative, the instruction directs the taxpayer to TD F 90.22-1, the FBAR. The new FBAR and its instructions significantly broaden the scope of persons required to file the form: trust protectors, owners of foreign mutual funds, foreign persons with a U.S. presence, and others are now required to file an FBAR.

II. Background

A. The Bank Secrecy Act of 1970 and the Regulations

The requirement to inform the U.S. government of the ownership of an interest in a foreign financial account arises from the Bank Secrecy Act of 1970.[7] The concern of Congress was that foreign financial accounts were being used to evade domestic criminal, tax, and other regulatory requirements.[8] By one of the more awkwardly worded Federal statutes, citizens and residents of the United States and persons "in, or doing business in" the United States are required to "keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency."[9] The records and reports are to contain information about the identity and address of the "participants" to the relationship, the legal capacity of the "participants," the identity of the real parties in interest, and a description of the transaction.[10] The statute grants the Secretary of the Treasury authority to prescribe exceptions and other matters.[11] The FBAR filing requirement in the statute is explained only by a short regulation.[12] The reporting requirement has withstood constitutional challenge.[13]

Note that the Bank Secrecy Act statutes require not just the fililng of FBARs but also the requirement to keep records with the same information.[14] The record keeping requirement is subject to the same sanctions as failure to file the FBAR. The information must be kept for five years.[15]

B. Prior Form

The previous edition of the FBAR was last revised in 2000. It was a modest two page document ("This side can be copied as many times as necessary in order to provide information on all accounts."[16]) with a page and a half of instructions. It required basic information about the existence of the foreign account: type, maximum value within a set of ranges, financial institution, country, and name and address of account owner.[17]

There was sparse official guidance for preparation of FBARs, making the FBAR instructions the most significant part of the prior form. Given the importance of the FBAR to tax and law enforcement, the instructions were meager. Cryptic changes to the interpretation of the form's coverage enhanced the confusion as to the ambit of the requirement to file an FBAR. Notably the IRS issued an information statement in 2007 stating, but with no publicity, that shares of a mutual fund and unit trust were included within the meaning of "financial account" subject to FBAR reporting.[18] This guidance-by-stealth was sharply criticized.[19] The number of pages on the IRS website devoted to FBAR issues have increased but add little to the existing regulations and instructions on the form itself.[20]

The importance of the instructions to the FBAR is dramatically illustrated by their effect of having the force of law. While other IRS instructions are not generally considered to have the force of law[21] — much less a basis for criminal action — the instructions to FBARs have been deemed to carry much more weight. In United States v. Clines,[22] the U.S. Court of Appeals applied definitions in the instructions to the FBAR to uphold a conviction for failing to file the return.

C. Transfer of Administration and Enforcement from FinCEN to IRS.

In 2003, the responsibility for administration and enforcement of FBAR filings was transferred from the U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") to the IRS under a memorandum of agreement, with FinCEN retaining its autority of other Bank Secrecy Act reports such as the Suspcious Activity Report.[23] The rationale given for the re-delegation of authority was that because FBARs were usually filed by individuals and more related to tax enforcement, it was a more "natural fit" for the IRS to administer compliance.[24]

III. FBAR Current Law

A. The New Instructions

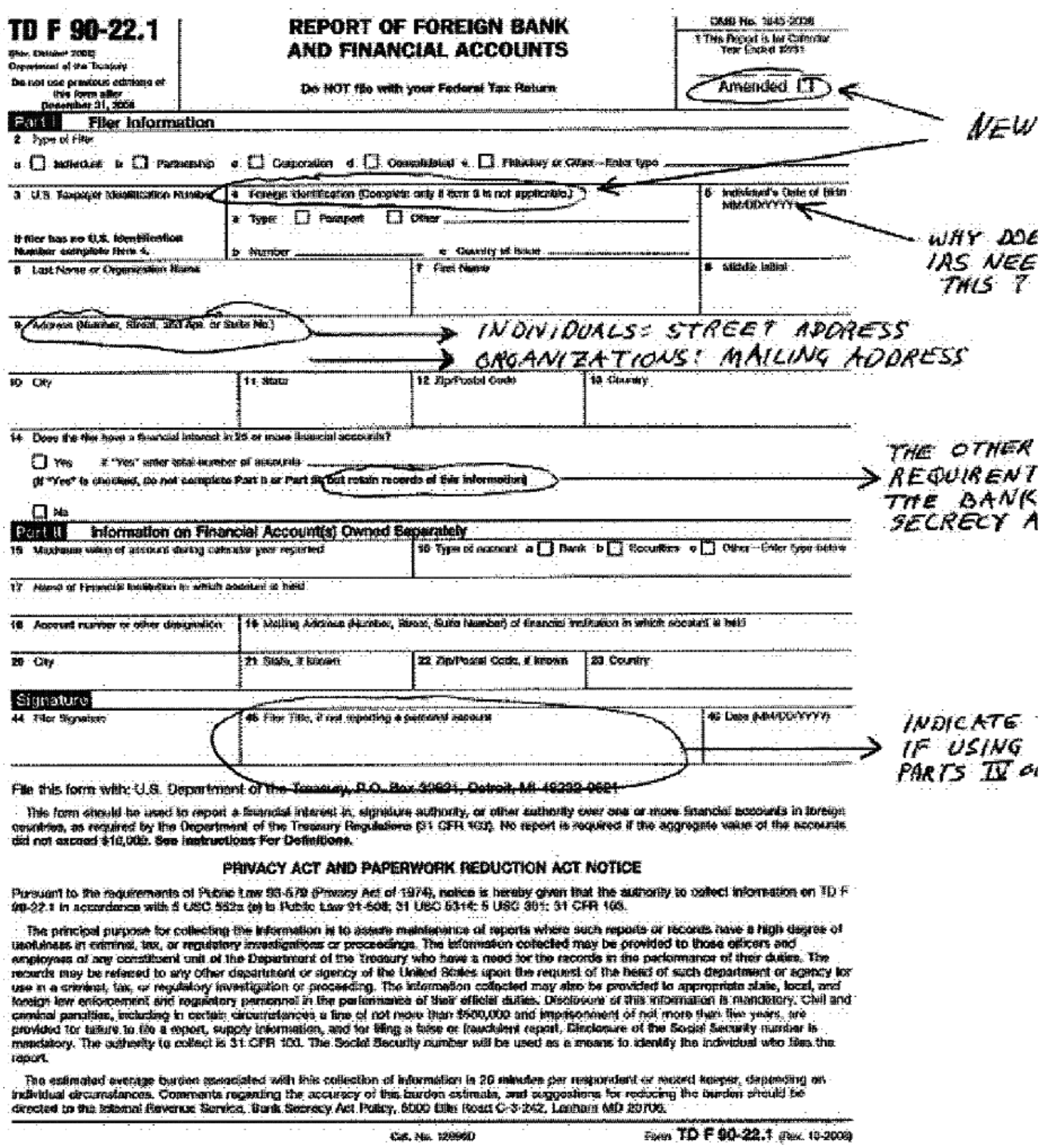
1. Generally

Though the FBAR is referenced in U.S. tax returns and its enforcement is administered by the IRS, the terms that describe the technicalities of filing are not tax terms of art or otherwise generally defined in the Internal Revenue Code and its regulations. The FBAR instructions define some of the terms and some are defined by reference to regulations issued under Title 31 of the U.S. Code.

The major changes to the form and its instructions are: 1) a simple box to check that it is an amended return; 2) new rules for jointly held accounts; 3) greater differentiation of capacity in which accounts are held and increased information required; 4) range of account sizes replaced with maximum value of the account; 5) identification number of non-U.S. citizen filers now required; and 6) more examples to illustrate types of accounts covered.

The format of the new FBAR is easier to follow, with the different types of a account holdings reported in different parts of the form and item numbers are consistent throughout all parts of the form. The first item on new form TD F 90.22-1 is a space for indication of the calendar year for which the form is being filed and provides a box to tick to indicate that it is an amended report. There was no obvious method for making an amended FBAR with the old form. If it is an amended FBAR, the filer is asked to "[p]lease also attach a statement explaining the changes."[25] There follows here the five separate parts of the new FBAR.

Part I requires information about the person filing the return. New is the requirement to provide identifying numbers from some document (Item 4) if the filer does not have a U.S. Taxpayer Identification Number (Item 3). On the previous form, this section contained a question as to whether the accounts were jointly owned, which is now addressed by Parts III, IV, and V.


TD F 90-22.1
(Rev. October 2008)
Department of the Treasury
Do not use previous editions of this form after December 31, 2008

REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS

Do NOT file with your Federal Tax Return

OMB No. 1545-2038
1 This Report is for Calendar Year Ended 12/31
Amended

NEW

Part I Filer Information

2 Type of Filer
a Individual b Partnership c Corporation d Consolidated e Fiduciary or Other—Enter type

3 U.S. Taxpayer Identification Number
If filer has no U.S. Identification Number complete Item 4.

4 Foreign identification (Complete only if item 3 is not applicable.)
a Type: Passport Other
b Number c Country of Issue

5 Individual's Date of Birth MM/DD/YYYY

WHY DOE IRS NEE THIS ?

6 Last Name or Organization Name
7 First Name
8 Middle Initial

9 Address (Number, Street, and Apt. or Suite No.)

INDIVIDUALS: STREET ADDRESS
ORGANIZATIONS: MAILING ADDRESS

10 City
11 State
12 Zip/Postal Code
13 Country

14 Does the filer have a financial interest in 25 or more financial accounts?
Yes If "Yes" enter total number of accounts
(If "Yes" is checked, do not complete Part II or Part III, but retain records of this information)
No

THE OTHER REQUIRENT THE BANK SECRECY A

Part II Information on Financial Account(s) Owned Separately

15 Maximum value of account during calendar year reported
16 Type of account a Bank b Securities c Other—Enter type below
17 Name of Financial Institution in which account is held
18 Account number or other designation
19 Mailing Address (Number, Street, Suite Number) of financial institution in which account is held
20 City
21 State, if known
22 Zip/Postal Code, if known
23 Country

Signature

44 Filer Signature
45 Filer Title, if not reporting a personal account
46 Date (MM/DD/YYYY)

INDICATE IF USING PARTS IV OR

File this form with: U.S. Department of the Treasury, P.O. Box 32621, Detroit, MI 48232-0621

This form should be used to report a financial interest in, signature authority, or other authority over one or more financial accounts in foreign countries, as required by the Department of the Treasury Regulations (31 CFR 103). No report is required if the aggregate value of the accounts did not exceed $10,000. See Instructions For Definitions.

PRIVACY ACT AND PAPERWORK REDUCTION ACT NOTICE

Pursuant to the requirements of Public Law 93-579 (Privacy Act of 1974), notice is hereby given that the authority to collect information on TD F 90-22.1 in accordance with 5 USC 552a (e) is Public Law 91-508; 31 USC 5314; 5 USC 301; 31 CFR 103.

The principal purpose for collecting the information is to assure maintenance of reports where such reports or records have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings. The information collected may be provided to those officers and employees of any constituent unit of the Department of the Treasury who have a need for the records in the performance of their duties. The records may be referred to any other department or agency of the United States upon the request of the head of such department or agency for use in a criminal, tax, or regulatory investigation or proceeding. The information collected may also be provided to appropriate state, local, and foreign law enforcement and regulatory personnel in the performance of their official duties. Disclosure of this information is mandatory. Civil and criminal penalties, including in certain circumstances a fine of not more than $500,000 and imprisonment of not more than five years, are provided for failure to file a report, supply information, and for filing a false or fraudulent report. Disclosure of the Social Security number is mandatory. The authority to collect is 31 CFR 103. The Social Security number will be used as a means to identify the individual who files the report.

The estimated average burden associated with this collection of information is 20 minutes per respondent or record keeper, depending on individual circumstances. Comments regarding the accuracy of this burden estimate, and suggestions for reducing the burden should be directed to the Internal Revenue Service, Bank Secrecy Act Policy, 5000 Ellin Road C-3-242, Lanham MD 20706.

Cat. No. 12996D Form TD F 90-22.1 (Rev. 10-2008)

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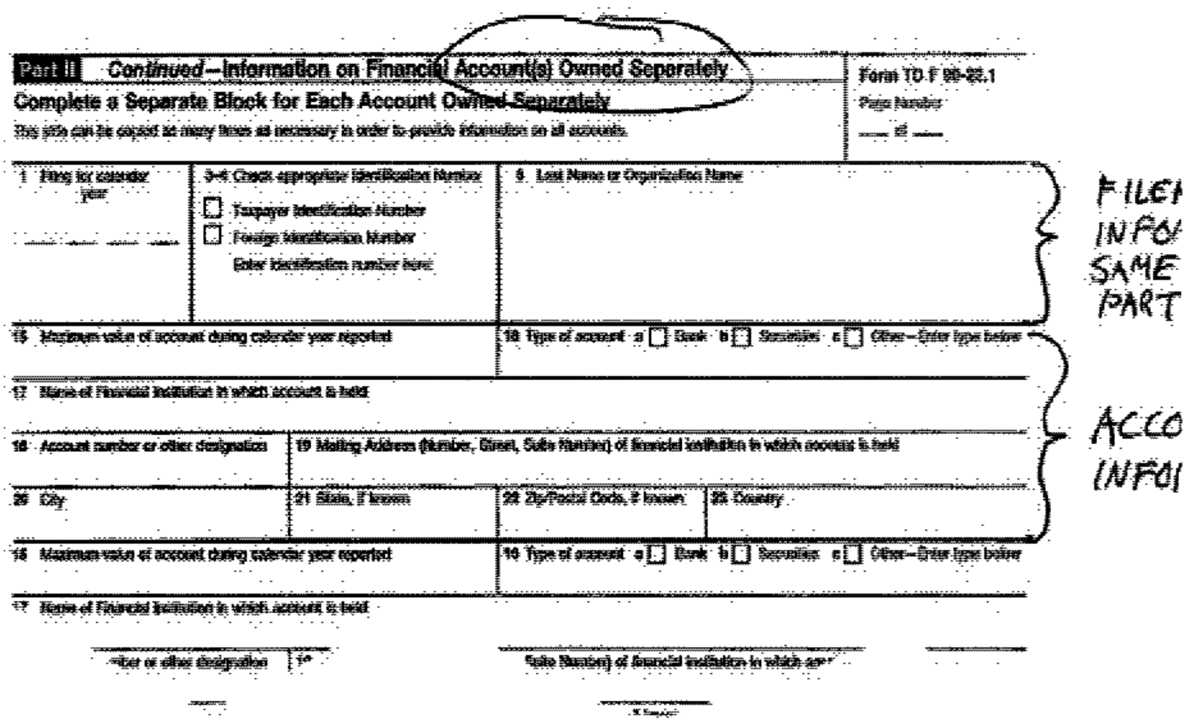
Part II requires information on financial accounts owned separately. Unlike the previous form which had a set of ranges for the value of the account, the new FBAR requires the maximum amount in the account during the reporting period to be provided.

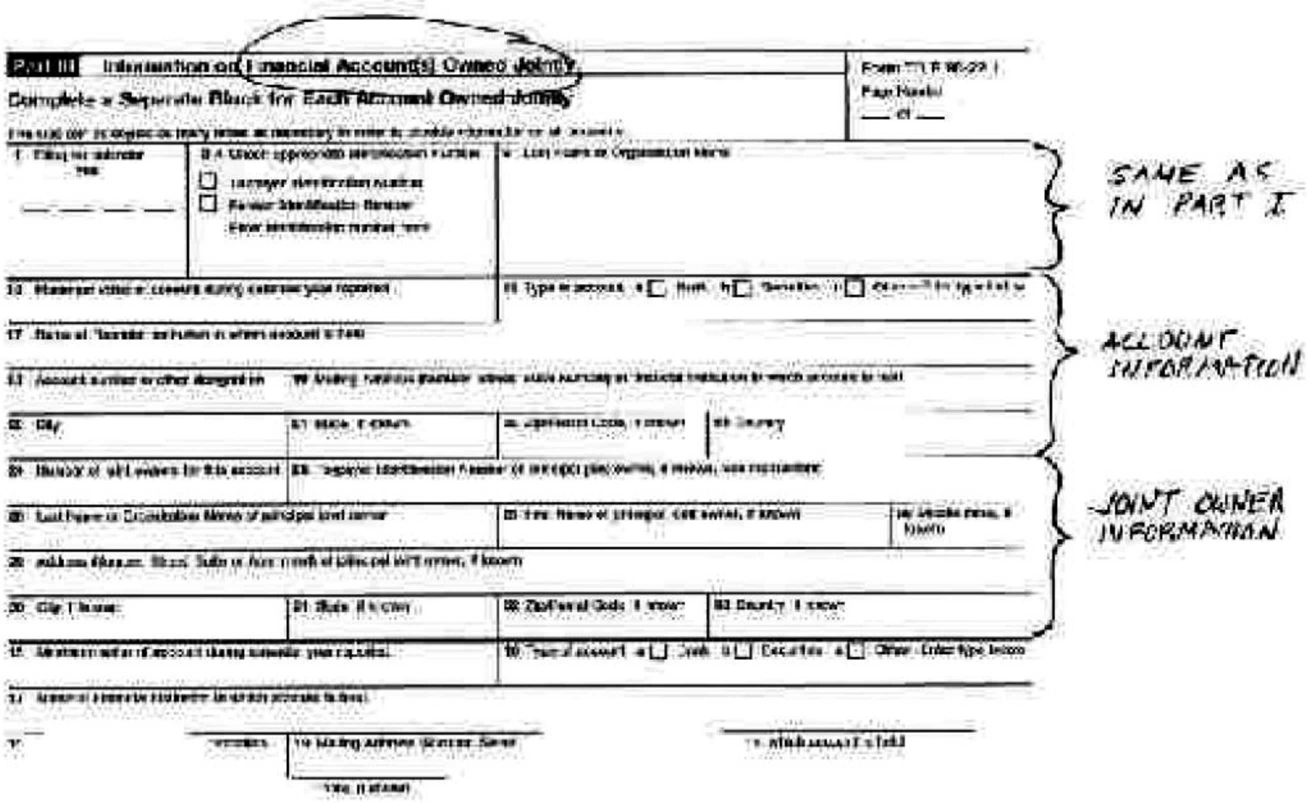


Part II Continued—Information on Financial Account(s) Owned Separately
Complete a Separate Block for Each Account Owned Separately
This side can be copied as many times as necessary in order to provide information on all accounts.

Form TD F 90-22.1
Page Number
___ of ___

1 Filing for calendar year
3-4 Check appropriate Identification Number
Taxpayer Identification Number
Foreign Identification Number
Enter identification number here:
5 Last Name or Organization Name
15 Maximum value of account during calendar year reported
16 Type of account a ☐ Bank b ☐ Securities c ☐ Other—Enter type below
17 Name of Financial Institution in which account is held
18 Account number or other designation
19 Mailing Address (Number, Street, Suite Number) of financial institution in which account is held
20 City
21 State, if known
22 Zip/Postal Code, if known
23 Country
15 Maximum value of account during calendar year reported
16 Type of account a ☐ Bank b ☐ Securities c ☐ Other—Enter type below
17 Name of Financial Institution in which account is held

Part III and the following parts are new. This part requires information about jointly owned accounts. On the old form, FBAR filers had to figure out how to describe the person for whom the report was being filed in these situations. The new FBAR provides for filing a joint FBAR by per-

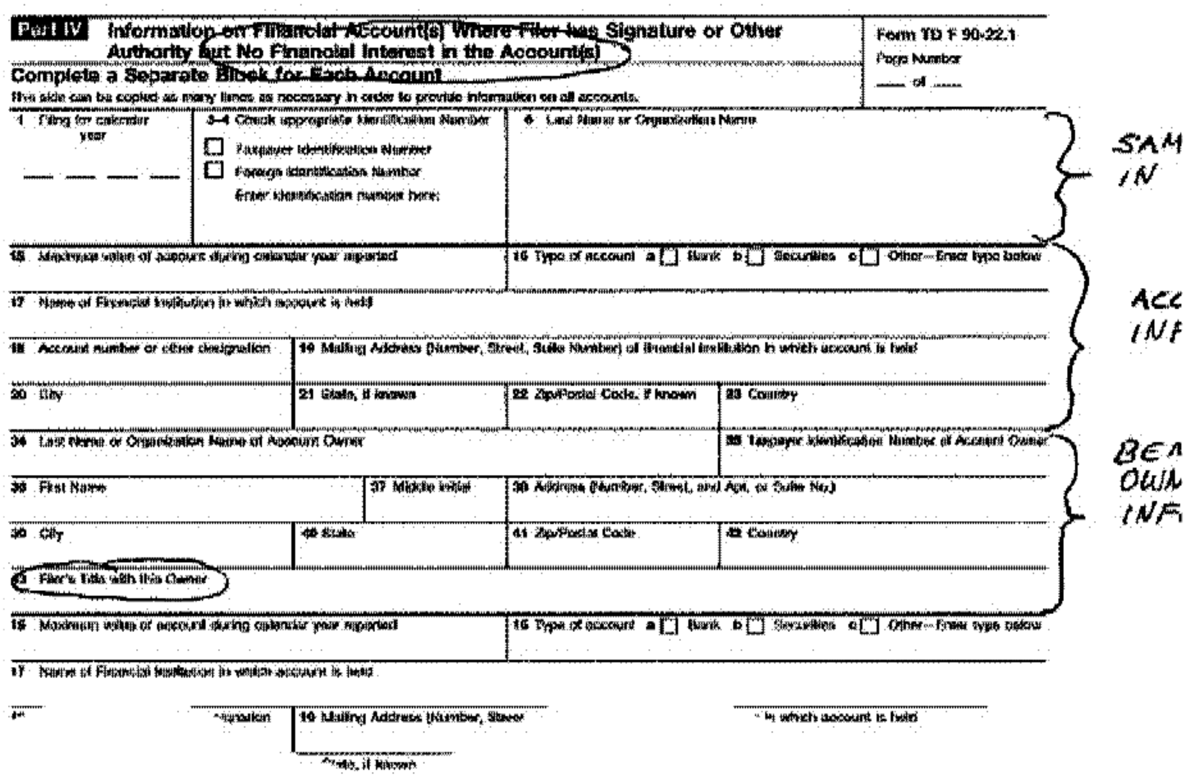


Part III Information on Financial Account(s) Owned Jointly
Complete a Separate Block for Each Account Owned Jointly

Form TD F 90-22.1
Page Number
___ of ___

sons holding a foreign account jointly.

Part IV requires information about accounts for which the filer has signatory authority but no financial interest. Perhaps the most drastic change to the FBAR instructions and form is the requirement that the identity of a foreign owner of an account over which a U.S. person had signatory authority must now be disclosed.[26] Because the requirement to file an FBAR under the previous instructions only applied to U.S. persons, if the owner of the financial account was not a U.S. person the filer could appropriately not provide the information relative to the foreign owner. [27]


Part IV Information on Financial Account(s) Where Filer has Signature or Other Authority but No Financial Interest in the Account(s)

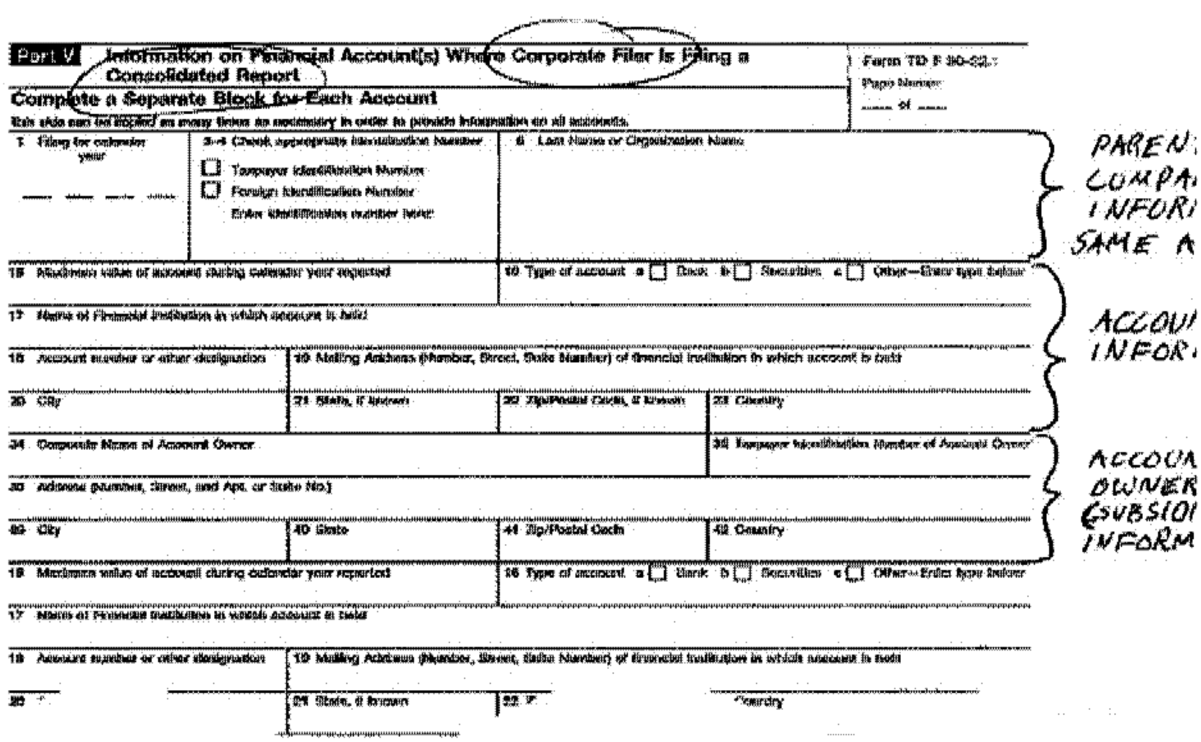
Form TD F 90-22.1 Page Number ___ of ___

Complete a Separate Block for Each Account

This side can be copied as many times as necessary in order to provide information on all accounts.

1 Filing for calendar year
3-4 Check appropriate Identification Number: Taxpayer Identification Number; Foreign Identification Number; Enter identification number here:
6 Last Name or Organization Name
15 Maximum value of account during calendar year reported
16 Type of account a Bank b Securities c Other—Enter type below
17 Name of Financial Institution in which account is held
18 Account number or other designation
19 Mailing Address (Number, Street, Suite Number) of financial institution in which account is held
20 City
21 State, if known
22 Zip/Postal Code, if known
23 Country
34 Last Name or Organization Name of Account Owner
35 Taxpayer Identification Number of Account Owner
36 First Name
37 Middle initial
38 Address (Number, Street, and Apt. or Suite No.)
39 City
40 State
41 Zip/Postal Code
42 Country
43 Filer's Title with this Owner
15 Maximum value of account during calendar year reported
16 Type of account a Bank b Securities c Other—Enter type below
17 Name of Financial Institution in which account is held

Part V requires information about financial accounts of a corporation filing for other entities.


Part V Information on Financial Account(s) Where Corporate Filer Is Filing a Consolidated Report

Form TD F 90-22.1 Page Number ___ of ___

Complete a Separate Block for Each Account

This side can be copied as many times as necessary in order to provide information on all accounts.

1 Filing for calendar year
3-4 Check appropriate Identification Number: Taxpayer Identification Number; Foreign Identification Number; Enter identification number here:
6 Last Name or Organization Name
15 Maximum value of account during calendar year reported
16 Type of account a Bank b Securities c Other—Enter type below
17 Name of Financial Institution in which account is held
18 Account number or other designation
19 Mailing Address (Number, Street, Suite Number) of financial institution in which account is held
20 City
21 State, if known
22 Zip/Postal Code, if known
23 Country
34 Corporate Name of Account Owner
35 Taxpayer Identification Number of Account Owner
38 Address (Number, Street, and Apt. or Suite No.)
39 City
40 State
41 Zip/Postal Code
42 Country
15 Maximum value of account during calendar year reported
16 Type of account a Bank b Securities c Other—Enter type below
17 Name of Financial Institution in which account is held
18 Account number or other designation
19 Mailing Address (Number, Street, Suite Number) of financial institution in which account is held

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2. The Operative Instruction

Given the premise that the FBAR Instructions, unlike other instructions to tax forms, have the force of law (see II.B., above) and there being so little other interpretive or authoritative guidance, it is important to set out and parse the operative instruction. This is found in the first section of the FBAR Instructions and reads, in its entirety, as follows:

> Each [1] *United States person* who has a [2a] *financial interest* in or [2b] *signature or other authority* over [3a] any *foreign financial accounts*, including banks, securities, or other types of financial accounts, [3b] in a *foreign country*, [4] if the aggregate value of these financial accounts exceeds $10,000 at any time during the calendar year, [5] must report that relationship each calendar year by filing this report with the Department of the Treasury on or before June 30, of the succeeding year.[28]

The rest of the FBAR Instructions are exceptions, definitions, or instructions specific to a item box on the report. Particularly note that the requirements for [2a] *financial interest* and [2b] *signature or other authority* are in the disjunctive; meeting either standard is sufficient. Each segment of the operative instruction is analyzed below.

3. *United States person* ([1], *supra*)

The term *United States person* is defined in the FBAR Instructions to mean "a citizen or resident of the United States, or a person in and doing business in the United States" and invokes the Treasury Regulations for a "complete" definition of "person." The applicable regulation includes within the definition "all entities cognizable as legal personalities."29 The FBAR Instruction states that a branch of a foreign entity that is "doing business in the United States" is required to file the FBAR even if not separately incorporated.

The phrase "doing business in the United States" is not defined. As will be seen in the analysis of other FBAR terms of art, *United States person* and other phrases are similar to Internal Revenue Code concepts but there is no equivalent definition within Title 31 of the U.S. Code, its regulations, or the FBAR Instructions. Since FBAR filings are being administered by the IRS one would expect the examining agent to apply I.R.C. principles just as a matter of familiarity, however, this allows for an arbitrary approach by the agent in the absence of controlling authority.[30]

4. *Financial interest* ([2a])

The FBAR Instructions expand the definition of financial interest by eliminating the restriction in the former instructions which limited its applicability to interests in which a U.S. person was involved. Specifically, a United States person has a *financial interest* in a foreign account if the *United States person*:

a. has legal title or is owner of record of the foreign account, even if some other person, including a non-*United States person*, is the beneficial owner;

b. established a foreign trust that has a foreign account and a "trust protector" has been appointed;

c. is the *United States person* for whom another person is the holder of legal title acting as agent or in some capacity on behalf of such *United States person*;

d. is the direct[31] or indirect owner of more than 50% of vote or value of a corporation which is the owner of record or holder of legal title of the foreign account;

e. is the owner of more than 50% of the profits or capital interests in a partnership which is the owner of record or holder of legal title of the foreign account; or

f. has a beneficial interest, directly or indirectly, in more than 50% of the assets or income of a trust which is the owner of record or holder of legal title of the foreign account.

5. *Signature or other authority* ([2b])

The FBAR Instructions contain the almost identical language as in the previous form's instructions for the meaning of *signature or other authority*. A new phrase, "either directly or through an agent, nominee, attorney, or insome other capacity on behalf of the U.S. person," is rather all-encompassing and appears to include authority as is sometimes exercised by trust protectors. The remoteness of control that still remains within the coverage of the FBAR requirement was illustrated in United States v. Clines. Though the defendant did not have signatory authority over a foreign bank account owned by the company, he had a "capital account" with the company from which he could direct distributions to be made and was thus convicted of failing to report his interest.[32]

6. *Foreign financial accounts* ([3a])

Item 16 of Parts II through V of the new FBAR each asks for the type of account, giving a choice of "Bank," "Securities," of "Other — Enter type below." The meaning of "bank" and "securities" accounts are obvious but many types of holdings not previously thought of as coming within the ambit of the FBAR are now, somewhat more certainly but not without doubt, required to be disclosed on the FBAR. It was noted previously that an obscure Fact Sheet issued by the IRS in 2007 was the first pronouncement by the IRS that it considered foreign mutual funds and unit trusts to be within the scope of "financial account" as that term was defined in the definitions with the 2000 FBAR. The new instructions explicitly reference mutual fund.[33]

The regulation uses the phrase "bank, securities, or other financial account" to reference the type of account for which an FBAR must be filed.[34] The new FBAR instructions use the phrase "any bank, securities, securities derivatives or other financial instruments accounts" and continues to explain the scope of such definition by referencing commingled funds, mutual funds, debit cards, and prepaid credit cards.[35] The authorizing statute, however, uses the phrase "foreign financial agency" which the Treasury explained in the regulations to mean a "person acting outside the United States for a person … as a financial institution, bailee, depository trustee, or agent, or acting in a similar way related to money, credit, securities, gold, or a transaction in money, credit, securities, or gold."[36] These various authorities create some ambiguity in how the instructions to the new FBAR should be considered, given the expansion of the definition of types of accounts to be reported without corresponding changes in the statute or regulations. Nevertheless, it is common practice for filers of FBARs, even before the new form and instructions, to file an FBAR for an *United States persons'* greater than 50% interest in a foreign trust or company which itself had a foreign bank account.

7. *Foreign country* ([3b])

The FBAR Instructions state that the term *foreign country* includes all areas outside the "United States." The term "United States" is defined by reference to Title 31 regulations; this definition differs from that under the I.R.C. in that the Indian Lands and the U.S. territories are included within the term for purposes of the FBAR.[37]

The determining factor as to whether the account is in a foreign country is where the account is located, not the country in which the institution is chartered. Therefore, accounts opened in U.S. branches of foreign banks are not subject to FBAR reporting but accounts opened in foreign branches of U.S. banks are.

8. *Value of these financial accounts exceeds $10,000* ([4])

The FBAR is only required to be filed if the amount in the account exceeds $10,000 at any time during the reporting (calendar) year. This instruction is the same as with the previous form and carries over the ambiguous wording "aggregate value of these accounts" as if to mean that even if multiple accounts were each less than the threshold amount, if the aggregate sum of all accounts exceeded $10,000, an FBAR must be filed for all accounts. This language is presumably superseded by the explicit instruction for each item 15 in which the amount in multiple accounts are to be valued separately.

The amount is reported in U.S. dollars using the official exchange rate as of the end of the year.[38] For stock, securities, or other non-monetary asset accounts, the amount is the fair market value at the end of the year or at the time the assets were withdrawn. [39]

9. *FBAR Due June 30 of Following Year* ([5])

The FBAR is required to be filed on or before June 30, of the year following the year for which the report covers. All FBARs are filed with the one IRS FBAR-dedicated office in Detroit but local IRS offices and tax attaches in some U.S. embassies can accept them. There is no authority or provision for an extension of time to file but the new form does allow for amended returns. The FBAR Instructions direct that for late-filed returns, a statement explaining the reason for the late-filing should be attached.[40]

B. Special Instructions for Multiple Accounts, Jointly Held Accounts, Parent-Subsidiaries and Exceptions

1. Parent-Subsidiary

A corporation which owns more than 50% interest, directly or indirectly, in another entity may file a consolidated FBAR for those majority owned subsidiaries (Part I, Item 2d and Part V).

2. Accounts Held Jointly by Spouses.

Spouses who own the foreign account jointly "should," according to the FBAR Instructions file one return, reporting all jointly held accounts. Each spouse would sign in the signature box (Item 44) and indicate in the item 26 box that the joint owner is a spouse.

3. More Than 25 Accounts.

As with the previous form, the new FBAR allows holders of more than 25 foreign accounts to merely indicate so on the form (Item 14) but the holder must retain the records.[41] Note that the requirement to maintain records is the second part of the Bank Secrecy Act as relevant to holders of foreign accounts and is subject to the same penalties.

4. Exceptions.[42]

a. Nostro Accounts. International interbank transfer accounts, called "nostro" accounts are covered by other Bank Secrecy Act reporting requirements and are excepted from FBAR reporting.

b. Military Banking Facility. Accounts at banking facilities established and operated to serve U.S. Government installations outside the United States are not considered to be in a foreign country even if actually located there.

c. Individual Stocks and Bonds. The FBAR Instructions state that "[i]ndividual bonds, notes, or stock certificates" and "unsecured loan to a foreign trade or business that is not a financial institution" are not considered financial accounts for FBAR purposes. No ownership percentage is indicated for the stock so it might be assumed that this only applies to stock ownership less than 50% in vote or value.

d. Foreign Subsidiary of U.S. Parent Corporation. The foreign subsidiary of a U.S. corporation is not required to file the FBAR although its parent company would be.

e. Officers of Domestic, Publicly or Widely Held Corporations. An officer or employee of a publicly traded domestic corporation or a domestic corporation with more than $10 million in assets and 500 or more shareholders if such officer or employee has no personal interest in the account and a responsible officer of the corporation has advised such person that the FBAR for the account has been filed, are not required to file an FBAR for that account.

f. Officers of Banks Under Examination. Employees of banks under examination by bank supervisory agencies need not file an FBAR if they have no personal interest in the foreign account.

B. Enforcement, Penalties, and Collection

Since the transfer of enforcement and administration of FBAR filings to the IRS, the agency has established procedures for its examinations of FBAR compliance.[43] Because of concerns about disclosures of taxpayer information in violation of I.R.C. §6103, a "good faith" determination must be made that an apparent FBAR violation was in furtherance of an income tax violation under the I.R.C. in order to allow the IRS examiner to use the information obtained in the income tax examination in the FBAR examination.[44] The IRS has summons and other requisite powers to investigate FBAR matters,[45] with summons authority arising from Title 31. The IRS promulgated Power of Attorney (Form 2848) is not to be used.

Prior to the enactment of the American Jobs Creation Act of 2004,[46] the civil penalty for failure to file an FBAR was a minimum of $25,000 or the value of the account "at the time of the violation" up to $100,000.[47] The statute required that the violation be done "willfully." The AJCA 2004 changed the statute, bifurcating the penalty into a willful category and non-willful category, adding a reasonable cause exception to the latter.[48]

The current penalty structure that exists now may be summarized as follows:

Level of Violation	Civil Penalty	Criminal Penalty
Negligence (only applicable to a "financial institution or non-financial trade or business")	Up to $500[49]	[not applicable]
Non-willful	Up to $10,000 for each violation[50]	[not applicable]
Pattern of negligent activity	In addition to $500 penalty, not more than $50,000[51]	[not applicable]
Willful failure either 1) to file FBAR or 2) retain FBAR-related records	Up to greater of a) $100,000 or b) 50% of amount in the account "at time of the violation"[52]	Up to $250,000 or 5 years or both[53]
Willful failure either 1) to file FBAR or 2) retain FBAR-related records while violating certain other laws		Up to $500,000 or 10 years or both[54]
Knowlingly and willfully filing false FBAR		$100,000 or 5 years or both[55]

The Bank Secrecy Act statute, its regulations, and the FBAR Instructions do not describe what the standard is for neglience in failing to file an FBAR. FBAR examiners have been advised however to "[u]se general negligence principles," and the reasonable cause and good faith exception to I.R.C. §6662 penalties as guidance.[56] The FBAR statute, as noted above, does provide for a reasonable cause exception; however its construct appears to require not only that the failure was due to reasonable cause but that the "balance in the account … was properly reported."[57]

There is an anomaly in the penalty provisions of the statute in that the penalty may be based on the "balance in the account at the time of the violation." As the violation is the failure to file the FBAR on or before June 30 and the balance in the account on that date may be substantially different than it is for the period covered by the FBAR, a penalty may be imposed on an account that has since been drawn down or substantially increased since the end of the reporting period. Civil and criminal penalties may be imposed together.[58] Details of guidelines for mitigation of FBAR penalties are set out in the Internal Revenue Manual,[59] however, the existing Last Chance Compliance Initiative has been revoked.[60] Effective March 23, 2009, the IRS instituted a new penalty framework for voluntary disclosure requests involving foreign accounts and entities.[61] The new program will apply to requests which have already been submitted to the IRS and will remain in effect for six months.[62] The program directs examining agents to assess taxes and interest for the last six years, require filing of all returns or amended returns including FBARs, "assess either the accuracy or delinquency penalty" with no reasonable cause exception, and assess a penalty equal to 20% of the highest amount in the foreign account "[i]n lieu off all other penalties that might apply, including FBAR and information return penalties." [63]

The limitations period for assessing the civil penalty for failure to file an FBAR is six years, beginning on the date of the "transaction."[64] The Government must initiate its lawsuit to collect the civil penalty within two years of the date the penalty was assessed, or, if a criminal action involving the same transaction is pending, the date the judgment becomes final.[65] Note that the violation of the FBAR statute and regulation, civil and criminal, is the failure to file; there is no attendant unpaid tax as with income tax returns (in which cases the liability for unpaid tax runs as long as no return has been filed). Therefore, no civil or criminal penalties can be assessed for FBAR violations after the statute expires, even though a related income tax liability may arise.

For criminal failure to file an FBAR, the catchall five-year statute of limitations applies.[66] The willfulness requirement to show the requisite criminal intent may be inferred by concealing signatory authority over the foreign account.[67]

The FBAR does not come within the scope of the types of returns to which the tax return preparer penalty applies[68] but preparation and submission of FBARs does comes within the scope of practice before the IRS covered by Circular 230.[69] Information reported on the FBAR is not taxpayer information under I.R.C. §6103 but is not subject to disclosure under the Freedom of Information Act.[70] FBAR information may, however, be disclosed to state, local, and foreign government agencies.[71]

Changes to the Internal Revenue Manual set up an administrative appeals process within the existing IRS Appeals framework.[72] The FBAR penalty has been designated as an Appeals Coordinated Issue.[73]

IV. Conclusion

The new and somewhat improved FBAR clarifies some questions that existed under the previous form but still relies on instructions that are inadequate considering the types of penalties which can be imposed for violatoins. More uniform enforcement is to be expected as the IRS becomes more familiar with the form and the information it reveals. Taxpayers and practitioners should expect more FBAR examinations to be initiated in conjunction with regular income tax audits.

The manner in which the new FBAR was promulgated has not rectified the ambiguities in the hodgepodge of incongruous definitions and use of tax terms of art without definition. The lack of clear statutory and regulatory authority for the changes compounds the dissatisfaction of practitioners. The enhanced enforcement efforts will lead to conflict between the IRS and practitioners who will challenge these regulatory deficiencies and anomalies.

ENDNOTES

1 Joseph M. Irwin, Attorney at Law, Dallas, Texas. 100 Crescent Ct., Ste. 700, Dallas, Texas 75201, joe@erwintaxlaw.com.

2 Memorandum For All LMSB Industry Directors, et al., From: Robert L. Trujillo, Director, Planning, Quality, Analysis, and

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Support, Internal Revenue Service, Oct. 31, 2008.

3 The Qualified Intermediary scheme is the arrangement for non-U.S. financial institutions or other persons acting as financial intermediaries to act as withholding agent for non-U.S. recipients of U.S. source income. *See* Treas. Regs. §§ 1.1441-1.

4 See. Steven Toscher and Michel R. Stein, "FBAR Enforcement is Coming !," 5 J. of Tax Prac. & Proc. 27. (Dec. 2003-Jan. 2004).

5 31 U.S.C. §5314; 31 C.F.R. §103.24.

6 The question on U.S. income tax returns asks the taxpayer:
7a At any time during 2008, 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 page B-2 for exceptions and filing requirements for Form TD F 90-22.1.
b If "Yes," enter the name of the foreign country ______.
U.S. Individual Income Tax Return (2008 IRS Form 1040), Schedule B, Part III, Item 7; *see also*, 2008 Instructions for Schedules A&B (Form 1040), p. B-2; U.S. Income Tax Return for Estates and Trusts (2008 IRS Form 1041), Other Information, Item 3; U.S. Return of Partnership Income (2008 IRS Form 1065), Schedule B, Item 10; U.S. Corporation Income Tax Return (2008 IRS Form 1120), Schedule N – Foreign Operations of U.S. Corporations, Item 6.

7 Pub. L. 91-508, 84 Stat. 1124, §§241, 242 (Oct. 26, 1970), codified to 12 U.S.C. §§ 1829b, 1951-1959 and 31 U.S.C. §§ 5311—5330.

8 California Bankers Association v. Schulz, 416 U.S. 21, 27 (1974).

9 31 U.S.C. §5314(a).

10 31 U.S.C. §5314(a).

11 31 U.S.C. §5314(b).

12 The regulation provides, *in toto*:
Each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signatory authority over, a bank securities or other financial account in a foreign country shall report such relationship to the Commissioner of the Internal Revenue for each year in which such relatinship exists, and shall provide such information as shall be specified in a reporting form prescribed by the Secretary to be filed by such persons. Persons having a financial interest in 25 or more foreign financial accounts need only note that fact on the form. Such persons will be required to provide detailed information concerning each account when so requested by the Secretary or his delegate.
31 C.F.R. §103.24.

13 *E.g.*, California Bankers Association v. Schulz, 416 U.S. 21 (1974) (claims of self-incrimination are premature where no allegation that reporting will tend to incriminate).

14 31 U.S.C. §5314(a); see, Hale E. Sheppard, "Evolution of the FBAR: Where We Were, Where We Are, And Why It Matters," 7 *Hous. Bus. & Tax L. J.* 1, 4 (2006).

15 31 C.F.R. §103.38(d).

16 Report of Foreign Bank and Financial Accounts (Treasury Form TD F 90.22-1)(Rev. 7/2000), Part II – Information on Financial Accounts, Continuation Page.

17 *Id.*, Part II – Information on Financial Accounts.

18 IRS Fact Sheet 2007-15 (Feb. 27, 2007); *see, e.g.*, Blum, "Tax Practitioner Questions Foreign Financial Accounts Reporting Requirements," 2008 TNT 89-17, *Tax Notes Today* (May 7, 2008) ("This is the first pronouncement I am aware of that someone in the Government thinks that shares in a mutual fund or units in a unit trust are a 'financial account.'").

19 A practitioner complained to an official in the Treasury Department about the addition of mutual fund and unit trusts interest to the definition of "financial account" by use of Fact Sheet 2007-15 with the following:

> Was this guidance, which is, as mentioned, less than intuitive, issued in regulations, proposed regulations, a notice, a revenue ruling, or any normal channel of communications? No. . . . The only way I came across it was by a blind search of www.irs.gov. . . . I submit that this is not how guidance should be published when there is a substantial penalty for non-compliance. . . . I would love to talk about the policy issues behind this, but as far as I am aware, there is no one at a policymaking level to talk to. There is only this one analyst, and our experience is that all this person will say in response to any question is "when in doubt, report." That may be a correct attitude for someone in a purely adminstrative position, but as far as I can determine, there is no more senior person anywhere in the IRS or Treasury with whom one can discuss these matters. . . . I respectfully submit that this is a most unsatisfactory state of affairs. I have a large client base that finds TD F 90-22.1 issues to be of great interest, and in many cases, it is impossible to give advice with any degree of confidence.

Blum, "Tax Practitioner Questions Foreign Financial Accounts Reporting Requirements," 2008 TNT 89-17, *Tax Notes Today* (May 7, 2008).

20 *E.g.*, "FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR)," www.irs.gov/ businesses/small/article/0,,id=148845,00.html (March 13, 2009); "Workbook on the Report of Foreign Bank and Financial Accounts (FBAR)," www.irs.gov/businesses/small/article/0,,id=159757,00.html (Feb. 19, 2009); "Headliner Volume 262 / February 26, 2009 – The definition of 'in and doing business in' the United States for FBAR purposes," www.irs.gov/businesses/small/article/0,,id=204798,00.html (Feb. 27, 2009); "Report of Foreign Bank and Financial Accounts," www.irs.gov/businesses/small/article/0,,id=148849,00.html (Feb. 23, 2009).

21 *E.g.*, Casa de La Jolla Park, Inc. v. Commissioner, 94 T.C. 384, 396 (T.C. 1990) (" . . . even if the instructions were misleading, the sources of authoritative law in the tax field are the statute and regulations and not Government publications."); *see*, Treas. Reg. §§601.602(a) ("The Internal Revenue Service develops forms and instructions that explain the requirements of the Internal Revenue Code and regulations." (emphasis added)).

22 958 F.2d 578 (4th Cir. 1992), *cert. denied*, 505 U.S. 1205 (1992).

23 31 C.F.R. §103.56(g); *see also*, I.R.M. §1.2.43.10 (Mar. 24, 2008), Del. Order 4-35 (Rev. 1).

24 IRS Information Release, 2003-48 (April 10, 2003).

25 Report of Foreign Bank and Financial Accounts (Form TD F 90.22-1)(Rev. Oct. 2008), General Instructions, p. 7 (hereinafter "FBAR Instructions").

26 Bruce, et al., "New U.S. Foreign Bank Account Report Makes Big Changes," 52 *Tax Notes Int'l* 235, ___, 2008 WTD 207-8 (Oct. 20, 2008).

27 *See*, Report of Foreign Bank and Financial Accounts (Form TD F 90.22-1)(Rev. 7/2000), Instructions, Item 26 (speaks only in terms of filing requirements for U.S. persons).

28 FBAR Instructions, Who Must File this Report, p. 6.

29 31 C.F.R. §103.11(z).

30 See discussion of reasonable cause exception to the civil penalty, below.

31 As with many other terms used in the FBAR Instructions, the use of "corporation," "partnership," "trust," "direct," and "indirect" have specific meanings in the context of the Internal Revenue Code but such are not defined for FBAR purposes.

32 958 F.2d at 582-583; *but see* Memoradum for BSA Compliance Examiners and Managers, From: Beth M. Elfrey, Director, Fraud/BSA, Internal Revenue Service, Subject: Interim Guidance (Reissued on Money Transmitter Report of Foreign Bank and Financial Accounts (FBAR) Filing Requirements [Control Number: SBSE-04-0608-041], June 18, 2008, p. 2, FAQ 4 ("A distinction, however, must be drawn between having authority over a bank account of a non-bank foreign agent and having authority over a foreign agent who owns a foreign bank account. Having authority over a person who owns a foreign bank account is not the same as having authority over a foreign bank account.").

33 The FBAR Instructions provide, in pertinent part: "Such accounts generally also encompass any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund (including mutual funds)." FBAR Instructions, General Definitions, p. 6. The Internal Revenue Manual also states that an insurance policy having a cash surrender value is an example of a financial account, but this is not included in the FBAR Instructions. I.R.M. §4.26.16.3.2 (July 1, 2008) Financial Account, ∂1.A.

34 31 C.F.R. §103.24.

35 FBAR Instructions, p. 6.

36 31 C.F.R. §103.11(p).

37 FBAR Instructions, p. 6; 31 C.F.R. §103.11(nn); cf. I.R.C. §7701(a)(9).

38 FBAR Instructions, p. 7.

39 FBAR Instructions, pp. 7-8.

40 FBAR Instructions, p. 7.

41 31 C.F.R. §103.24.

42 All of these exceptions are under the apparent authority of the

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Secretary of the Treasury under the statute. 31 U.S.C. §5314(b); 31 C.F.R.§103.55(a).

43 31 C.F.R. §103.56(g), as amended by 68 Fed. Reg. 26,468 (May 16, 2003); I.R.M. §4.26.17 (May 5, 2008) Report of Foreign Bank and Financial Accounts (FBAR) Procedures.

44 I.R.M. §4.26.17.2. (Jan. 1, 2007).

45 I.R.M. §4.26.17.5.3 (Jan. 1, 2007).

46 Pub. L. 108-357, 118 Stat. 1586 (Oct. 22, 2004) (AJCA 2004).

47 31 U.S.C. §5321(a)(5)(B)(ii) (2003).

48 31 U.S.C. §5321(a)(5), as amended by Pub. L. 108-357, §821(a), 118 Stat. 1586 (Oct. 22, 2004). The amendment is effective for violations after date of enactment. *Id.*, §821(b).

49 31 U.S.C. §5321(a)(6)(A); 31 C.F.R. §103.57(h).

50 31 U.S.C. §5321(a)(5)(B).

51 31 U.S.C. §5321(a)(6)(B). Penalties of more than $10,000 are supposed to be approved by IRS Division Counsel. Memorandum For All LMSB Industry Directors, et al., From: Robert L. Trujillo, Director, Planning, Quality, Analysis, and Support, Internal Revenue Service, Oct. 31, 2008.

52 31 U.S.C. §5321(a)(5)(C).

53 31 U.S.C. §5322(a); 31 C.F.R. §103.59(b).

54 31 U.S.C. §5322(b); 31 C.F.R. §103.59(c).

55 18 U.S.C. §1001; 31 C.F.R. §103.59(d).

56 I.R.M. §4.26.16.4.3.1 (July 1, 2008), ∂3.

57 31 U.S.C. §5321(a)(5)(B)(ii) provides that the (a)(5)(A) penalty is not to be imposed if: "such violation was due to reasonable cause, <u>and</u> … the balance in the account at the time of the transaction was properly reported." (emphasis added).

58 31 U.S.C. §5321(d).

59 I.R.M. §4.26.16.4 (July 1, 2008).

60 Memorandum for SBSE Examination Area Directors, LMSB Industry Directors, From: Faris R. Fink, Deputy Commissioner, SB/SE and Barry B. Shott, Deputy Commissioner, LMSB International, Subject: Emphasis on and Proper Development of Offshore Examination Cases, Managerial Review, and Revocation of Last Chance Compliance Initiative, March 23, 2009, reproduced at 2009 TNT 57-32, *Tax Notes Today* (March 27, 2009).

61 Memorandum for Commissioner LMSB and Commissioner SB/SE, From: Linda E. Schiff, Deputy Commissioner for Services and Enforcement, Subject: Authorization to Apply Penalty Framework to Voluntary Disclosure Requests Regarding Unreported Offshore Accounts and Entities, March 23, 2009, reproduced at 2009 TNT 57-34, *Tax Notes Today* (March 27, 2009)(hereafter "Penalty Framework Memorandum").

62 Penalty Framework Memorandum.

63 Penalty Framework Memorandum. The wording of the memorandum makes unclear the authority for this 20% penalty. Further guidance is expected.

64 31 U.S.C. §5321(b)(1). This is another anomaly in the rules for FBARs because records are only required to be kept for 5 years. 31 C.F.R. §103.38(d).

65 31 U.S.C. §5321(b)(2).

66 <u>U.S. v. Lowry</u>, 409 F. Supp. 2d 732, 740-741 (W.D. Va. 2006) (18 U.S.C. §3282, not I.R.C. §6531 applies).

67 <u>United States v. Sturman</u>, 951 F.2d 1466 (6th Cir. Ohio 1991). The court in <u>Sturman</u> noted:

> [The defendant] concealed his signature authority, his interests in various transactions, and his interest in corporations transferring cash to foreign banks. This conduct could be adequate for the jury to infer willfulness on the part of the defendant…. [T]he defendant did admit knowledge of and failure to answer a question concerning signature authority at foreign banks on Schedule B of his income tax return. This section of the return refers taxpayers to a booklet that further outlines their responsibilities for reporting foreign bank transactions…. These resources indicate that the defendant could have learned of the additional requirements quite easily. It is reasonable to assume that a person who has foreign bank accounts would read the information specified by the government in tax forms.

Id., at 1476-1477.

68 The tax return preparer penalty of I.R.C. §6694 applies to a "tax return preparer," which is defined at I.R.C. §7701(a)(36) as "any person who prepares … any return of tax imposed by this title [26 U.S.C.] …."

69 Circular 230 [31 C.F.R.] §10.2(a)(4) provides:

> Practice before the Internal Revenue Service comprehends all matters connected with a presentation to the Internal Revenue Service … relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, …

Circular 230 [31 C.F.R.]. §10.22(a)(1) provides:

> A practitioner must exercise due diligence … [i]n preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters….

Circular 230 [31 C.F.R.] §10.34(b)(2) provides:

A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service . . . [t]hat contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

70 31 C.F.R. §103.54.

71 31 C.F.R. §103.53.

72 I.R.M. §1.2.43.10 (Mar. 24, 2008), Del. Order 4-35 (Rev. 1), ∂23.

73 http://www.irs.gov/individuals/article/0,,id=108652,00.html (March 20, 2009). An Appeals Coordinated Issue is an issue, fact or legal, of such importance that it requires IRS-wide coordination to ensure nationwide consistency. I.R.M. §8.7.3.2.2. (Nov. 6, 2008).

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SHOULD FALSE IMPRISONMENT DAMAGES BE TAXED?

Robert W. Wood[1]

Claims for false imprisonment may be brought in various ways under federal or state law. An individual who has been wrongfully incarcerated may sue under 42 U.S.C. Section 1983 for a violation of his constitutional rights. The individual may also sue under state tort law, making claims for the traditional torts of false imprisonment, malicious prosecution, or abuse of process. Furthermore, many states now expressly provide a statutory scheme for addressing false imprisonment claims.

At the root of all of these causes of action is a fairly common fact pattern: a plaintiff is arrested or convicted, spends time behind bars, is later exonerated, and then seeks redress for his injuries. There may or may not be prosecutorial misconduct. Although there may well be nuances between the differing legal bases upon which such a claim may be brought, I have argued that the commonality of this fact pattern should mean that such recoveries should be excludable from income under Section 104 of the Code.[2] I will not re-state all of those arguments here, but will endeavor to summarize them briefly.

<u>Section 104 Authorities</u>

The Internal Revenue Code has excluded personal injury damages from income for eighty years. For most of this time, damages for any personal injury (or for sickness) could be excluded from income, whether or not the injury or sickness was physical. In 1996, the statute was narrowed, with the new requirement that the personal injuries or sickness must be "physical" to give rise to an exclusion.

Since 1996, Section 104 has excluded from gross income damages paid on account of physical injuries or physical sickness. The IRS has interpreted this rule as requiring observable bodily harm in order for an exclusion to be available.[3] In appropriate cases, however, the IRS is willing to presume the existence of observable bodily harm.

Thus, in Chief Counsel Advice Memorandum 200809001,[4] the IRS considered the tax treatment of a settlement with an institution for sex abuse. The abuse had occurred while the plaintiff was a minor, and the settlement was paid many years later, by which time the abuse victim had reached the age of majority. Not surprisingly, by that time there were no physical signs of any abuse, injury or sickness.

Nevertheless, the IRS ruled that the entire settlement was excludable under Section 104. Although the taxpayer had failed to demonstrate any signs of physical injury, the IRS found it reasonable to *presume* there had (at some point) been observable signs of physical injuries in such case.[5] It is unclear how important it was to the reasoning of the ruling that the victim was a minor at the time of the abuse, and had reached the age of majority when he received a settlement. Arguably, it should be irrelevant, as the situation could be just as compelling without the age factor. Yet one senses that the Service was trying to eke out a narrow exception from its "we must see it" mantra.

Significantly, the Service failed to back off on the notion that Section 104 requires an outward sign of injuries. Nevertheless, it still gave the taxpayer relief on an unquestionably sympathetic fact pattern. In essence, the IRS ruled that at least under *some* circumstances, while it would not dispense with its view that one must be able to observe the bodily harm, one could occasionally *presume* the injuries. That is clever. It may appear to be a tiny step, but it is also a significant step.

Is False Imprisonment Physical?

It is hard to imagine a more obvious degree of physicality than being physically confined behind bars. Even if no bruises or broken bones befall the plaintiff while behind bars, it seems axiomatically physical to be physically confined. But is it a physical injury or physical sickness?

I argue yes. First, I note that it is almost a certainty that there will be ancillary claims in any long-term false imprisonment case. Whether characterized as assault, battery, medical malpractice, etc., most long-term inmates have had altercations that can provide the proverbial physical hook on which one can hang the more general deprivation of liberty claim. Invariably, the presence of such ancillary claims makes the case easier for treating the recovery as excludable under Section 104.

Yet even in the hypothetical case of someone who is wrongfully incarcerated and claims no abuse, battery, or medical malpractice, in my opinion, Section 104 should clearly apply. If a taxpayer is raped, that physical trauma may or may not be visible. Even if tears or bruising do not appear, in my opinion a recovery for that rape should be excludable under Section 104. The act itself manifests injury. False imprisonment, at least serious and long-term cases thereof, should be the same.

Historically, helpful authority can be found concerning the tax treatment of payments made to Japanese-Americans placed in internment camps during World War II. There are also authorities regarding payments made to survivors of Nazi persecution, to U.S. prisoners of war in Korea, etc. At one time or another, all of these types of recoveries were held to be nontaxable as payments for a deprivation of liberty.[6]

In all of these historic cases, these persons were treated as receiving damages for a loss of personal liberty. The payments in each case were therefore held to be nontaxable. There was no wage loss claim or anything else to make the payment in such circumstances appear even arguably to be taxable. The IRS can be forgiven for being skeptical of personal physical injury allocations in many employment cases, where the nature, severity, and consequences of the physical contact and resulting physical injuries are often modest. Long-term false imprisonment is entirely different.

After all, we ended up with the 1996 changes to Section 104 precisely because of abuses in employment cases, where the wage versus non-wage dichotomy was patent. In employment cases preceding the 1996 amendments, the emotional distress moniker was added to virtually every situation. It was no secret that most damages seemed to be labeled as "emotional distress" in view of the obvious tax advantages such nomenclature imported.

The Service's rigidity in its view today may be explained by taxpayer sins of the past. That is unfortunate, for there is nothing whatsoever abusive about a recovery for long-term wrongful incarceration being afforded tax-free treatment. Taxable or not, no amount of money can ever make such victims whole.

Nevertheless, the IRS appears to have concluded that the authorities dealing with recoveries by civilian internees or prisoners of war (which we might collectively call the "internment authorities") should no longer be relied upon. Indeed, in the Service's view, the "physical" requirement interposed into Section 104 in 1996 undercuts these internment authorities. In Revenue Ruling 2007-14, 2007-12 IRB 747, the IRS "obsoleted" all of these revenue rulings, ostensibly due to the 1996 statutory change to Section 104. The IRS does not state publicly exactly why it obsoleted these internment rulings.

However, my off the record understanding is that the Service felt that the 1996 legislation said "physical" and meant "physical." Being wrongfully locked up — by itself anyway – just isn't physical. Yet I believe wrongful imprisonment is b*y its very nature* physical. The fact that the internment rulings predate the 1996 statutory change should be irrelevant.

General Welfare Exception

Quite apart from Section 104 of the Code, it is independently arguable that the general welfare exception (GWE) shall apply to false imprisonment recoveries. The GWE exempts from taxation payments that are:

- Made from a governmental general welfare fund;
- For the promotion of the general welfare (that is, on the basis of need rather than to all residents); and
- Not made as a payment for services.[7]

The GWE is intended to exempt from taxation amounts the government pays for the general welfare. The IRS has applied the GWE to various government payments, ranging from housing and education to adoption and crime victim restitution.[8] It is reasonable to believe that payments from the government to make a victim of false imprisonment whole should be within the scope, purpose, and terms of the GWE.

Recent Case

Despite my arguments, there has been no tax case discussing the application of either Section 104 or the general welfare exception to a significant false imprisonment case in which the plaintiff spent years wrongfully behind bars. There is, however, a recent case involving a type of false imprisonment that could well skew the law in an inappropriate direction. The case is *Daniel J. and Brenda J. Stadnyk v. Commissioner*.[9]

In Stadnyk, the taxpayer received a settlement of $49,000 in 2002, and the question was whether that settlement was excludable from her income. The settlement resulted from a rather involved set of facts relating to the purchase of a used car. When the taxpayer was unhappy with the car and could not obtain satisfaction from the dealership, she placed a stop payment order on the check she tendered to pay for the car.

Although the stop payment order listed the reason for the stop payment as "dissatisfied purchase," the bank (Bank One, which later would become a defendant) incorrectly stamped the check "NSF" – the customary label for a check with insufficient funds – and returned it to the used car dealer. The dealership filed a criminal complaint against the taxpayer for passing a worthless check. Several weeks later, at 6:00 PM one evening, officers of the Fayette County, Kentucky Sheriff's Department arrested the taxpayer at her home. They did so in the presence of her husband, her daughter and a family friend. She was taken to the Fayette County detention center, handcuffed, photographed, and confined to a holding area.

Several hours later, she was handcuffed and transferred to the Jessamine County Jail, where she was searched via pat-down and with use of an electric wand. She was required to undress to her undergarments, to remove her brassiere in the presence of police officers, and to don an orange jumpsuit. At approximately 2:00 AM the next morning, she was released on bail. Several months later, she was indicted for theft by deception as a result of the check, but the charges were subsequently dropped.

Most of us would be pretty upset by such a course of events. Not surprisingly, the taxpayer eventually filed suit against the dealership and its owners for breach of fiduciary duty. She also sued the bank. She sought compensatory damages and special damages, including damages for lost time and earnings, mortification and humiliation, inconvenience, damage to reputation, emotional distress, mental anguish, and loss of consortium. She also sought punitive damages, and alleged counts for malicious prosecution, abuse of process, false imprisonment, defamation and outrageous conduct.

After a mediation, the taxpayer settled her case. At the mediation, everyone seemed to agree that the modest $49,000 settlement would not represent income to the plaintiff and would not be subject to tax. Indeed, the attorney for the taxpayer, the mediator and the attorney for the defendant Bank One all stated rather definitively at the time that the settlement proceeds would not be taxed. Nevertheless, the taxpayer received a Form 1099 for the payment. She did not report the payment on her 2002 tax return, and eventually landed in Tax Court.

Pure Confinement

In considering the appropriate tax treatment of the payment, Judge Goeke of the Tax Court noted that the plaintiff did not suffer any physical injuries as a result of her arrest or detention, save that she was physically restrained against her will and subjected to police arrest procedures. Indeed, the taxpayer stated that she was not grabbed, jerked around, bruised or physically harmed as a result of her arrest or detention. She did visit a psychologist approximately eight times over two months as a result of the incident. The costs of these visits were covered by her insurance. She did not have any out-of-pocket medical expenses for physical injury or mental distress suffered as a result of her arrest and detention.

In analyzing the applicability of Section 104, the Tax Court recited the usual authorities and the nature of the claims that had to be reviewed. One of the inevitable discussions was over the two-tier requirement of *Schleier*,[10] which imposed two thresholds in order to bring an amount within the exclusion provided by Section 104. First, the payment must be made to satisfy a claim for tort or tort-type rights. Second, the payment must be made on account of personal physical injuries or physical sickness. Despite its Supreme Court provenance, this test has proven to be more tautological than helpful.

The Tax Court in *Stadnyk* lamented the fact that although there had been a mediation, there was no record of the mediation to show precisely what the parties were focusing on during the mediation process. Indeed, the court looked primarily to the complaint, and to the fact that in Tax Court, the taxpayer was relying heavily on the false imprisonment claim as a way to support her claim of excludability under Section 104. Yet this complaint – like so many others in the real world – contained multiple claims.

Indeed, the Tax Court pointed out that the taxpayer had also alleged the torts of negligence and breach of fiduciary duty against Bank One. The IRS argued that those claims were based on contract, and were simply not tort claims. The Tax Court seemed to be favoring the taxpayer, noting that it was not as clear as the IRS postulated that a lawsuit relating to a bank and customer relationship was based on contract alone. Admitting of the possibility of tort claims, the Tax Court even noted that it was possible that the bank's actions with respect to the check had proximately caused her arrest.

To the Tax Court, that made it incorrect to view the woman's complaint against Bank One as solely a contract claim. The Tax Court also didn't view it solely as a claim over the wrongful dishonor of a check. In fact, the Tax Court pointed out that the taxpayer was suing Bank One not merely because of the alleged mishandling of her check. Rather, she sued Bank One because of the ordeal she suffered as a result of her arrest and detention.

This kind of approach sounds rooted in common sense. It seems to recognize that cutting through the formalities of multiple causes of action, this was a suit over one incident and one set of damages. Although Bank One did not initiate the criminal proceedings against her, its erroneous marking of her check had actually precipitated her arrest. Moreover, the Tax Court found that when Bank One settled the case, it entered into a settlement agreement with an intent to resolve her claims for tort or tort-type rights. The Tax Court therefore concluded that the first prong of the *Schleier* test was met.

Physical Injury or Physical Sickness?

Unfortunately, Mrs. Stadnyk was not so lucky with respect to

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the physical injury or physical sickness requirement enunciated by *Schleier*. The Tax Court commenced its analysis with a discussion of the legislative history to the 1996 statutory change. The terms "physical injuries" and "physical sickness" do not include emotional distress (except for damages not in excess of the cost of medical care attributable to that emotional distress).

In fact, Mrs. Stadnyk had admitted that she did not suffer any physical harm during her arrest or detention. Although she is to be commended for her honesty, she did not try to spin her story as involving even a technical battery. She was not grabbed, jerked around, or bruised. While she argued that physical restraint and detention by itself constitutes a physical injury, the Tax Court disagreed. It said baldly that:

> "Physical restraint and physical detention are not 'physical injuries' for purposes of Section 104(a)(2). Being subjected to police arrest procedures may cause physical discomfort. However, being handcuffed or searched is not a physical injury for purposes of Section 104(a)(2). Nor is the deprivation of personal freedom a physical injury for purposes of Section 104(a)(2)."[11]

The Tax Court found language from a Kentucky state court case to the effect that the tort of false imprisonment protects one's personal interest in freedom from physical restraint.[12] The same Kentucky court went on to say that the injury from false imprisonment is "in large part a mental one," and that the plaintiff can recover for mental suffering and humiliation. The Tax Court therefore concluded that the alleged false imprisonment against Mrs. Stadnyk did not cause her to suffer any physical injury, which a Section 104 exclusion would require.

The court nevertheless found that Mrs. Stadnyk was not liable for Section 6662 penalties. The Tax Court acknowledged that Mr. and Mrs. Stadnyk had not sought tax advice concerning the recovery. It nevertheless seemed reasonable to rely upon the parties to the mediation and the various lawyers. All of them said with little equivocation that they expected the recovery to be tax-free. Thus, although Mrs. Stadnyk had to pay the tax and the interest, there were no penalties.

<u>Bad Case; Bad Law</u>

Stadnyk is an unfortunate case, whether or not one views it as correct. It can certainly be argued that the Tax Court was right to analyze *this particular recovery* as taxable. I do not agree with this argument, but reasonable minds can differ. But are the Tax Court's platitudes about false imprisonment correct?

I believe one must answer that question with a resounding "no." Whatever a Kentucky state court may have said about the nature of a false imprisonment claim, there is nothing mental about being locked behind bars and subjected to the physical confinement it entails. Put another way, although it may well lead to mental damages, the primary thrust of a false imprisonment claim is not mental. Even if you are handled with kid gloves, confinement is physical.

Yet even if we acknowledge that Mrs. Stadnyk's recovery is not physical enough to be tax free, one must be able to draw lines. Clearly, no one would want to spend from 6:00 PM to 2:00 AM in jail as Mrs. Stadnyk did. Nevertheless, that period of eight hours (during some part of which she was being processed and transported, and thus apparently was not confined in a cell), hardly compares with spending months or years locked behind bars.

Can anyone seriously compare Mrs. Stadnyk's experience to that of an exhonoree who is wrongfully convicted and wrongfully imprisoned in a penitentiary for, say ten years? I think not. I recognize that qualitative decisions are not easy.

Arguing that *serious* false imprisonment cases should be treated differently than non-serious ones is analytically difficult and perhaps impracticable. Exactly where you draw the line between trivial and serious false imprisonment is subjective. Indeed, one could reasonably conclude that Mrs. Stadnyk's recovery too should be tax-free.

Yet I do not think it is silly to agree that Mrs. Stadnyk's recovery can be taxable, and yet to argue forcefully that a serious and long-term exhonoree should receive tax-free treatment. Line drawing may not be easy, but even if one agrees that Mrs. Stadnyk's recovery should be taxed, it does not follow that *all* false imprisonment recoveries should be taxed. The Tax Court's broad and unnecessary dicta in *Stadnyk*, blathering on about *all* false imprisonment recoveries is, to my mind, simply wrong.

One way to distinguish the serious false imprisonment case involving long tenure in prison from a case such as Mrs. Stadnyk's relates to ancillary claims. Mrs. Stadnyk herself indicated that she experienced no roughing up and no physical injuries, no medical claims, etc. She suffered indignities, but she was not bruised, pushed or manhandled.

In my experience, a true long-term incarceration case is vastly different. There are almost always incidents of physical trauma, often leaving permanent scars. There are often battery claims, medical malpractice claims, and more. Yet as a matter of analytical purity, it is worthwhile to ask what *would* happen if the tax consequences of a payment in settlement of a wrongful long-term incarceration case were considered in isolation.

That is, consider the rare (and perhaps even unimaginable) case in which a person is wrongfully incarcerated for ten years, but is fortunate enough to be able to state (as Mrs. Stadnyk) did that he endured no pushing, no shoving, no bruising, no rapes, no assaults, no batteries, no medical malpractice, etc. In my view – even without the presence of the customary ancillary claims for separate torts, and even without the customary damages usually accompanying those torts – such a false imprisonment recovery should *itself* be tax-free.

In my opinion, *Stadnyk* is an unfortunate and probably an incorrect decision, even on its facts. As a technical matter, of course, a Tax Court memo decision is non-precedential.[13] Quite apart from that, neither taxpayers nor the government should put too much stock in the broad statements made by Judge Goeke in *Stadnyk*.

ENDNOTES

1. Robert W. Wood practices law with Wood & Porter, in San Francisco (www.woodporter.com), and is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. 2008) and *Qualified Settlement Funds and Section 468B* (2009), both available at www.taxinstitute.org. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.
2. See Wood, "Are False Imprisonment Recoveries Taxable?," *Tax Notes*, April 21, 2008, p. 279.

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3 Perhaps the best illustration of the Service's view on this point is the so-called "bruise" ruling, Letter Ruling 200041022.
4 Nov. 27, 2007.
5 See further discussion in Wood, "IRS Allows Damages Exclusion Without Proof of Physical Harm," *Tax Notes*, March 31, 2008, p. 1388.
6 See Civil Liberties Act of 1988, P.L. 100-383, Section 101-109, 102 stat. 903, 903-911 (1988). See also Rev. Rul. 56-462, 1956-2 C.B. 20 (dealing with Korean War payments); Rev. Rul. 55-132, 1955-1 C.B. 213 (exempting from tax payments made to US citizens who were prisoners of war during World War II). See also Rev. Rul. 58-370, 1958-2 C.B. 14 and Rev. Rul. 56-518, 1956-2 C.B. 25 (providing tax-free treatment for payments by Germany and Austria for persecution by the Nazis).
7 See ITA 200021036. See also Wood and Morris, "The General Welfare Exception to Gross Income," *Tax Notes*, October 10, 2005, p. 203.
8 See Rev. Rul. 76-373, 1976-2 C.B. 16; Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 76-395, 1976-2 C.B. 16; Rev. Rul. 75-271, 1975-2 C.B. 23; Letter Ruling 200409033 (Nov. 23, 2004); Rev. Rul. 74-153, 1974-1 C.B. 20; Rev. Rul. 74-74, 1974-1 C.B. 18.
9 T.C. Memo 2008-289.
10 *Commissioner v. Schleier*, 515 U.S. 323 (1995).
11 *Stadnyk*, T.C. Memo 2008-289 at page 17.
12 See *Banks v. Fritsch*, 39 S.W. 3d 474 (Ky. Ct. App. 2001).
13 See *Nico v. Comm'r*, 67 T.C. 647, 654 (1977), *aff'd. in part, rev'd. in part on other grounds*, 565 F.2d 1234 (2d Cir. 1977): "we consider neither Revenue Rulings nor Memorandum Opinions of this Court to be controlling precedent."

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AGREEMENT OF LIMITED PARTNERSHIP FOR OPPORTUNITY INVESTMENTS, LP

THOMAS C. BAIRD

BAIRD, CREWS, SCHILLER & WHITAKER, P.C.

15 North Main

Temple, Texas 76501

(254)774-8333

18TH ANNUAL ADVANCED DRAFTING:
ESTATE PLANNING AND PROBATE COURSE
Houston, Texas
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AGREEMENT OF LIMITED PARTNERSHIP

FOR OPPORTUNITY INVESTMENTS, LP

I. FORMATION AS A TEXAS LIMITED PARTNERSHIP

A. Formation.

This limited partnership is created under the TPL and other relevant laws of the State of Texas and in accordance with and subject to the terms and conditions set forth in this Agreement among the undersigned General and Limited Partners. This limited partnership will become effective upon the Certificate of Formation being filed with the Texas Secretary of State and this Agreement being executed ("Effective Date"). The limited partnership will not conduct any business until the Effective Date.

Comment: The FLP is actually formed when the certificate of formation is filed with the Secretary of State. If you represent a general partner, it is not as important for the term of the partnership to commence upon the filing of the certificate of formation. However, if you represent a limited partner, it is advisable to delay the formation of the partnership until the filing of the certificate of formation. Otherwise, it is possible that the limited partners will have unlimited liability for obligations incurred by the partnership from the time the partners enter into a partnership agreement until the certificate of formation is filed because a limited partnership, as opposed to a general partnership, is not formed until the certificate of formation is filed. See TBOC §§3.001(c) and 3.011(a). To avoid any personal liability to the limited partners, the FLP needs to refrain from conducting any business until the certificate of formation has been filed with the Secretary of State and all partners have executed a written partnership agreement. If your patriarch or matriarch could die before the certificate of for-

B. Certificate; Foreign Qualification.

A certificate of formation that meets the requirements of the TPL will be filed with the Secretary of State of the State of Texas and will be amended from time to time as required by the TPL, including but not limited, if and when appropriate, to reflect the substitution or addition of Partners in accordance with this Agreement. Upon the request of the General Partner, each other Partner will immediately execute all certificates and other documents consistent with the terms of this Agreement that the General Partner believes are necessary or desirable for the General Partner to accomplish all filing, recording, publishing, and other acts that may be appropriate to comply with all requirements to form, operate, qualify, continue, and terminate the Partnership as (a) a limited partnership under the TPL and the laws of the State of Texas and (b) a limited partnership, or a partnership in which each Partner other than the General Partner has limited liability, in all other jurisdictions where the Partnership proposes to operate.

Comment:
See Chapter 3 (Title I) of the TBOC; TBOC §153.051 (supplemental provisions relating to amendments to certificate of formation); and TBOC §153.553 (provisions regarding execution of filing instruments).

To form an FLP, the partners must enter into a partnership agreement, and the general partner must execute a certificate of formation, which must be filed with the Secretary of State along with the filing fee. It must contain:

- the FLP's name;
- the fact that the type of entity being formed is a limited partnership;
- the initial registered office street address and the initial registered agent's name and address;
- the address of the principal U.S. office where the records will be kept;
- each general partner's name and mailing address; and
- other matters the general partner elects to include and which are authorized by the TBOC.

The Certificate must be amended to reflect the admission of a new general partner, the withdrawal of a general partner, a change in the partnership's name, and certain changes in the name of the registered agent and address of the registered office and to correct incorrect information in the Certificate. See TBOC §153.051. The Certificate may be amended for certain other purposes. See TBOC §153.052.

If you represent a limited partner, you might want to include a provision that requires the general partner, prior to commencing any activities in any jurisdiction other than Texas, to cause the partnership to comply with all requirements for the qualification of the partnership as a limited partnership, or a partnership in which each partner other than the general partner has similar limited liability, in such jurisdiction, including appointing a registered agent and maintaining a registered office in such jurisdiction.

II. PARTNERSHIP NAME

The limited partnership's name is *OPPORTUNITY INVESTMENTS, LP* ("Partnership").

Comment: The name must contain the word "Limited," the phrase "Limited Partnership," or an abbreviation of that word or phrase. See TBOC §5.055(a). In addition, if the partnership is to be a limited liability limited partnership, the name must also contain the phrase "limited liability partnership" or an abbreviation of that phrase. See TBOC §5.055(b). The name of a limited partnership that is a limited liability limited partnership complies with TBOC §§5.055(a) and 5.055(b) if the name of the limited partnership contains the phrase ìlimited liability limited partnershipî or an abbreviation of that phrase. See TBOC §5.055(c). For all limited partnerships, including limited liability limited partnerships, the name may not indicate that the partnership is formed for a purpose that it is not authorized by law to pursue or be deceptively similar to the name of another entity that was formed in Texas or registered to do business in Texas or to a name that has been reserved or registered in Texas. See TBOC §§5.052 and 5.053. Also, the name may not include the word "lotto" or "lottery" or imply the partnership was formed to benefit veterans or their families and contain the word or phrase, or any variation or abbreviation of "veteran", "legion", "foreign", "Spanish", "disabled", "war", or "world war" unless approved in writing by the appropriate organization. See TBOC §§5.061 and 5.062. Also, under §17.46(b)(25) of the Texas Deceptive Trade Practices Act (§17.01 et seq. of the Texas Business and Commerce Code), the use of the word "corporation" or "incorporated" or any abbreviation of either term in the name of an entity that is not incorporated is a deceptive trade practice.

III. REGISTERED AGENT, REGISTERED ADDRESS, AND PRINCIPAL OFFICE

The Partnership's registered agent and street address in Texas is: Thomas Baird, 15 North Main, Temple, Texas 76501. The street address of the Partnership's principal office in the United States is: 15 North Main, Temple, Texas 76501. All Partnership's records required by the TPL will be maintained at the principal office or such other place that is consistent with the purpose of the Partnership as the General Partner may designate from time to time by notice to the other Partners. The Partnership may have such other office or offices as the General Partner may designate from time to time by notice to the other Partners.

Comment:
See TBOC §5.201. The FLP must maintain and have in Texas:

- a registered office, which need not be a place of its business; and
- a registered agent for service of process in Texas, which may be an individual who is a resident of Texas and whose business office is the same as the partnership registered office or a corporation with a business address that is the same as the registered office.

The registered office may not be solely a mailbox service or a telephone answering service.

The registered agent or registered office may be changed

Comment:
See TBOC §153.551. An FLP must keep and maintain the required records at its principal office in the U.S. or make them available upon request within five days of written request. The required records to be kept are:

- a current list that states each limited partner's name and mailing address; identifies the general partners and the limited partners in alphabetical order; each general partner's business and resident address; the percentage owned by each partner; and if one or more classes are established, the names of the partners of each class or group;
- copies of the limited partners' federal, state, and local tax returns for the most recent six tax years;
- copies of the partnership agreement, certificate of formation, all amendments, restatements, copies of any powers of attorney, and any documents that create classes or groups of partners; and
- a written statement of cash contribution and agreed value of any other property contributed that the partners have agreed to make in the future; the time additional contributions are to be made or events requiring additional contributions; events requiring the FLP to be wound up; the date upon which each limited partner became a partner; and books and records of the FLP's accounts.

The records must be maintained in a written form or in a manner subject to being reduced to written form. The FLP must keep in its registered office in Texas and make available to its partners on reasonable request the street address of the principal U.S. office. A partner or assignee may make a written request of partnership information at any reasonable time and make copies. Records required to be kept under TBOC §153.551 and other information regarding the business affairs and financial condition of the FLP may be copied at the partner's sole expense. However, copies of the partnership agreement, certificate of formation, and all amendments or restatements, and any tax return described under TBOC §153.551(a)(2) shall be provided without charge.

IV. PURPOSES

A. Manage Partnership Assets and Promote Harmony Among the Partners.

The Partnership's purpose is to make a Profit, increase wealth, and provide a means for the Family to become knowledgeable of, manage, and preserve Family Assets. The Partnership will accomplish the following:

- resolve any disputes that may arise among the Family to preserve family harmony and avoid litigation expense and problems;
- control Family Assets;
- consolidate fractional interests in Family Assets;
- increase Family wealth;
- establish a method by which annual gifts may be made without fractionalizing Family Assets;
- continue the ownership of Family Assets and restrict non-Family's right to acquire interests in Family Assets;
- provide protection to Family Assets from future

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creditor claims against Family members;
- prevent a Family member's interest in the Partnership being transferred because of a failed marriage;
- provide flexibility in business planning not available through trusts, corporations, or other business entities;
- facilitate the administration and reduce the cost associated with a family member's disability or probating a family member's estate; and
- promote the Family's knowledge of and communication about Family Assets.

Comment:
There must be non-tax business reasons for forming an FLP. If you do not have non-tax reasons for forming an FLP, the estate and gift tax valuation benefits may not be allowed. The non-tax business reasons for forming an FLP are as follows:

1. An FLP provides a structure by which the patriarch or the matriarch has some indirect control over cash flow that goes to the children. When a parent gives a limited partnership interest to a child, the child may not spend it, which gives the parents leverage over their children.
2. An FLP provides consolidation advantages in that fragmented family assets may be placed in the FLP to allow for easier and more prudent management.
3. The FLP allows simplified annual gift giving by allowing "slices" of partnership interests in the FLP to be transferred, thus, keeping the family assets whole.
4. The FLP helps keep the assets in the family because it provides for restrictions on transfers and buy-sale provisions. If a child leaves or loses a limited partnership interest to someone not desired by the family, the family may buy the interest back at a discounted fair market value. This applies to both voluntary and involuntary transfers.
5. Limited partnerships are considered to be one of the best asset-protection entities in which to do business. The FLP can provide limited liability to the limited partners from the FLP's creditors and some protection from the limited partner's judgment creditors.
6. The FLP's restrictions on transferability and buy-sale provisions provide protection to a limited partner from a spouse in the event of a divorce. The interest may be separate property and there are restrictions on transferability.
7. An FLP is more flexible than a trust. The FLP is a contract among family members that may be amended or terminated without adverse tax consequences.
8. Winding up and terminating an FLP has less onerous tax consequences than winding up and terminating a corporation. Another tax issue is the Texas margin tax. Under the Texas margin tax, a passive limited partnership entity is one in which at least 90% of its gross revenue is from interest, dividends, gains in real property, oil and gas interests, or from other taxable entities. As long as the FLP is classified as a passive entity for Texas margin tax purposes, it will not be subject to the margin tax. If the FLP has active gross revenue (revenue that is not passive revenue) of more than 10%, then the FLP will be subject to the Texas margin tax.
9. Income distributed to limited partners is not subject to self-employment tax, unlike distributions to a partner of a general partnership or LLC members.
10. The business-judgment rule applies to the FLP partners, as opposed to a higher fiduciary standard to the trustees of a trust, when investment decisions are made on behalf of family members and their assets.
11. An FLP may provide for mediation and binding arbitration in disputes by its partners while similar provisions will not be enforced in disputes between the trustees and beneficiaries involving trusts. The mediation and binding arbitration provisions promote family harmony by reducing the emotional stress and financial cost that is associated with litigation.
12. An FLP can provide confidentiality provisions restricting family members from disclosing family business transactions or problems, and if the confidentially provisions are violated, it will be a breach of the partnership agreement, causing damages to accrue to the breaching party.
13. The FLP can be used to reduce or eliminate probate and guardianship proceedings in foreign jurisdictions and, if used with a revocable trust, can eliminate those same proceedings in Texas.
14. The FLP can be used to create a mechanism by which family communication may be formalized concerning the operation of the family business and investment of family assets. It can provide a means by which family members can become knowledgeable of family business operations and assets.

B. Purposes Allowed by the TPL.

The Partnership is authorized to engage in all business permitted by the TPL. If the Partnership qualifies to do business in a foreign jurisdiction, it may transact all business permitted in that jurisdiction. There is no jurisdictional restriction upon the Partnership's Property or activity.

Comment:
TBOC §2.001 states that a limited partnership formed under this Act may engage in any lawful business unless a more limited purpose is stated in the partnership agreement. If the limited partnership engages in a business that is regulated by another statute, it may be formed under the TBOC only if permitted by the other statute. It is intended that the FLP be organized with broad purposes to accomplish the non-tax business reasons stated in Section IV.A. The broader the purpose clause in an FLP, the better.

Be careful when defining the purpose of a single-purpose partnership. Avoid using the phrase ìand such other purposes for which limited partnerships may be formed under the TPLî or similar open-ended language unless the partners intend to engage in all of their business endeavors through this partnership. The purpose clause is often used to interpret a number of matters, including the scope of a partner's authority and a partner's duties to the other partners. For example, a general partner will have more authority to bind the partnership for actions unrelated to the primary purpose of the partnership if the partnership has a broad purpose clause. Also, an allegation that a partner has usurped a partnership opportunity by purchasing a parcel of land that is close to the property owned by the partnership may be negated if the purpose of the partnership is to own and develop only that specified property.

C. Partnership's Authority

To accomplish the Partnership Purposes, the Partnership's authority includes the following:

1. **Farm & Ranch.**
   a) Engaging in farming and ranching;
   b) acquiring, owning, holding, developing, and operating farm and ranch properties, either as operator, managing agent, principal, agent, partner, stockholder, syndicate member, associate, joint venturer, participant, or otherwise;
   c) investing in and raising funds for farming and ranching;
   d) purchasing, constructing, acquiring, owning, developing, operating, leasing, mortgaging, pledging, selling, or otherwise disposing of crops, livestock, and facilities; and
   e) doing anything necessary or incident to farming and ranching.
2. **Real Estate.**
   a) Engaging in the real estate business;
   b) acquiring, owning, holding, developing, and operating real estate properties, either as operator, managing agent, principal, agent, partner, stockholder, syndicate member, associate, joint venturer, participant, or otherwise;
   c) investing in and raising funds for real estate development and operation;
   d) purchasing, constructing, acquiring, owning, developing, operating, leasing, mortgaging, pledging, selling, or otherwise disposing of buildings, fixtures, and improvements; and
   e) doing anything necessary or incident to the real estate business.
3. **Stocks and Bonds.**
   Purchasing, selling, investing, and dealing in the following:
   a) stocks;
   b) bonds;
   c) notes;
   d) evidences of indebtedness of any Person, domestic or foreign;
   e) bonds and any other obligations of any governmental entity, domestic or foreign;
   f) bills of exchange and commercial paper, and any other securities; and
   g) gold, silver, grain, cotton, and other commodities and provisions usually dealt on exchanges or over-the-counter markets.
4. **Business Entities.**
   a) Investing Partnership Property or carrying on a trade or business and form all types of business entities or trusts; or
   b) acquiring general or limited partnership interests in a partnership, membership interests in a limited liability company or a joint venture, shares in a corporation, or interests in any syndication.
5. **Make Conveyances.**
   To buy, sell, lease, and deal in services, personal property, and real property.
6. **Make Investments.**
   Engage in any other trade, business, or investment activity.
7. **Oil and Gas.**
   Buying, selling, trading, exchanging, acquiring, transferring, assigning, leasing, developing, managing, and operating oil, gas, and other mineral interests, either alone or together with others.
8. **Other Lawful Business Enterprise.**
   Operating any lawful business enterprise that accomplishes other Partnership Purposes.
9. **Guaranties.**
   Guaranteeing the financial transactions of others, with or without charging a fee.
10. **Borrowing and Lending.**
    a) Borrowing and lending money; and
    b) unless prohibited, allowing a Partner to lend money to and transact other business with the Partnership or Partners.
11. **Investments.**
    Investing and reinvesting any Partnership Property or income whether or not the original purpose for the investment has been accomplished. It is understood that, until the end of the Partnership's term, this Partnership's investment objectives are to continue until the Partnership's affairs are wound up.
12. **Depreciable Property.**
    Purchasing, leasing, acquiring, selling, or disposing of machinery, equipment, buildings, and other depreciable property.
13. **Acquiring Partnership Property.**
    Purchasing, acquiring, holding, operating, selling, leasing, or disposing of full or fractional interests in improved or unimproved real and personal property.
14. **Borrowing and Raising Money.**
    Borrowing or raising money by:
    a) issuing, accepting, endorsing, or executing notes, drafts, bills of exchange, warrants, bonds, debentures, instruments or evidences of indebtedness;
    b) securing the indebtedness by mortgage, pledge, transfer, or assignment in trust of all or any part of the Property; and
    c) selling, pledging, or disposing of the Partnership's obligations.
15. **Operate Offices.**
    Operating one or more offices, leasing or acquiring office space, engaging personnel, and doing all things necessary to operate the office.
16. **Insurance.**
    Carrying insurance that the General Partner deems necessary and appropriate.
17. **Entering into Contracts.**
    Making, entering into, delivering and performing all contracts, agreements, or undertakings.
18. **Paying Expenses.**
    Paying all costs and expenses and performing all acts deemed appropriate by the General Partner to carry out the Partnership Purposes.
19. **General Partner's Authority.**
    The General Partner may take any action permitted by this Agreement and the TPL to accomplish the Partnership Purposes. These permitted activities include any act customary or reasonably related to acquiring, owning, managing, selling, investing, reinvesting, or financing the Partnership Property. These customary activities include buying and selling options, short sales, hedging, and purchases on margin.

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Comment: The extensive list of partnership purposes is to support the non-tax reasons for creating the FLP. Often when third parties examine an FLP, they look to the purposes clause to make sure that the partnership is authorized to make the investment or conduct the business operation contemplated. Banks, stockbrokers, attorneys, and accountants are always more cooperative when they see a reference to their specific type of transaction mentioned in the purpose provision. It is critical that the purpose provisions include re-investment language and language to the effect that if an investment is liquidated, new investments will be established and continued until the partnership term ends. This type of provision can also provide justification to an appraiser for the assumptions the appraiser may make about the distributable cash flow that may be available to be distributed to the partners over the remaining partnership term.

V. THE PARTNERSHIP'S TERM

Comment: One of the primary design considerations for an FLP is that it must be a term-of-years partnership or a perpetual partnership; that is, the partnership will continue until a specified date or perpetually. If a term-of-years or perpetual partnership is created under the TPL, the FLP may utilize all the favorable default state law provisions. Having a specified date for the FLP to terminate or having a perpetual partnership also supports assumptions that are made by an appraiser in calculating the fair market value of a partnership interest. If an appraiser can determine the amount of cash that will be available to be distributed to the partners, the appraiser can evaluate a partnership interest in a manner similar to a fixed-income security using the capitalization method to determine fair market value. The ability to value a partnership interest as a fixed-income security by the capitalization method is helpful in achieving an FLP's estate and gift tax valuation benefits.

This Partnership's term is perpetual. The Partnership may be wound up at any time by Unanimous Consent unless sooner wound up in accordance with the TPL or this Agreement.

Comment:
Having language such as "the partnership may not continue beyond a specified date" is not an applicable restriction for Code §2704(b) purposes. The IRS may take the position that it is a liquidation restriction when in reality it is a restriction against continuing. The IRS definition of "liquidation restriction" in the regulations is not fully satisfied by the use of this language. If anything, it is a restriction against continuing and not a restriction against liquidating.

If the IRS claims the term limitation is a liquidation restriction and they ignore the language, the limited partnership interest to be transferred will still have a reduced fair-market value. It is irrelevant what a limited partner's rights are (including the right to withdraw) after Revenue Ruling 93-12. What is relevant after Revenue Ruling 93-12 is, what are the transferee's rights? A limited partner may not liquidate an FLP even if the limited partner may withdraw. If the limited partner cannot liquidate the partnership, the fair-market value of his or her limited partnership interest will still be based on the FLP's going-concern value rather

If the term provision is disregarded under Code §2704(b), the limited partner still may not withdraw, because TBOC §153.110 says ìA limited partner may withdraw from a limited partnership only at the time or on the occurrence of an event specified in a written partnership agreement. The withdrawal of the partner must be made in accordance with that agreement.î The IRS position will be hard to justify after a careful reading of the TBOC and Code §2704(b).

TBOC §§153.155(b), 153.157, and 153.158 provides that in a perpetual partnership or in a partnership for a particular term, unless a partnership agreement provides to the contrary, the withdrawal of a general partner before the end of the term breaches the partnership agreement. This breach subjects the general partner to damages and gives the other partners the right to purchase the withdrawing general partner's general partnership interest or to convert it to a limited partnership interest.

Again, TBOC §153.110 states that ìA limited partner may withdraw from a limited partnership only at the time or on the occurrence of an event specified in a written partnership agreement. The withdrawal of the partner must be made in accordance with that agreement.î Thus, if the partnership agreement states a definite time to wind up its affairs or if the partnership term is perpetual, a limited partner may not withdraw. To take advantage of the favorable default statutory language whereby the partners may recover damages against a withdrawing general partner and either purchase the general partnership interest or convert it to that of a limited partnership interest and force all limited partners to remain in the partnership until its term ends, it is critical that the partnership agreement state a definite term and a time at the end of which the partnership will be wound up or state that the partnership's term is perpetual.

VI. PARTNERS

A. Admitting New Partners.

The initial Partners are those Partners who executed this Agreement as General and Limited Partners on the Effective Date. After the Effective Date, no Person may be admitted as a Partner except as provided in this Agreement and the TPL. Once the Person is admitted as a Partner, the Person has the rights and obligations of a Limited Partner or General Partner, as applicable. Any new Partner will be required to accept and assume, in writing, this Agreement's terms and conditions.

Comment:
TBOC §153.101(b) states that after forming an FLP, a person acquiring a partnership interest directly from the FLP becomes a new limited partner upon complying with the partnership agreement's provision governing admission of new limited partners. If the partnership agreement contains no relevant admission provisions, the person becomes a new limited partner upon the written consent of all partners. This agreement does not provide a mechanism for admitting new limited partners to acquire partnership interests directly from the FLP. Thus, it will require unanimous consent of all partners to admit a new limited partner who acquires a limited partnership interest directly from the FLP.

TBOC §153.101(c) states that after forming an FLP, an assignee of a partnership interest becomes a new limited partner as provided by TBOC §153.253(a) of the Act. This section states that an assignee may be admitted as a partner:

- if a written partnership agreement provides; or
- by unanimous consent.

Admitting an assignee as a new limited partner is provided for in this agreement in Article XII.

TBOC §153.151(a) states that after forming an FLP, additional general partners may be admitted as provided in a written partnership agreement; or if a partnership agreement does not provide for admitting additional general partners, additional general partners may be admitted with the written consent of all partners. Admission of a new general partner is provided for in this agreement in

B. Management by General Partners.

The General Partner is responsible for exclusively managing, operating, and controlling the Partnership's business and affairs. The General Partner will act as a "manager" of the Partnership. If there is more than one General Partner, all the General Partners' obligations under this Agreement will be joint and several. Any actions taken by the General Partners will be valid if approved by a majority of the General Partners, except as otherwise provided in this Agreement.

The General Partners by their unanimous consent may designate a managing partner ("Manager"). A designated Manager will serve until the designation is revoked or the Manager ceases to serve for any other reason. If a Manager is designated, the Manager is authorized and directed to manage and control the Partnership's assets and business. The Manager may exercise all the powers that may be exercised by the General Partners' majority consent. If a Manager is designated, any reference to "General Partner" in this Agreement includes "Manager" if applicable.

The General Partner may hire the Partnership's employees, appoint any individual as a Partnership officer, and delegate to the officer or employee any power or duty a General Partner may have. The fact that a Partner is directly or indirectly any person's affiliate will not prohibit that person from being employed or dealing with the Partnership. Any employment or dealing will be done at reasonable rates for similar services, supplies, or materials.

A General Partner may employ, select, remove, and change the authority and responsibility of any consultants or professionals as the General Partner considers necessary to assist in prudently managing the Partnership and its Property. The fact that a Partner is directly or indirectly any Person's affiliate will not prohibit that Person from being employed or dealing with the Partnership as a consultant or professional.

The General Partner will remain responsible to the Partnership for the acts or omissions of the Manager, agent, or employee and for performing their General Partner duties provided for in this Agreement or the TPL.

The General Partner may delegate management functions to any corporation, partnership, limited liability company, or other entity qualified to manage the Partnership property and to conduct the business activities of the Partnership. Any delegation of authority is to be considered in compensating the General Partner for services to the Partnership.

Comment:
Pursuant to TBOC §§ 153.152(a), 153.003(a), and 152.203(a), a general partner has the right to manage and conduct the business of the partnership.

TBOC §§ 154.101, 154.102, and 154.103 state that a written partnership agreement may establish voting classes of one or more general partners having certain expressed relative rights, powers, and duties. It may also provide for the future creation of differing classes of general partners. It also states that a written partnership agreement may contain provisions for place, date, and time to vote; notice; waiver of notice; action by consent without a meeting; establishment of a record date; quorum requirements; voting in person or by proxy; or any other matter relating to the right to vote.

C. Admission of Additional General Partner.

Additional General Partners may be admitted as provided in Section XV.C.

D. Removal of a General Partner.

A general partner may not be removed unless there is at least one remaining General Partner or a successor General Partner as provided in Section XV.C. Except as otherwise provided in this Agreement, **Unanimous Consent** is required to remove an existing General Partner. If a General Partner is removed for any reason, the GP Units held by the General Partner being removed and classified as GP Units must be sold by the removed General Partner and purchased in accordance with Section XII.B.2 of this Agreement. The General Partner will, however, be removed upon at least a **Majority in Interest** agreeing if:

- a General Partner materially breaches the General Partner's obligations and does not cure, or commence and diligently prosecute curing, the breach within 90 days after notice of the breach by any Limited Partner; or
- the General Partner commits any act or omission of fraud or malfeasance to the Partnership's injury.

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Comment:
If you are not drafting a partnership for an FLP, and if you represent a general partner, you may prefer to delete this section in its entirety. A general partner may not generally be removed by the partners unless the partnership agreement expressly provides otherwise. See TBOC §153.155(a)(3).

If you are not drafting a partnership for an FLP, and if you represent a limited partner, you may want to reduce the standard for removal by, for instance, requiring a majority in interest, rather than a supermajority in interest, of the limited partners to agree to the removal or requiring a majority in interest or supermajority in interest of only the limited partners who are not affiliated with the general partner. You may also want to consider other things that can trigger the removal, such as (a) the general partner or any of its officers, directors, agents, or employees being guilty of fraud, dishonesty, unethical business conduct, moral turpitude, or similar acts of misconduct that are likely to materially adversely affect the partnership; (b) any officer, director, agent, or employee of the general partner becoming mentally or physically incapacitated to such extent that the general partner is unable to perform fully its duties under the partnership agreement for more than a specified period of time; (c) a transfer of the general partner's partnership interest in violation of the partnership agreement is purported to be made; or (d) a transfer by the general partner of all of its rights as a general partner, all of its partnership interest as a general partner, or all of its status rights as a general partner.

Coordinate the standard for removal with the provisions regarding indemnification and standards of performance of the general partner to avoid inconsistent results.

E. A General Partner's Authority.

The General Partner may do all things appropriate in carrying out the Partnership Purposes, including:

- selling, exchanging, assigning, conveying, leasing, and transferring legal and equitable title to the Partnership Property on terms and conditions deemed reasonable by the General Partner;
- acquiring, utilizing for Partnership Purposes, and operating, improving, and developing any Partnership Property;
- retaining, without liability, any property in the form it is received without regard to its productivity or the proportion that any one asset or class of assets may bear to the whole, and the General Partner will not have liability nor responsibility for loss of income from or depreciation in the value of the property that was retained in the form in which it was received by the General Partner;
- registering or taking title to Partnership assets in the Partnership's name or as Trustee, with or without disclosing the identity of his or her principal; or permitting the securities to be registered in "street name" under a custodial arrangement with an established securities brokerage firm, trust department, or other custodian;
- borrowing money, financing, refinancing, or otherwise incurring obligations for the Partnership's account and pledging, mortgaging, and granting a security interest in the Property;
- carrying out the Partnership Purposes through other partnerships, corporations, limited liability companies, or other entities;
- compromising claims against the Partnership;
- making any election under any tax law in the manner the General Partner deems advisable, the election or failure to elect of which may not result in any cause of action against the General Partner;
- executing and accepting any instrument, conveyance, or agreement incident to the Partnership's business or property without the Partners' joinder, ratification, or consent;
- paying all Partnership debts, obligations, and expenses;
- performing the Partnership's obligations, and exercising all the Partnership's rights, under any agreement to which the Partnership or its nominee is a party;
- loaning funds to any Partner on terms and conditions deemed reasonable by the General Partner;
- advancing any monies to the Partnership required for the Partnership's business, but with no obligation to do so;
- acquiring and determining amounts of insurance coverages required by the Partnership Purposes, Property, or business;
- entering into contracts and business undertakings to further the Partnership Purposes;
- opening and maintaining bank and investment accounts and arrangements, drawing checks and other orders for paying money, and designating individuals with authority to sign or give instructions with respect to those accounts and arrangements;
- maintaining the Partnership Property in good order;
- collecting sums due the Partnership;
- investing and reinvesting Property to accomplish Partnership Purposes, including investing the Property in accordance with the Modern Portfolio Theory;
- distributing Distributable Cash subject to other provisions of this Agreement;
- executing and filing certificates or instruments as required or permitted by the TPL and any other laws of Texas or any other jurisdiction where the Partnership does business; and
- withholding any funds due to a limited partner who is a foreign person as may be required by the Internal Revenue Code and its promulgated regulations.

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Comment: TBOC §153.152(a)(1) states that a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners. Thus, a general partner has broad authority and discretion to manage and bind the FLP. The powers listed above have been specifically enumerated for the benefit of third parties who deal with the FLP and are more comfortable in dealing with a general partner who is given specific authority in a partnership agreement. In addition, an appraiser will look to the authority given a general partner. If broad authority has been given a general partner to manage the FLP, support is provided for a valuation discount of a limited partner's interest due to the lack of control or managerial authority. These powers have also been enumerated to support and work in conjunction with the partnership purposes stated in Article IV of this agreement. The broad authority granted to the general partner to invest and reinvest partnership property is another factor to be taken into consideration by an appraiser. The fact that the general partner will in all probability continue to reinvest partnership property and not make distributions to the limited partners justifies the valuation discounts of a limited partnership interest due to the

F. Restrictions on General Partner.

The General Partner may not enter into any of the following transactions without the consent of **70 Percent in Interest**:

- incur Partnership indebtedness that exceeds the loan to value ratio of 50% (cumulative of all Partnership liabilities and the Property's cumulative value measured at book value);
- before the Partnership actually winds up, sell substantially all the Property in liquidation or business cessation;

Comment: The parenthetical phrase eliminates any ambiguities that may exist as to authority to take actions during winding up that are inconsistent with carrying on the ordinary course of business such as, for example, selling of assets.

- compromise any claim or dispute having an amount or value in issue that exceeds 50% of the Property's total value;
- confess a judgment against the Partnership;
- do any act that violates this Agreement;
- possess Property or assign the right of the Partnership or its Partners in specific Property for other than a Partnership Purpose;
- make, execute, or deliver any assignments for the benefit of creditors, or on the Assignee's promise to pay the Partnership's debts; or
- do any act for which the Limited Partners' consent is required by the TPL.

Comment: Consider modifying this list to address any other areas of specific concern to the limited partners. Concerns about the limited partners losing limited liability as a result of possessing too many management-type

G. Requirement of Unanimous Consent.[

The General Partner may not enter into any of the following transactions without Unanimous Consent:

- Wind up the Partnership, except as otherwise provided in Section XV.A.2 of this Agreement;
- admit additional or substitute partners except as otherwise provided in Article XII of this Agreement;

Comment: Unless the partnership agreement otherwise provides, after the partnership is formed, the consent of all partners is required to admit a person as a partner. See TBOC §§153.101(b), 153.151(a), and 153.253(a).

- do any act that makes it impossible to carry on the Partnership's Purposes and the Partnership's business. Selling or otherwise disposing of any Property will not, however, be deemed to be an act making it impossible for the Partnership to carry on its business;
- engage in any business activity other than that consistent with the Partnership's Purposes; or
- amend this Agreement except as provided for elsewhere in this Agreement.

Comment:
Unless the partnership agreement otherwise provides, the consent of all partners is required to amend the partnership agreement. See TBOC §§152.208 and 153.003(a).

Because this agreement is drafted with a bias in favor of the general partner, it contains only a limited number of restrictions on the authority of the general partner and several of the restrictions merely restate the restrictions mandated by statute. For instance, the admission of partners is outside the authority of the general partner unless the partnership agreement otherwise provides. See TBOC §§153.101(b), 153.15I(a), and 153.253(a).

See TBOC §§ 154.104, 154.102, and 154.103. This provision has been included to evidence the fact that the limited partners have very little authority to manage or control the FLP. This provides additional support to the appraiser that the limited partnership interest in an FLP should have a discounted value because of the lack of control or management authority. In addition, for non-tax business reasons, there are certain occasions where an action to be taken by the partnership is so critical to the partnership purposes that the limited partners need to have the right to voice their approval or disapproval of the action.

H. Compensation and Reimbursement of General Partner.

The General Partner must diligently and faithfully devote the time to managing the Partnership necessary to serve the Partnership Purposes and must perform all a General Partner's duties provided for in this Agreement and the TPL. The General Partner is not, however, required to devote all the General Partner's time to managing the Partnership. A General Partner must receive reasonable annual compensation for services rendered to the Partnership. Reasonable compensation is to be measured by the time required in administering the Partnership, the value of property under the General

Partner's administration, and the responsibilities assumed in discharging the duties of office. Additionally, the compensation must comply with Code Section 704(e), if applicable. This compensation is a guaranteed payment. The General Partner may be reimbursed for all reasonable and necessary business expenses incurred in administering the Partnership. **The General Partner may adjust a General Partner's compensation based upon the General Partner's performance and dedication of time to the Partnership's business. Upon the death of both Thomas Baird and Cindy Baird, 70 Percent in Interest of Limited Partners** may adjust a General Partner's compensation based upon the General Partner's performance and dedication of time to the Partnership's business. If the Partnership's cash flow is insufficient to pay the compensation, the unpaid portion of the compensation may be deferred and bear interest at the Default Interest Rate. Payments to the General Partner for services rendered to the Partnership will not be a return on invested capital, but will be paid as compensation for services rendered.

Comment: In accordance with Code §704(e), the Family Partnership Rules are satisfied by having the FLP agreement provide that partners who provide services to the FLP be adequately compensated for their services. FLPs that have capital as a material income-producing factor are required to have income distributed on the basis of the ownership of that capital. The FLP is designed for non-tax and valuation discount tax benefits and not for income shifting, although it may be available.

I. Indemnification and Limitations on General Partner's Liability.

To the extent Texas law will permit, a General Partner who succeeds another:

- will be responsible only for the property and records delivered by or otherwise acquired from the preceding General Partner; and
- may accept as correct the preceding General Partner's records without duty to audit the records or to inquire further into the predecessor's administration and without liability for a predecessor's errors and omissions.

A GENERAL PARTNER IS NOT LIABLE FOR ACTS OR OMISSIONS IN PERFORMING ITS DUTIES WITH RESPECT TO THE PARTNERSHIP FOR ANY OTHER REASON, INCLUDING THE GENERAL PARTNER'S SOLE, PARTIAL, OR CONCURRENT NEGLIGENCE, OR FOR TAKING ANY ACTION THAT IT IS AUTHORIZED TO TAKE BY THIS AGREEMENT UNLESS PERFORMED IN BAD FAITH OR WITH GROSS NEGLIGENCE OR WILLFUL MISCONDUCT THAT IS NOT EXCUSED BY ANY OTHER PROVISION OF THIS AGREEMENT.

Comment: Note that a certain part of the language in this provision is in bold in order to meet the requirement under Texas law that a provision that purports to release a person from the person's own negligence must be conspicu*ous. See Dresser Industries, Inc. v. Page Petroleum, Inc.*,

A General Partner will not have liability for loss of income from or depreciation in the value of the property that was retained in the form that the General Partner received it.

The General Partner is entitled to all indemnification authorized in the TPL.

The General Partner only owes a fiduciary duty of loyalty and care to the Partnership and to the Partners.

Each General Partner will indemnify the Partnership and each Limited Partner from any loss, damage, claim, or liability incurred by them, including reasonable attorneys' fees and expenses, due to or arising from the General Partner's gross negligence, fraud, bad faith, or willful misconduct.

To the fullest extent permitted by Subchapters B and C of Chapter 8 of the TBOC (as the same now exists or as it may hereafter be amended to the extent the amended version is more favorable to the Person seeking a remedy under this Section), the Partnership will indemnify each General Partner and former General Partner (and each General Partner's and former General Partner's affiliates, officers, directors, partners, employees, and agents) and each delegate, officer, employee, and agent (as such terms are used in Chapter 8 of the TBOC) of the Partnership, **INCLUDING, IN EACH CASE, FOR CLAIMS BASED ON OR ARISING FROM SUCH PERSON'S SOLE, PARTIAL, OR CONCURRENT NEGLIGENCE**. This indemnification includes direct and indirect costs and reasonable attorneys' fees and expenses, which will be satisfied from Partnership assets only. The indemnity will be from any loss, damage, claim or liability incurred by them because of any act (other than an act of gross negligence, fraud, willful misconduct, or bad faith) performed by the General Partner on the Partnership's behalf or in furthering the Partnership Purposes. The provisions of this paragraph constitute a contract to indemnify as contemplated by TBOC §8.151(b).

The right of any Person under this section will survive the termination of that Person's status that gives rise to its rights under this section and the termination of this Agreement and the termination of the Partnership.

In the event of the death of a Person seeking a remedy under this section, the right under this section will inure to the benefit of such Person's heirs, executors, administrators, and personal representatives.

The rights conferred in this section will not be exclusive of any other right that a Person seeking a remedy under this section may have or hereafter acquire under any statute, resolution of Partners, agreement, or otherwise.

The Partnership may purchase insurance to minimize all or part of any indemnification risk.

For purposes of this section, the term "General Partner" also refers to the General Partner's heirs, administrators, executors, successors, and assigns.

The Partners authorize any General Partner, in the General Partner's discretion, to register the Partnership as a registered limited liability limited partnership under Section 153.805 of the TBOC. They further authorize the General Partner to take or cause the Partnership to take all actions, at the Partnership's expense, as necessary to effect and maintain the registration, including changing the Partnership's name to include the designation "LLLP".

Comment:
The rights to indemnification are governed by Title I, Chapter 8, of the TBOC. Those provisions are fairly complex. It is particularly important to focus on the fact that TBOC §8.151 permits an entity to contractually commit to indemnification — even if the other provisions of Chapter 8 would not permit indemnification — if the owners of the entity approve that contract.

Coordinate the provisions regarding indemnification with those relating to the standard of conduct of and right to remove the general partner in order to avoid inconsistent and conflicting treatment.

These provisions don't just permit broad indemnification — they require it. Determine if that is appropriate with respect to all categories of persons to be indemnified. Also determine if you want to limit the obligation of the partnership to indemnify the general partner and others, as contemplated by TBOC §8.003.

J. Waiver of Self-Dealing.

Provided the transaction terms are no less favorable than those the Partnership may obtain from unrelated third parties, the General Partner may enter into any transaction on the Partnership's behalf despite the fact that another party to the transaction may be:

- a trust of which a Partner is a trustee or beneficiary;
- an estate of which a Partner is a personal representative or beneficiary;
- a business controlled by one or more Partners or a business of which any Partner is also a director, officer, or employee;
- any affiliate, employee, stockholder, associate, manager, partner, or business associate;
- any Partner, acting individually; or
- any Partner's relative.

It is expressly understood that each Partner may invest the Partner's personal assets for the Partner's own account and may conduct the Partner's personal affairs and investments without regard to whether they constitute a Partnership "opportunity."

A Partner may engage in or possess an interest in any other business or venture of any nature and description, independently or with others, including ones in competition with the Partnership. The Partner has no obligation to offer to the Partnership or any other Partner the right to participate. Neither the Partnership nor its Partners has by virtue of this Agreement any right in any independent venture or its income or Profits.

Comment:
If there are specific agreements or transactions that are to be entered into between the partnership and a general partner or one of its affiliates, the general partner may desire to have the partnership agreement expressly bless those agreements and transactions in order to avoid any claims that they represented a breach of the general partner's duty of loyalty. See TBOC §§152.204, 152.205, and 153.003(a).

If you represent a limited partner, you may want to require, in addition to approval of the general partner, approval of some portion of the limited partners if the general partner or one of its affiliates is the other party to the transaction

K. Amendment to Certificate of Formation.

If a General Partner is unwilling or unable to sign a required amendment to the Certificate of Formation, the amended certificate may be signed by any remaining or successor General Partners. Each General Partner appoints his, her, or its successor and any remaining General Partners, if any, as his, her, or its attorney-in-fact to sign the amended certificate.

Comment: See TBOC §§ 153.051, 153.052, and 153.053.

L. Reliance by Third Parties.

Any Person dealing with the Partnership, other than a Partner, may rely on the General Partner's authority in taking any action in the Partnership's name without inquiry into this Agreement's provisions. Any document executed by the General Partner is deemed to be the Partnership's action as to any third parties. No purchaser, tenant, transferee, or obligor will have any obligation to see to the application of payments made to the General Partner.

Any Person dealing with the Partnership or the General Partner may rely upon a certificate signed by the General Partner as to:

- the Partners' identity;
- any conditions precedent to acts by the Partnership;
- the Persons who are authorized to execute any documents and bind the Partnership; and
- any other matter involving the Partnership or any Partner.

M. Limited Partners' Liability and Authority to Act.

No Limited Partner will be personally liable for any debts or other Partnership obligations. The Limited Partners may not take part in managing or controlling the business, transact any Partnership business, or have power to sign for or to bind the Partnership. This provision may not, however, prevent a Limited Partner from acting in a capacity or exercising a power enumerated in Section 153.013 of the TBOC.

A Limited Partner owes no fiduciary duty to the Partnership or any of the other Partners solely as a result of being a Limited Partner.

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Comment:
The above sentence is included to avoid any uncertainty about this issue. If limited partners are to have fiduciary duties, they should be clearly spelled out in the partnership agreement.

See TBOC §§ 153.102, 153.103, 153.104, and 153.105. The fact that a limited partner may not participate in the FLP's management is another factor that an appraiser can use to support a determination that a limited partnership interest has discounted value.

N. Voting of Limited Partners.

Limited Partners may vote upon the matters listed below:

- removing the General Partner;
- electing a successor General Partner;
- winding up the Partnership;
- amending this Agreement;
- extending the Partnership's term; and
- any matter requiring the Limited Partners' vote as set out elsewhere in this Agreement or in the TPL.

Those matters to be voted on by the Limited Partners may be done by written consent. A written consent may be utilized at any meeting of the Partners, or it may be utilized in obtaining approval by the Partners without a meeting.

Only Partners of record, acting personally or through a Qualified Representative, are entitled to vote on matters submitted to a vote of Partners. A Partner is deemed present at a meeting only if present in person or through a qualified representative. Partners are not entitled to vote by proxy unless the proxy is exercised by a Qualified Representative.

Comment:
The provisions of the above paragraph are intended to assure that the status rights associated with a partnership interest are not indirectly transferred. Again, you should consult with a tax advisor to determine if this provision presents a risk that a transferee will not be treated as a partner for federal income tax purposes.

As to the above section, see Chapter 6 of the TBOC, and TBOC §§ 154.101, 154.102, and 154.103.

O. Restrictions of Limited Partners.

No Limited Partner may withdraw from the Partnership or receive a return of any of its contributions to the Partnership until the Partnership's affairs are wound up in accordance with Section 11.052 of the TBOC and this Agreement. A Limited Partner who breaches this Agreement will be liable to the Partnership for damages caused by the breach. The Partnership may offset for the damages against any distributions or return of capital to the Limited Partner who has breached this Agreement. A Limited Partner will breach this Agreement if the Limited Partner:

- attempts to withdraw from the Partnership;
- interferes in the management of the Partnership affairs;
- engages in conduct that may result in the Partnership losing its tax status as a partnership;
- engages in conduct that tends to bring the Partnership into disrepute;
- owns a Partnership Interest that becomes subject to a charging order, attachment, garnishment, or similar legal proceedings;
- breaches any confidentiality provisions of this Agreement; or
- fails to meet any commitment to the Partnership.

No Limited Partner may cause the Partnership's winding up by court decree or otherwise.

Comment:
The following factors may be used by an appraiser to justify a discounted value for a limited partnership interest:

- the fact that the limited partner may not withdraw from an FLP before the FLP's term ends;
- even if the limited partner may withdraw, the fact that the limited partner cannot cause the FLP's liquidation; and
- the fact that a limited partner cannot compel a return of the Limited Partner's capital contribution before the FLP's term ends.

P. Partnership Communication.

At least once a year, as soon as possible after the financial statements are completed, a meeting may be held for all Partners. The General Partner will review and discuss the financial statements at the meeting and report to the Limited Partners the Partnership's financial condition. The annual meeting will be held at a place designated by the General Partner on or before the third Tuesday in April each year. All partners must receive prior notice of the meeting date, time, and place. Failure to have an annual meeting, however, is not a breach of this Agreement.

The General Partner or **70 Percent in Interest of Limited Partners** may establish an Advisory Committee of the Partnership consisting of three or more Limited Partners (the "Advisory Committee"). If the Advisory Committee is established, at least once each calendar year, the General Partner will call an Advisory Committee meeting. Notice must be given to each member on or before the tenth day before the meeting. At this meeting, the General Partner will apprise the Advisory Committee of the Partnership's business and affairs since the latest Advisory Committee meeting. The Advisory Committee may make recommendations to or otherwise advise and consult with the General Partner regarding the Partnership's business and affairs. The Advisory Committee is not, however, authorized to take any action on the Partnership's behalf or to compel any Partner to take any action. The Advisory Committee may make a report of the meeting to the remaining Limited Partners. A Limited Partner or representative is entitled to payment from the Partnership for its expenses regarding attendance at the Advisory Committee meetings.

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Comment: See TBOC §§ 154.101, 154.102, 153.103, 153.104, and 153.105. This provision has been included to support the purposes as stated in Article IV of this agreement by providing for partnership communication and educating family members who are limited partners about the FLP's affairs. In certain cases, the advisory committee can be used to provide for the payment for services of certain

Q. Ownership of Partnership Property.

All Property will be owned by and in the Partnership's name. Each Partner expressly waives the right to require partition of any Property. The Partners will execute any documents necessary to reflect the Partnership's ownership of its Property and will record the documents in the public offices that may be necessary or desirable in the Partners' discretion. No Partner may demand or receive Property other than cash in return for the Partner's contribution.

Comment:
See TBOC §§ 154.203 and 154.001. The following are factors that an appraiser may use to support the determination that a limited partnership interest is subject to a valuation discount:

- the fact that a partner does not own an interest in any particular partnership property;
- the fact that a partner cannot compel a return of capital; and
- the fact that a partner cannot require a distribution other than cash.

R. Confidentiality of Information.

Each Partner is entitled to all information under the circumstances and subject to the conditions stated in this Agreement and the TPL. The Partners agree, however, that the General Partner or 70 Percent in Interest of Limited Partners may determine, due to contractual obligations, business concerns, or other considerations:

- that certain information regarding the business, affairs, Property, and the Partnership's financial condition will be kept confidential and not provided to some or all other Limited Partners; and
- that it is not just or reasonable for those Partners, Assignees, or representatives to examine or copy that information.

The Partners acknowledge that they may receive information regarding the Partnership in the nature of trade secrets or that otherwise is confidential. They acknowledge that the release of this information may be damaging to the Partnership or Persons with which it does business. Each Partner will hold in strict confidence any information it receives regarding the Partnership that is identified as being confidential (and if that information is provided in writing, that is so marked). The Partners acknowledge that breaching this section's provisions may cause irreparable injury to the Partnership for which monetary damages are inadequate, difficult to compute, or both. Accordingly, the Partners agree that this section's provisions may be enforced by specific performance. No Partner may disclose confidential information to any Person other than another Partner, except the following disclosures:

- Those compelled by law. But the Partner must notify the General Partner or 70 Percent in Interest of Limited Partners, as appropriate, promptly of any request for that information, before disclosing it, if practicable.
- Those to advisers or representatives of the Partner or the Partner's Assignees, but only if they have agreed to be bound by this section's provisions.
- Those of information the Partner also has received from a source independent of the Partnership that the Partner reasonably believes obtained that information without breaching any confidentiality obligation.

Comment:
This provision has been included to help accomplish the FLP's purposes as stated in Article IV of this agreement.

The partnership is required to provide to partners and former partners access to the partnership's books and records pursuant to TBOC §152.212. Under certain circumstances, a general partner may believe that a limited partner's access to the partnership's records could be detrimental to the partnership, particularly if the limited partner is a competitor or is otherwise likely to use the information to disadvantage the partnership. Any such restriction must not unreasonably restrict access to the books and records, as mandated by TBOC §152.213.

If you represent a limited partner, you may want to limit the ability of the general partner to restrict access to the books and records of the partnership if you are concerned the restriction is intended to protect the general partner more

S. Classes.

This Partnership will have only one class of partnership interest.

Comment: See TBOC §§ 154.101 and 154.102. If an FLP has only one class of partnership interest, Code §2701 will not be applicable.

T. Classification of Partners as General Partners or Limited Partners.

A Partner's interest in the Partnership is determined in accordance with this Agreement according to whether the Partner holds GP Units or LP Units. A Partner holding GP and LP Units will be treated as a General Partner with respect to the Partner's GP Units, and as a Limited Partner with respect to the Partner's LP Units.

U. Life Insurance Owned by Partnership.

If the Partnership owns any life insurance policy insuring any Partner's life or possesses any incident of ownership with respect to any policy, the insured Partner may not exercise or participate in exercising any incident of ownership with respect to the policy. The insured Partner may not borrow from the insurance company or any other person using the policy as collateral. Additionally, the insured Partner may not surrender the policy or any portion of the policy for its cash surrender value or cancel or terminate any policy. Any exercise of any incident of ownership in any policy may be exercised only by a majority of the Partners other than the insured Partner. Any decision by the Partnership to acquire or dispose of a life insurance policy insuring any Partner's life may be made by a Majority in Interest of the Partners other than the insured Partner and without any participation by the insured Partner.

V. Incorporation of Chapter 6 of TBOC.

Except to the extent in direct conflict with a provision of this Agreement as to meetings and voting, Chapter 6 of the TBOC applies to the Partnership.

Comment: This provision expressly incorporates the provisions of Chapter 6 of the TBOC, which governs meetings and voting. The provisions of the TBOC relating to meetings and voting that are found in Title I, Chapter 6, do not apply to limited partnerships unless provided in the governing documents. See TBOC §6.301. See also TBOC §§ 154.102 and 154.103 of the TBOC. These provisions may not be needed in every partnership and variations may be appropriate if they are adopted.

W. Competition.

Neither this Agreement nor the relationship created hereby will preclude or limit, in any respect, the right of any Assignee or of any Partner or any Affiliate of any Assignee or of any Partner to engage, directly or indirectly, through participation, investment, or otherwise, in any opportunity or business of any type, including those that may be the same as or similar to the Partnership or its business, those that compete with the Partnership, and those in which the Partnership has invested. No Assignee, Partner, or any Affiliate of an Assignee or a Partner will have any obligation to offer to the Partnership or any other Assignee or Partner the right to participate in any such activity. Neither the Partnership nor any Assignee, Partner, or any Affiliate of an Assignee or a Partner will have any right, by virtue of this Agreement or the relationship created by this Agreement, with respect to any such activity.

Comment:
A general partner owes a duty of loyalty to the partnership. See TBOC §152.204(a)(1). However, the partnership agreement may specify certain activities that do not violate that duty of loyalty as long as the specified activities are not "manifestly unreasonable." See TBOC §152.002(b)(2). If you represent the general partner, you may want to make clear the types of activities in which the general partner may engage without violating its duty of loyalty.

There may be instances in which the parties desire to limit the ability of some or all of the limited partners to compete with the partnership. Because TBOC §152.204 presumably binds only general, and not limited partners, it would be prudent to spell those limitations out in the partnership agreement.

VII. CAPITAL CONTRIBUTIONS

A. Initial Contributions.

Each Partner will contribute to the Partnership, as that Partner's initial Capital Contribution, cash or other property, the description and Gross Asset Value of which are set forth on Schedule A. In exchange for that portion of their respective initial contributions as constitutes at least one-tenth of one percent of the total contributions made by all the Partners, each General Partner will receive GP Units that collectively represent at least one-tenth of one percent Percentage Interest. The balance of the initial contributions will be represented by LP Units.

Comment: TBOC §153.201 states that a partner's contribution may be in the form of cash, property, services rendered, or promissory note or other obligation to pay cash or transfer property to the limited partnership. In accordance with TBOC §153.202(a), a promise made by a limited partner to make a contribution is not enforceable unless the promise is in writing and signed by the limited partner. The FLP is normally funded with real estate not protected by homestead law, oil and gas interests, marketable securities, cash, life insurance, family trust assets, collectibles and art, plant and equipment leased to family operating companies, and farm and ranch land. If family members keep collectibles or art in their homes, there must be a valid rental arrangement as the FLP must be operated as a trade or business. Be aware if the farm and ranch land is intended to qualify for Code §2032(a) special use valuation. Be careful not to disqualify the farm or ranch for special use valuation by insuring that the partner's interest at death must continue to satisfy the requirements for a closely-held business under Code §6166(b)(1). There is no counterpart to Code §2032(a) under the gift tax. When you make gifts of limited partnership interests involving farms and ranches as the FLP's primary assets, you will not get the benefit of the special use valuations. Aggressive gift programs are not used in an FLP where the FLP consists primarily of Code §2032(a) property. You may want to separate the Code §2032(a) property into one FLP and then make gifts of limited partnership assets of another FLP that has investment assets. If you have Code §2032(a) property, you may transfer it to an FLP so long as you continue to meet the closely-held business definitions in Code §6166(b)(1) and the FLP consents to the liability for the recapture tax. The FLP is normally not funded with homestead real property, IRAs, "S"-corporation stock, tangible personal property, or heavily encumbered assets or operating entities.

B. Optional Contributions.

The Partners may make additional Capital Contributions to the Partnership on a pro rata or non-pro rata basis. Optional Capital Contributions by a Limited Partner will be subject to the General Partner's consent. Optional Capital Contributions by a General Partner will be subject to the consent of 70 Percent in Interest of Limited Partners. The required consent need not be in writing. Any optional Capital Contributions will be presumed to have been made with the required consent unless there is clear and convincing evidence to the contrary. Schedule A will be amended from time to time to reflect the description and Gross Asset Value of additional Capital Contributions and corresponding GP Units, LP Units, or both.

Comment: The right to make optional capital contributions can be very important and adds greatly to an FLP's flexibility. The consent required to make optional contributions can vary widely, depending on the FLP's business objectives.

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C. Required Contributions - All Partners.

If required, in the General Partner's discretion, the Partners will be required to make additional Capital Contributions to the Partnership to meet the Partnership's operating expenses. The additional Capital Contributions must be made within 30 days from date of written notice by the General Partner. Any required Capital Contributions will be made pro rata, in accordance with the Partners' Percentage Interest unless otherwise agreed to by all Partners in writing.

Comment: TBOC §153.202(a) states that a promise by a limited partner to transfer property must be in writing to be enforceable. TBOC §153.202(d) states that a partnership agreement may provide that the partnership interest of a partner who fails to make a payment of cash or transfer property is subject to specified consequences. Pursuant to TBOC §153.203, unless otherwise provided in the partnership agreement, a partner's obligation to make a contribution or to return property distributed in violation of Chapter 153 of the TBOC or the partnership agreement may be compromised or released only by consent of all the partners. A provision requiring additional capital contributions for operating expenses is a factor that an appraiser will use in determining a partnership interest's discounted value. This type provision is normally used when the FLP's assets primarily consist of non-liquid assets. This type provision is also often used when creditor protection is a major objective of the FLP. It is not used when a substantial portion of the limited partnership interest is owned by

D. Required Contributions - General Partners.

The General Partner, or all General Partners collectively if more than one General Partner, must at all times hold GP Units that represent no less than one-tenth of one percent Percentage Interest. Accordingly, in addition to other available means by which the General Partners may each maintain a one-tenth of one percent Percentage Interest, the General Partners agree to contribute capital, from time to time, in the form of cash or other property, so that the General Partner, or all General Partners collectively if more than one General Partner, maintain a Percentage Interest of no less than one-tenth of one percent.

Comment:
Until the adoption of "check the box" regulations, it was prudent to have the general partner(s) contribute, in the aggregate, at least 1% of all capital contributions. Since the adoption of those regulations, it's not unusual to see capital contributions from the general partner of 0.1% or even 0.01%.

TBOC §153.151(c) provides that a written partnership agreement may provide that a general partner may acquire a partnership interest without making a capital contribution. In addition, TBOC §153.151(d) provides that a written partnership agreement may provide that a person may be admitted as a general partner without acquiring a partnership interest in the limited partnership.

E. Gift.

All or any part of one or more of the Limited Partners' Capital Contributions may be made by one or more of the other Partners on the Limited Partner's behalf as a gift.

F. Adjustments to Percentage Interest.

To simplify the Partnership accounting, any adjustment to the Partners' Percentage Interest caused by required or optional Capital Contributions will be made semi-annually on the June 30 or December 31 following the contribution.

Comment: The partnership agreement needs to have percentage fluctuations in the capital accounts for the partners, including a floating interest format based on contribution. But the timing of the adjustment needs to be restricted to avoid an accounting nightmare caused by floating adjustments of partnership interest, i.e., quarterly or semi-annually.

G. Failure to Contribute.

1. Partnership's Remedies if Partner Fails to Make Required Capital Contribution.

If a Partner fails to make a Capital Contribution by the time required that Partner is a "Delinquent Partner". On notice to the Delinquent Partner, the Partnership may exercise one or more of the following remedies:

- Take any action (including court proceedings) necessary to obtain payment by the Delinquent Partner of the portion of the Delinquent Partner's Capital Contribution that is in default. In addition, the Partnership may collect interest on the delinquent amount at the Default Interest Rate from the date the Capital Contribution was due until the date it is made. Any action taken will be at the Delinquent Partner's cost and expense.
- Permit the other Partners (the "Lending Partner, " whether one or more), to advance the portion of the Delinquent Partner's Capital Contribution that is in default. The Lending Partner will advance funds in proportion to their Percentage Interest or other percentages as they may agree. Advancing funds by the Lending Partner will have the following results:
    - The sum advanced constitutes a loan from the Lending Partner to the Delinquent Partner. Additionally, the sum advanced constitutes a Capital Contribution of that sum to the Partnership by the Delinquent Partner in accordance with the applicable provisions of this Agreement.
    - The principal balance of the loan and its accrued interest is due on the tenth day after written demand by the Lending Partner to the Delinquent Partner.
    - The loan amount bears interest at the Default Interest Rate from the day the advance is made until the date the loan, and accrued interest, is repaid to the Lending Partner.
    - All distributions from the Partnership that otherwise would be made to the

Delinquent Partner (whether before or after the Partnership's winding up) instead will be paid to the Lending Partner. The distributions will be paid to the Lending Partner until the loan and all accrued interest have been paid in full. The payments will be applied first to accrued interest and then to principal.

- The payment of the loan and accrued interest is secured by a security interest in the Delinquent Partner's Partnership Interest, as more fully set forth in this section.
- The Lending Partner may take any action (including court proceedings) necessary to obtain payment from the Delinquent Partner of the loan and all accrued interest. Any necessary action taken will be at the Delinquent Partner's cost and expense.

- Exercise a secured party's rights under the Texas Uniform Commercial Code.
- Exercise any other rights and remedies available at law or in equity.

2. Delinquent Partner Grants Security Interest in Partnership Interest.

Each Delinquent Partner grants to the Partnership and each Lending Partner a security interest in its Partnership Interest and its proceeds under the Texas Uniform Commercial Code. The security interest granted secures payment of all Capital Contributions the Delinquent Partner has agreed to make and all loans and accrued interest made by Lending Partners to the Delinquent Partner. On any default in the payment of a Capital Contribution or a loan or its accrued interest, the Partnership or the Lending Partner, as applicable, has all rights and remedies of a secured party under the Texas Uniform Commercial Code. Each Partner must execute and deliver to the Partnership and the Lending Partner (as applicable), upon their request, all financing statements and other instruments necessary to effectuate the preceding provisions of this Section VII.G. At the option of a Lending Partner or the General Partner, the original or a copy of this Agreement may serve as a financing statement.

Comment: TBOC §153.202(d) states that a partnership agreement may provide that the partnership interest of a partner who fails to make a required contribution is subject to specific consequences. If the FLP does not provide for required capital contributions, this provision will not be appropriate. This type provision is also considered by an appraiser in determining the discounted value of a partnership interest.

H. No Right to Demand Return of Capital Contribution.

No Partner may demand the return of all or any part of that Partner's Capital Contributions. No Partner or Assignee is entitled to the return of any part of its Capital Contributions or to be paid interest in respect of either its Capital Account or its Capital Contributions. An unreturned Capital Contribution is not a liability of the Partnership or of any Partner or Assignee. No Partner or Assignee is required to contribute or to lend any cash or property to the Partnership to enable the Partnership to return any Partner's or Assignee's Capital Contributions.

Comment: This provision has been included to prevent a partner from demanding a return of that partner's capital contribution. TBOC §153.110 provides that a limited partner may not withdraw before the FLP's term ends or the partnership agreement provides to the contrary. TBOC §153.158(a) provides that a withdrawing general partner's general partnership interest may be converted to a limited partnership interest. Article V of this agreement provides that this FLP has a perpetual term. All these factors are evidence that the FLP is intended to exist for an extended period of time and that the capital contributions made to the FLP are essential for accomplishing its purposes. This provision provides added assurance that the FLP's capital will remain in the partnership. This provision also makes the limited partnership interest illiquid. An appraiser will consider these factors in determining the discounted value of a limited partnership interest.

VIII. CAPITAL ACCOUNTS

Comment: Capital accounts arc typically used to keep track of the economics of the interest owners for both tax and other purposes. If the partnership agreement fails to otherwise specify the manner in which profits and losses are to be allocated and if there is no sharing ratio specified in the partnership's books and records required to be kept under TBOC §153.551(a), profits and losses are allocated in proportion to capital accounts. See TBOC §153.206(b)(2). Capital accounts may also be the basis on which distributions are made if the partnership agreement and partnership books and records are silent as to distri-

A. Establishing the Capital Accounts.

A "Capital Account" will be established for each Partner and will be maintained at all times throughout the Partnership's existence in a manner so as to correspond with the rules set forth in the Regulations under Code Section 704(b). The Partners' Capital Accounts may not bear interest. A Partner's Capital Account will be increased by:

- the amount of the Partner's Capital Contribution to the Partnership; and
- allocations of income or gain to the Partner for partnership book purposes in accordance with Article IX; and

reduced by:

- the amount of money distributed to the Partner by the Partnership;
- the Agreed Value of any property distributed to the Partner by the Partnership ("Agreed Value" being the Gross Asset Value of any Contributed Property or distributed property net of any liability assumed or taken subject to by the Partnership or the distributee, as the case may be);
- allocations of deduction or loss to the Partner for partnership book purposes by the Partnership in accordance with Article IX.

B. Adjusting the Capital Accounts.

The Partners' Capital Accounts and the Carrying Value of all Property will, immediately before issuance or distribution, be adjusted upward or downward to reflect any Unrealized Gain or Unrealized Loss attributable to all Property if any of the following occurs:

- if any additional Partnership Interests are to be issued in consideration for a contribution of Property or cash (other than a de minimis amount); or
- if any Property or cash (other than a de minimis amount) is to be distributed in the liquidation of the Partnership or a Partnership Interest.

The adjustment will be consistent with the provisions of Code Section 704(b) and the Regulations. The upward or downward adjustment will be as if the Unrealized Gain or Unrealized Loss had been recognized upon actual sale of the Property upon the Partnership's liquidation immediately before issuance.

C. Adjusting the Capital Account Upon the Transfer of a Partnership Interest.

If any portion of a Partnership Interest is transferred to a Permitted Transferee as a gift or deemed gift, the Partners' Capital Accounts and the Carrying Value of all Property will, immediately before the transfer, be adjusted upward or downward. The adjustment will be made to reflect any Unrealized Gain or Unrealized Loss attributable to the Property in a manner similar to that set forth in Section VIII.B of this Agreement.

D. Transferee's Capital Account.

Except as otherwise required by the Regulations under Code Section 704(b), if any interest in the Partnership is transferred in accordance with this Agreement, the transferee will succeed to the transferor's Capital Account to the extent it relates to the transferred interest.

E. No Requirement to Restore Deficit Capital Account.

No Partner will be required to restore a deficit in that Partner's Capital Account upon liquidation of the Partnership or the Partner's Partnership Interest.

Comment:
The capital account provision of this FLP has been drafted to comply with Code §704(b) and Code §704(c). Complying with these provisions alleviates the need to restore a negative capital account at the FLP's termination.

For partnerships that elect registered limited liability limited partnership status, this provision may need to be modified to provide that a partner or assignee who creates a liability for the partnership does have a duty to restore a negative capital account to the extent of such liability, at least to the extent that the partner or assignee is not entitled to be indemnified by the partnership for such liability.

F. General Partner's Capital Account.

The General Partner's General Partnership Interest will be maintained separately from any Limited Partnership Interest the General Partner may have.

Comment: TBOC §§ 153.153 and 153.154 state that a partner may be both a general partner and a limited partner. The partner will be treated differently depending on

IX. ALLOCATIONS

A. General.

Except as otherwise provided in this Article IX, for federal income-tax purposes, each item of income, gain, loss and deduction will be allocated among the Partners in the same manner as its correlative item of "book" income, gain, loss or deduction is allocated in accordance with this Article IX.

B. Profits and Losses.

1. Allocating Profits and Losses.

Profits and Losses will be allocated as follows:

a) First, Losses will be allocated to the Partners in accordance with and in proportion to the Partners' Percentage Interest but only to the extent of the Partners' Adjusted Capital Accounts.
b) Second, to the extent the allocation of Losses to a Partner create an Adjusted Capital Account Deficit for that Partner, the Losses will be allocated to the General Partner. The Adjusted Capital Account Deficit is the deficit balance, if any, in the Partner's Adjusted Capital Account.
c) Third, Profits will be allocated to the General Partner in a cumulative amount equal to the cumulative Losses allocated to the General Partner under Section IX.B.1.b) of this Agreement.
d) Fourth, Profits will be allocated to Partners in accordance with the Partners' Percentage Interests.
e) To the extent the General Partner deems it necessary to insure that the Agreement and the allocations under this Agreement meet the requirements of Code Section 704 and the Allocation Regulations, however, the following type allocations (in the following priority) will be made to the appropriate Partners in the necessary and required amounts as set forth in the Regulations under Code Section 704(b) before any other allocations under Section IX.B of this Agreement:
    - Partner nonrecourse debt minimum gain chargeback under Regulations Section 1.704-2(i).
    - Partnership minimum gain chargeback under Regulations Section 1.704-2(f). The General Partner may, however, seek a waiver of the chargeback in appropriate circumstances under Regulations Section 1.704-2(f)(4) in its sole discretion.
    - If any Partners unexpectedly receive any adjustments, allocations, or distributions described in Regulations Section 1.704-1(b)(2)(ii)(d)(4), (5), or (6), items of Partnership income and gain to the Partners in an amount and manner sufficient to eliminate the deficit balances in their Capital Accounts created by the adjustments, allocations, or distributions as quickly as possible and in a manner that complies with Regulations Section 1.704-1(b)(2)(ii)(d). Amounts Partners are

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obligated to restore under this Agreement or are treated as obligated to restore in accordance with Regulations Sections 1.704-1(b)(2)(ii)(c), 1.704-1(b)(2)(ii)(h), 1.704-2(g), or 1.704-2(i)(5) are, however, excluded from the deficit balance.

- Partner nonrecourse deductions under Regulations Section 1.704-2(i) that will in all cases be allocated to the Partner that bears economic risk of loss for the indebtedness to which the deductions are attributable.
- To the extent an adjustment to the Property's adjusted tax basis under Code Sections 734(b) or 743(b) is required to be taken into account in determining Capital Accounts under Regulations Section 1.704(b)(2)(iv)(m), the amount of the adjustment to the Capital Accounts will be treated as an item of gain (if the adjustment increases the basis of the asset) or loss (if the adjustment decreases the basis). The gain or loss will be specially allocated to the Partners in a manner consistent with the manner in which their Capital Accounts are required to be adjusted under Regulations Section 1.704-1(b)(2)(iv)(m).

2. Reallocations to Compensate for Distortions Caused by the Regulatory Allocations.

The allocations set forth in Section IX.B.1.e) of this Agreement (the "Regulatory Allocations") are intended to comply with certain requirements of Regulations Sections 1.704-1(b) and 1.704-2. The Regulatory Allocations may affect results not consistent with the manner in which the Partners intend to divide Partnership distributions. Accordingly, the General Partner may divide other allocations of Profits, Losses, and other items among the Partners to prevent the Regulatory Allocations from distorting the manner in which distributions are divided among the Partners under Article X if the distributions were made in accordance with the Partner's Percentage Interest but for application of the Regulatory Allocations. In general, the reallocation will be accomplished by specially allocating other Profits, Losses and items of income, gain, loss and deductions, to the extent they exist, among the Partners so that the net amount of the Regulatory Allocations and the special allocations to each Partner is zero. The General Partner will have discretion to accomplish this result in any reasonable manner that is consistent with Code Section 704 and the related Regulations. In accordance with Regulations Section 1.752-3(a)(3), solely for determining each Partner's proportionate share of the Partnership's "excess nonrecourse liabilities" [as defined in Regulations Section 1.752-3(a)(3)], the Partners' respective interests in Profits will be equal to their Percentage Interest.

C. Transferor - Transferee Allocations; Section 754 Election.

Income, gain, loss, deduction, or credit attributable to any interest in the Partnership that has been transferred will be allocated between the transferor and the transferee under any method allowed under Code Section 706 as agreed by the transferor and the transferee. The General Partner, at its discretion, may make the election provided under Code Section 754 and any corresponding provision of applicable state law.

Comment: A Code §754 election is a factor an appraiser will use to justify additional discounts to the value of the partnership interest. The election or non-election of Code §754 can cause significant tax consequences to occur, which in turn can impact the net dollars to be received by a partner.

D. Reliance on Advice of Accountants and Attorneys.

The General Partner will have no liability to the Limited Partners or the Partnership if the General Partner relies upon the written opinion of tax counsel or accountants retained by the Partnership with respect to all matters (including disputes) relating to computations and determinations required to be made under this Article IX or other provisions of this Agreement. After all allocations under this Article IX have been made, the General Partner, in its discretion, will reallocate income among the Partners to the least extent necessary to insure that the provisions of Code Section 704(e) and the Regulations have been fulfilled, especially Regulations Section 1.704-1(e)(3).

E. Tax Allocations; Code Section 704(c).

With regard to income, gain, loss, depreciation, depletion, and cost recovery deductions for federal income-tax purposes: In the case of a Contributed Property, the items will be allocated among the Partners in the manner provided in Section 704(c) of the Code and its Regulations to take account of the Built-in Gain and Built-in Loss at the time of contribution and, in the case of any Property the Carrying Value of which has been adjusted in accordance with Article VIII, the items will be allocated among the Partners in a manner consistent with the principles of Section 704(c) of the Code and its Regulations to take into account differences between the Gross Asset Value and the property's adjusted tax basis at the time of the adjustment. Allocations under this Section IX.E are solely for purposes of federal, state, and local taxes. They will not affect, or in any way be taken into account in computing, any Partner's Capital Account or share of Profits, Losses, or other items or distributions under any provision of this Agreement.

F. Partner Acknowledgment.

The Partners agree to be bound by the provisions of this Article IX in reporting their shares of Partnership income and loss for income-tax purposes.

Comment:
TBOC §153.206 states that the profits and losses of a limited partnership will be allocated in accordance with the written partnership agreement. If the partnership agreement doesn't otherwise provide, the profits and losses will be allocated in accordance with the then current percentage or other interest in the partnership stated in the partnership records. If there is no allocation in the partnership agreement and the records do not state the percentage, the profits and losses will be allocated in proportion to the capital accounts.

TBOC §153.208 states that sharing distributions will be in accordance with the written partnership agreement. If the partnership agreement does not so provide, distributions that are a return of capital will be made on the basis of the agreed value of the contributions made by each partner and reflected in the partnership records to the extent the contributions have not been returned. A distribution that is not a return of capital will be made in accordance with allocation of profits as determined under TBOC §153.206.

Code §704(b) states that all partners must share in all partnership tax items allocations and distributions on the basis of contributed capital contribution percentages.

X. DISTRIBUTIONS

A. General.

Subject to Article XI and other provisions of this Agreement, Distributable Cash may be distributed, at the General Partner's sole discretion, among the Partners pro rata in accordance with their Percentage Interests.

B. No Interest.

If any Partner does not withdraw the whole or part of their share of any cash distribution made in accordance with Section X.A, the Partner may not receive any interest without Unanimous Consent. Further, the non-withdrawn amount will become an Optional Capital Contribution under Section VII.B, if otherwise permitted at that time.

C. Transferor - Transferee Shares.

Unless agreed in writing by a transferor and transferee, Distributable Cash allocable to the transferred Partnership Interest that may have been transferred during any year will be distributed to the holder of the Partnership Interest who was recognized as the owner on the date the distribution was made, without regard to the results of Partnership operations during the year.

D. Partner Loans.

If any Partner advances any funds or makes any other payment to or on the Partnership's behalf, not required in this Agreement, to cover the Partnership's operating or capital expenses that cannot be paid from the Partnership's operating revenues, any advance or payment will be deemed a loan to the Partnership by the Partner. The loan will bear interest at the Default Interest Rate from the date the advance or payment was made until the loan is repaid. All Distributable Cash distributions will first be distributed to the Partners making the loans until the loans are repaid, together with interest. After the loans are repaid, the balance of the distributions, if any, will be made in accordance with Sections X.A and X.B. If distributions are insufficient to repay all loans as provided above, the funds available will first be applied to repay accrued interest on any loan. If any funds remain available, the funds will be applied in a similar manner to remaining loans in accordance with the order of the dates on which they were made, the oldest dated loans having priority. As to loans made on the same date, however, each loan will be repaid pro rata in the proportion that the loan bears to the total loans made on that date.

Comment: TBOC §154.201 states that except as otherwise provided by the partnership agreement, a partner may lend money to and transact other business with the FLP in the same manner as a person who is not a partner.

Comment:
The distributions in an FLP are left to the general partner's discretion and are usually reinvested. To get the best valuation discounts, it's best to minimize distributions. Do not put assets in the FLP the income from which will be needed by the partners for living expenses.

Control may be retained following transfer tax ownership. Tech. Advice Memo. 9131006, April 30, 1991, states that a general partner may retain investment and distribution authority over partnership assets without subjecting the limited partnership interest that the general partner has transferred to inclusion in the general partner's estate.

TBOC §153.209 states that except as otherwise provided by TBOC §153.209 and TBOC §153.210, a partner may receive distributions from the FLP before the partner's withdrawal from the FLP or the winding up of the FLP's

XI. LIMITATION ON GENERAL PARTNER'S DISCRETION TO MAKE DISTRIBUTIONS

A. Determining Distributable Cash.

With regard to Distributable Cash and Property, the General Partner will determine, in the General Partner's fiduciary capacity to the Partnership, the need for the Property to operate the Partnership business. The General Partner must keep with the Partnership Purposes and consider:

- current needs for operating capital;
- prudent reserves for future operating capital;
- current investment opportunities; and
- prudent reserves for future investment opportunities.

B. Considerations to Take Into Account When Determining Distributable Cash.

It is the General Partner's duty, in determining the amount of Distributable Cash available for paying distributions, to take into account:

- the Partnership's needs in its business and sums necessary to operate its business until the income from further operations is available;
- the amounts of its debts;
- the necessity or advisability of paying its debts,

or at least reducing them within the limits of the Partnership's credit;

- preserving its capital as represented in the Partnership's Property as a fund to protect its creditors; and
- the character of its surplus Property.

C. Needed Reserves for Partnership Purposes.

Any contributed Property or borrowed funds by the Partnership will be considered as needed for Partnership investment purposes. Any cash produced from selling Property contributed to the Partnership or from selling any Property purchased with borrowed funds, or any reinvestment of any of the Property, including the portion of the sale proceeds representing capital appreciation, will be considered as needed reserves for Partnership investment purposes. Any Distributable Cash derived from income will, to the extent deemed unnecessary for Partnership Purposes by the General Partner under the foregoing standard, be distributed in accordance with this Agreement.

Comment: This provision has been drafted to address the issues in Code §2036(a)(2) and Code §2038 as they may affect FLPs. The formula as to when to distribute cash may help with these issues. The language in this provision has been adopted from language in *United States vs. Marian A. Byrum, Executrix Under the Last Will and Testament of Milliken C. Byrum*, 408 U.S. 125, 92 S.Ct. 2382, ("Byrum"). Please note that the general partner may determine how and when to make distributions in a fiduciary capacity.

D. Distribution in Kind.

Unless otherwise approved by the General Partner and 70% in Interest of the Limited Partners, no assets will be distributed in kind, regardless of any potential unrealized depreciation or appreciation in respect thereof. Any in-kind distributions will be made proportionately among the Partners in accordance with the percentage of the distributions the Partners are entitled to receive.

Comment:
TBOC §154.203 prohibits an in-kind distribution of assets unless the partnership agreement provides otherwise. Determine what is appropriate for the particular transaction and modify as needed.

Remember that if assets are distributed in kind, the person to whom the distribution is made will lose the liability protection afforded by owning assets indirectly through the limited partnership. This could be of particular concern if, for instance, real estate assets on which there were latent or patent environmental hazards were distributed in kind. Furthermore, unless the assets that are distributed in kind are readily divisible, they will presumably be owned by the former owners of the partnership as tenants in common. Be sure you understand the consequences of that type of ownership before agreeing to any provision that permits in-kind distributions to be made to your client.

XII. RESTRICTIONS UPON PARTNERSHIP INTERESTS

The ownership and transferability of interests in the Partnership are substantially restricted. Neither record title nor beneficial ownership of any Partner's Partnership Interest may be transferred or encumbered except as otherwise set forth in this Agreement.

A. Generally.

This Partnership is formed by those who know and trust one another. They will have surrendered certain management rights (in exchange for limited liability in a Limited Partner's case), or they will have assumed management responsibility and risk (in a General Partner's case) based upon their relationship and trust. Capital is material to the Partnership's business and investment objectives and its federal tax status. An unauthorized transfer of a Partner's interest could create a substantial hardship to the Partnership, jeopardize its capital base, and adversely affect its tax structure. These restrictions upon ownership and transfer are not intended as a penalty, but as a method to protect and preserve existing relationships based upon trust and the Partnership's capital and its financial ability to continue. **Except as provided in Sections XII.B and XII.D, neither record title nor beneficial ownership of a Partnership Interest may be transferred without all Partners first consenting in writing ("Required Consent")**. In addition, no assignee of a Partnership Interest may assign any transferred interest except as provided in Article XII. To be a valid assignment, in addition to meeting Article XII's other requirements, the assignment must be in writing, the terms of which are not in contravention of any of the provisions of this Agreement. Additionally, the assignment must be received by the Partnership and recorded on the Partnership's books. Until the effective date of an assignment of a transferred interest, both the Partnership and the Partners may treat the assignor of the transferred interest as the absolute owner of the transferred interest in all respects. Upon the effective date of an assignment of transferred interests, the Partnership will not be required to recognize the interest of any transferee who has purportedly obtained a purported transferred interest as the result of a transfer or assignment that is not authorized by this Agreement and the transfer and assignment will be null and void for all purposes. If there is a doubt as to ownership of a Partnership Interest or who is entitled to Distributable Cash or liquidating proceeds or other Property, the General Partner may accumulate Distributable Cash or liquidation proceeds or other Property until the issue is resolved to the General Partner's satisfaction.

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Comment:
TBOC §153.251 states that, unless otherwise provided by the partnership agreement:

- a partnership interest is assignable in whole or in part;
- an assignment of a partnership interest does not trigger an event of winding up a limited partnership or entitle the assignee to become or exercise the rights or powers of a partner; and
- an assignment entitles an assignee to receive income, gain, loss, deduction, credit, or similar items and to receive distributions to which the assignor was entitled to the extent those items are assigned.

TBOC §153.252 states that unless otherwise provided by the partnership agreement:

- until the assignee becomes a partner, the assignor continues to be a partner and may exercise any rights or powers of a partner except to the extent those rights or powers are assigned; and
- upon the assignment by a general partner of all the general partner's rights as a general partner, the general partner's status as a general partner may be terminated by a majority vote of the limited partners.

TBOC §153.254(a) states that until the assignee becomes a partner, the assignee has no liability as a partner solely as a result of the assignment.

TBOC §153.255 states that ìRegardless of whether an assignee of a partnership interest becomes a limited partner, the assignor is not released from the assignor's liability to the limited partnership under Subchapter E and TBOC §§ 153.105, 153.112, and 153.162.î

TBOC §153.253(a) states that an assignee may become a limited partner if and to the extent the partnership agreement provides or all partners consent.

The FLP will rely primarily on state law restrictions on transferability of a limited partnership interest. Applicable state law generally states that the transferee of a limited partner becomes only an assignee with only limited rights and may not become a substitute limited partner without the consent of all or some designated percentage of the partners. Any additional restrictions on transferability or any provisions providing for the buy-sale of interest upon the occurrence of stated events should be comparable to those found among unrelated parties negotiated at arms

B. Disclosures, Limitations, and Exceptions.

The ownership and transfer or assignment of a Partnership Interest is further subject to the following disclosures, limitations, and exceptions:

1. Federal and State Law Disclosure and Limitations.

The Partnership Interests have not, nor will be, registered under federal or state securities laws. Partnership Interests may not be offered for sale, sold, pledged, or otherwise transferred unless so registered, or unless an exemption from registration exists. The availability of any exemption from registration must be established by an opinion of counsel, whose opinion must be satisfactory to the General Partner.

Comment: This provision assures that the applicable securities laws will be complied with before a partnership interest is transferred. This type provision also supports an appraiser's conclusion that the partnership interest lacks marketability.

2. Withdrawal of a General Partner In accordance with Section 153.155 of the TBOC.

Upon a General Partner's withdrawal, in accordance with Section 153.155 of the TBOC, the following will occur:

a) A deceased General Partner may transfer the deceased General Partner's GP Units by will or by a validly executed beneficiary designation to a Permitted Transferee. A Permitted Transferee who receives an assignment of GP Units from a deceased General Partner may qualify to become a General Partner by a vote of 70% in Interest.

b) The General Partner who is not deceased and commits an act of withdrawal in accordance with Section 153.155 of the TBOC or a Permitted Transferee who has received an assignment of GP Units who does not qualify to become a General Partner must sell all the GP Units of the withdrawing or deceased General Partner or the non-qualifying Permitted Transferee. Those GP Units must all be purchased by the remaining General Partners pro rata. If there are no remaining General Partners and there is a named successor General Partner, the named successor General Partner must purchase all the GP Units of the withdrawing or deceased General Partner or the non-qualifying Permitted Transferee. If there are no remaining General Partners and no named successor General Partner, the Limited Partner who has the most LP Units must purchase all the GP Units of the withdrawing or deceased General Partner or the non-qualifying Permitted Transferee. If more than one Limited Partner owns the number of LP Units that constitute the highest number of LP Units owned by a single Limited Partner, the oldest (by age) of those Limited Partners must purchase all the GP Units of the withdrawing or deceased General Partner or the non-qualifying Permitted Transferee. A Limited Partner who purchases GP Units in accordance with this subsection will automatically qualify as a General Partner.

c) The purchase price of the GP Units of a withdrawing or deceased General Partner or non-qualifying Permitted Transferee will be the fair market value of those GP Units. The fair market value will be determined by an Appraisal as of the date a General Partner dies or withdraws. The sale's closing will occur at the Partnership's principal office at 10 o'clock a.m. on the first Tuesday of the month following the month in which the Appraisal is rendered. The purchaser of the GP Units will have the option, to be exercised in writing delivered at closing, to pay its purchase money obligation in 15 equal annual installments (or the Partnership's remaining term if less than 15 years) with interest at the Default Interest Rate. The first installment of principal, with interest, will be due and payable on the first day of the calendar year following closing. Subsequent annual installments, with accrued interest, will be due and payable on the first day of each succeeding calendar year until the entire obligation is paid. The purchaser of the GP Units may prepay all or any part of the purchase money obligation at any time without penalty.

d) In no event will the GP Units ever be converted to LP Units or a General Partnership Interest be converted to a Limited Partnership Interest.

3. Death or Incapacity of a Limited Partner.

a) **Transfers by Limited Partner.** A Limited Partner who is (1) an individual or (2) a trust with an individual beneficiary who has a limited or unlimited power of appointment at the Limited Partner's death may transfer the Limited Partner's LP Units to a Permitted Transferee without Required Consent. The transfer may be accomplished:
   - in accordance with a Limited Partner's properly probated last will;
   - in accordance with the terms for a Permitted Transferee;
   - in accordance with the exercise of a limited or unlimited power of appointment or beneficiary designation of any trust; or
   - in accordance with a written and acknowledged assignment and designation of beneficiary delivered by the Partner to a General Partner before the Partner's death, effective as of the Partner's death or the beneficiary's death.

b) **Transferee Has the Status of an Assignee**. If there has been no pre-arranged transfer as provided above, the executor, administrator, guardian, conservator, or legal representative of a deceased or incapacitated Limited Partner will have an Assignee's status. In accordance with Section 153.113 of the TBOC, that person may exercise all the deceased or incapacitated Limited Partner's rights and powers to settle the Limited Partner's estate or administer the Limited Partner's property, including an Assignee's right to become a Limited Partner by obtaining Required Consent. A deceased or incapacitated Limited Partner's estate may not, however, become a substitute Limited Partner except as may be provided in this Article XII.

4. Estate-Planning Transfers

A Limited Partner who is an individual or a trust with an individual beneficiary with a limited or unlimited right to dispose of all or any part of the Limited Partner's interest in the trust during the Limited Partner's lifetime may transfer that Limited Partner's Limited Partnership Interest with or without consideration to a Permitted Transferee without Required Consent. Further, a transferee of a Limited Partnership Interest who is the donee of a gift of such interest for which the donor Partner expressly grants the right described in this sentence in the assignment document transferring such interest, shall have the right, exercisable for thirty (30) days after the date such transferee receives notice of the assignment of such interest, to redeem the Limited Partnership interest so transferred for assets of the partnership equal in value to the fair market value of such Limited Partnership interest determined as though such redemption right did not exist. If this right of redemption is granted in the assignment document transferring such interest and the donee assignee does not exercise the assignee's right of redemption within the 30-day specified time period, then at the end of the 30-day specified time period, the assignee will no longer have the right of redemption.

Comment: In response to *Hackl v. Comm'r*, 118 T.C. No. 14 (March 27, 2002) (ìHacklî), some planners have suggested giving the donees a Crummey withdrawal power with respect to gifts of limited partnership interests. Such a withdrawal right would enable the donees to withdraw the fair market value of their limited partnership interests for a limited period of time after each gift. If the donees can only withdraw the ìfair market value" of their interests, this type of provision should not have a significant impact on the amount of discount allowed in valuing the interests. This provision gives the transferor/donor the option each time he or she makes a gift to elect whether or not to allow the transferee/donee to have a Crummey withdrawal right.

5. Non-recognition of an Unauthorized Transfer.

The Partnership will not be required to recognize the interest of any Assignee or transferee who has obtained a purported Partnership Interest as the result of a transfer or assignment that is not authorized by this Agreement. If there is a doubt as to ownership of a Partnership Interest or who is entitled to Distributable Cash or liquidating proceeds, the General Partner may accumulate Distributable Cash or liquidation proceeds until the issue is resolved to the General Partner's satisfaction.

6. Acquisition of an Interest Conveyed to Another Without Authority.

a) The General Partner will have the unilateral option to acquire the interest of a transferee or Assignee of any GP Units, or any fraction of that interest if:
   - any Person acquires a Partnership Interest, or becomes an Assignee, as the result of a court order that the Partnership is required by law to recognize;
   - a Partner's interest in the Partnership is subjected to a lawful "charging order"; or
   - a Partner makes an unauthorized transfer or assignment of a Partnership Interest that the Partnership is required by law (and by a court order) to recognize.

b) The Partnership will have the unilateral option to acquire the interest of the transferee or

Assignee of any LP Units, or any fraction of that interest if:

- any Person acquires a Partnership Interest, or becomes an Assignee, as the result of a court order that the Partnership is required by law to recognize;
- a Partner's interest in the Partnership is subjected to a lawful "charging order"; or
- a Partner makes an unauthorized transfer or assignment of a Partnership Interest that the Partnership is required by law (and by a court order) to recognize.

c) Any Partnership Interest acquired under Section XII.B.6.a) or Section XII.B.6.b) above will be acquired upon the following terms and conditions:

- The Partnership or the General Partner, as the case may be, will have the option to acquire the interest by giving written notice to the transferee or Assignee that it intends to purchase the interest within 90 days from the date it is finally determined that the Partnership is required to recognize the transfer or assignment.
- The valuation date for determining the purchase price of the interest will be the first day of the month following the month in which notice is delivered.
- Unless the Partnership or the General Partner and the transferee or Assignee agree otherwise, the purchase price for the interest, or any fraction to be acquired by the Partnership or the General Partner, will be its fair market value as determined by an Appraisal.
- The sale's closing will occur at the Partnership's principal office at 10 o'clock a.m. on the first Tuesday of the month following the month in which the Appraisal is rendered.
- In order to reduce the burden upon the resources of the Partnership or the General Partner, the Partnership or the General Partner will have the option to pay its purchase money obligation in 15 equal annual installments with interest at the Default Interest Rate. If the Partnership's remaining term is less than 15 years, the obligation must be paid in the number of annual installments equal to the number of years remaining in the Partnership's term. The option to pay the purchase price in annual installments must be exercised in writing delivered at closing. The first installment of principal, with interest, will be due and payable on the first day of the calendar year following closing. Subsequent annual installments, with accrued interest, will be due and payable on the first day of each succeeding calendar year until the entire obligation is paid. The Partnership or the General Partner may prepay all or any part of the purchase money obligation at any time without penalty.
- By Required Consent, other than the Partner whose interest is to be acquired, the General Partner may assign the Partnership's option to purchase to one or more of the remaining Partners. When so assigned, any rights or obligations imposed upon the Partnership will instead become, by substitution, the rights and obligations of the Partners who are assigned the option.
- Neither the transferee nor Assignee of an unauthorized transfer or assignment or the Partner causing the transfer or assignment may vote on Partnership matters during the prescribed option period. If the option to purchase is timely exercised, they may not vote until the sale is closed.

7. Admitting Substitute Limited Partners.

a) **Requirements to Become a Substitute Limited Partner**. Any successor to a Limited Partner's Partnership Interest will be admitted to the Partnership as a substitute Limited Partner only upon doing both the following:

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- Furnishing to the General Partners:
  - a written acceptance in a form satisfactory to the General Partners of all this Agreement's terms and conditions; and
  - other documents and instruments as may be required to effect the successor's admission as a Limited Partner.
- Obtaining the Required Consent, which may be withheld or granted in the sole discretion of those constituting the Required Consent.

b) **Effective Date of Transfer**. A transferee will be admitted to the Partnership as a substitute Limited Partner as of the effective transfer date.

> **Comment:**
> Absent a provision in the partnership agreement concerning substitution of partners, unanimity of partners is required to authorize a substitution. See TBOC §153.253(a).
>
> Be sure to remember that an assignment does not, by itself, cause a substitution. A substitution must be addressed as a matter separate and apart from a mere assignment. Failure to handle this issue properly can result in the "wrong" people being partners.

C. Partnership Interest Pledge or Encumbrance.

Except as otherwise provided in this Agreement, no Partner may grant a security interest in or otherwise pledge, hypothecate, or encumber an interest in this Partnership or the Partner's distributions without Required Consent. It is understood that the Partners are under no obligation to give consent nor are they subject to liability for withholding consent.

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Comment:
The FLP needs to have transferability limitation. The TPL's default language should be sufficient. Do not over complicate with buy-sale provisions that may subject you to Code §2703. Code §2703 was adopted to prevent the arbitrary setting of values based upon buy-sale agreements or options. These arbitrary values are disregarded. As long as you rely on the TPL's transfer restrictions, you do not have Code §2703 problems. The substantial valuation discounts may be achieved without including any provisions that may be caught by Code §2703.

Creditors of a partner but not the partnership have an exclusive remedy of a charging order. See TBOC §153.256. A partner's creditor cannot generally reach partnership assets. A partner only owns a partnership interest and does not have any particular interest in any partnership property. See TBOC §154.001. A partner's creditor may not gain ownership of the partnership interest unless a security interest has been perfected under the Uniform Commercial Code. A creditor with a charging order does not become a substitute partner and does not have voting or other management rights or rights to cause the partner to withdraw, to liquidate the partnership, or to cause a distribution. A charging order only gives the creditor an income interest in the partnership interest. The holder of the charging order does not become a substitute limited partner and has only an assignee's status. It is important that valid estate planning, asset protection, and business

D. Right of First Refusal

1. Bona Fide Offer

If a Limited Partner receives a bona fide offer for the purchase of all or a part of its Limited Partnership Interest by a person who is not already a Partner, the Partner will give the General Partner written notice of all the details of the offer. The notice must include the name of the offeror; the percentage of interest in the Partnership covered by the offer; terms of payment, whether for cash or credit, and if on credit, the term and interest rate, as well as any and all other consideration being received or paid in connection with the proposed transaction; and any and all other terms, conditions, and details of the offer.

2. Option to Purchase.

The General Partner will have the initial exclusive right and option to purchase the Partnership Interest for itself or for the Partnership, at its election, at the same price and terms as the offer set out in the notice. The General Partner may exercise this right within 30 days after receipt of the notice. The General Partner may exercise the option by giving written notice to the Partner desiring to sell the interest. The sale and purchase will be closed within 90 days of the receipt of the notice. If more than one General Partner wishes to purchase the interest, each General Partner may purchase an equal fraction of the interest. A General Partner who does not elect to exercise this option will promptly notify the Partner wishing to sell the interest. If no General Partner exercises this option for itself or for the Partnership, the General Partner will notify the Limited Partners of the offer within 30 days of the date the General Partner received the notice by providing them a copy of the notice provided to the General Partner. The Limited Partners will have the secondary exclusive right and option to purchase the Partnership Interest at the same price and terms as the offer set out in the notice to the General Partner. The Limited Partners must exercise this right within 30 days after receipt of the notice from the General Partner. Any Limited Partner may exercise the option by giving written notice to the Partner desiring to sell the interest. The sale and purchase will be closed within 60 days of the purchasing Limited Partner's receipt of the notice. If more than one Limited Partner wishes to purchase the interest, each Limited Partner may purchase an equal fraction of the interest. A Limited Partner who does not elect to exercise this option will promptly notify the Partner wishing to sell the interest and the other Limited Partners. If none of the Partners exercise this option, the Partner selling the Partnership Interest may during the following 60 days sell the interest on the same terms as provided in the notice to the General Partner free of the restrictions imposed by this Agreement. However, the purchase price may not be less than and the terms of purchase for the offered Partnership Interest may not be more favorable than the purchase price and the terms of purchase that would have been applicable to the other Partners or Partnership had they purchased the same. Further, prior to the transfer, the purchaser and the Partnership's General Partner must have agreed to be bound by the terms of this Agreement. Further, any offered Partnership Interest not so disposed of within the 60-day period will thereafter again become subject to the terms of this Section. Neither the General Partners, nor any other Partner, nor the Partnership is required to determine the tax consequences to a Partner or an assignee of a partnership interest arising from the assignment of a partnership interest. The Partnership will continue with the same basis and capital amount for the assignee as was attributable to the assignor.

3. Applicability of Federal Law Disclosures and Limitation.

If a bona fide offer to purchase a Limited Partnership Interest is received by a Limited Partner, that offer must comply with the provisions of Section XII.B.1 of this Agreement.

4. Unauthorized Transfer.

If a Partner attempts to transfer Partnership Interest without complying with the provisions of this Section XII.D, then the transfer will be an unauthorized transfer, and the provisions of XII.B will apply.

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Comment: After the *Hackl* case, it is important to make clear that general partners are subject to fiduciary duties with respect to distributions and to give donees a right to sell their interests subject to a right of first refusal. Some planners even give donees the right to sell interests that could become ìfull-fledgedî substitute limited partners, subject only to a right of first refusal to build the best possible argument for the annual exclusion. (As a practical matter, the donee will probably have difficulty selling the interest in any event.) However, the *Hackl* court intimated that permitting the donees to sell their interests, alone, does not assure annual exclusion treatment because the extreme lack of marketability of interests may raise questions about whether the right is by itself sufficient to produce a present interest.

XIII. TAXES, ACCOUNTING, BOOKS, AND RECORDS

A. Fiscal Year; Accounting Records.

The Partnership's fiscal period will be the calendar year. The Partnership's accounting records will be kept on the cash receipts and disbursements method of accounting or in accordance with generally accepted accounting principles, at the General Partner's discretion. All books, records, accounts, papers, and memoranda in any manner relating to the Partnership (including those records required by the TPL) will be kept at the Partnership's principal office. Subject to the provisions of Section VI.R of this Agreement, each Partner at all reasonable times during regular office hours will have access to the records to inspect and copy them, at the Partner's expense (unless otherwise required by the TPL).

B. Financial Statements and Reports.

1. Reports to Be Delivered.

The General Partners will cause to be delivered to each Partner the following:

a) Within 90 days after each fiscal year end, an unaudited balance sheet and operations statement, Partners' equity, and changes in financial position, which must be prepared in accordance with the accounting method as provided in Section XIII.A above; and

b) Within 90 days after each fiscal year end:
   - U.S. federal income-tax Form K-1 and any similar forms required by any state or local taxing authority; and
   - any other information concerning the Partnership reasonably necessary to prepare the Partners' federal and state income-tax returns.

2. Extending Time to Deliver Reports.

The General Partner, upon showing good cause, may have a reasonable extension of the 90-day period applicable to the items described in Section XIII.B. "Good cause" will be determined without regard to the foreseeability of the cause. All financial statements and reports will be prepared at the Partnership's expense.

C. Tax-Matters Partner; Tax Elections.

The General Partner will be the initial "Tax-Matters Partner" for federal income-tax purposes. If there are multiple General Partners, a General Partner appointed by majority vote of the General Partners will be the Tax-Matters Partner. If there is no General Partner appointed, the General Partner with the largest combined General and Limited Partnership Interest will be the Tax-Matters Partner. Any successor Tax-Matters Partner will be a General Partner. Unless otherwise agreed to by a Majority in Interest, the Partnership will make the elections and adopt accounting methods and procedures for federal and state income-tax purposes as the Tax-Matters Partner deems to be in the Partnership's best interest.

D. Bank Accounts.

The General Partner will establish and maintain in the name of the Partnership one or more accounts at one or more banks. All Partnership funds will be deposited into such account or accounts. No other funds will be deposited into any such account. Funds deposited in any such account may be withdrawn only to pay Partnership debts or obligations, to make distributions to the Partners pursuant to this Agreement, or to make investments as the General Partner determines.

XIV. POWER OF ATTORNEY

A. Appointing an Agent.

Each Limited Partner, and any Assignee or transferee of the Limited Partner's interest in the Partnership, irrevocably constitutes and appoints the General Partner as their true and lawful attorney-in-fact and agent. The agent may execute, acknowledge, swear to, deliver, record, and file, in the Partner's, assignee's, or transferee's name, place, and stead, all instruments, documents and certificates that may from time to time be required by law to:

- effectuate, implement, and continue the Partnership's valid existence as organized and operated in accordance with this Agreement, including all certificates and other instruments (including counterparts of this Agreement and amendments) that the General Partners deem appropriate to reflect any amendment, change, or modification of the Partnership in accordance with this Agreement;
- reflect the Partnership's winding up in accordance with this Agreement, , including filing the certificate of termination required by the TPL with the Texas Secretary of State; and
- comply with the fictitious or assumed name statutes in effect in Texas and all other jurisdictions in which the Partnership conducts or plans to conduct business.

B. Limitations on Agent's Authority.

The agent and attorney-in-fact may not, however, amend, extend the term, or modify this Agreement when acting in an agent's capacity. The power of attorney granted in this Agreement:

- will be deemed to be coupled with an interest;
- will be irrevocable;
- will survive the death, winding up, incapacitation, or any Partner's legal disability and will extend to the Partners' heirs, executors, successors, and assigns; and

- may be exercised by the agent and attorney-in-fact for all (or any one) of them or in other manner, including by facsimile signature, as the agent and attorney-in-fact may deem appropriate.

C. General Partners' Powers Not Enlarged.

Nothing in this article, however, enlarges the powers granted to the General Partners in accordance with the other terms of this Agreement.

XV. EVENTS OF WINDING UP

A. Events of Winding Up.

Any one of the following events works an immediate winding up of the Partnership:

1. an event of withdrawal of a General Partner described in Section 153.155 of the TBOC;
2. by Unanimous Consent;
3. the entry of a judicial decree of winding up under Subchapter G of Chapter 11 of the TBOC;
4. the expiration of the Partnership's term as stated in Article V; or
5. any other event causing the Partnership to be wound up under the TPL.

Comment:
Unless the certificate of formation or the partnership agreement specifies a fixed date as an event requiring a winding up, the partnership may continue in perpetuity. See TBOC §3.003.

TBOC §11.051(2), which applies to all domestic entities and not just to Limited partnerships, states that one event that requires a winding up is a voluntary decision to wind up the partnership. TBOC §11.058, which relates only to limited partnerships, states that a voluntary decision to wind up a a domestic limited partnership requires the written consent of all partners in the limited partnership unless otherwise provided by the partnership agreement, but the voluntary decision to wind up may be revoked in accordance with TBOC §§11.151 and 153.501(d). TBOC §11.058 also contains additional events that require a winding up and how the event requiring a winding up may be cancelled.

TBOC §11.058(b), which relates only to limited partnerships. also provides that an event of withdrawal with respect to a general partner is an event requiring a winding up. Although it is not technically necessary to list an event of withdrawal with respect to a general partner as an event requiring winding up in the partnership agreement, it may be prudent to do so in order to put the partners on

Under the TBOC, the same event could be classified as several different types of events requiring a winding up. For instance, if the partnership agreement includes a specific date, that could conceivably be an event requiring a winding up under TBOC §11.051(1) ("the expiration of the domestic entity's period of duration"), TBOC §11.051(3) ("an event specified in the governing documents…other than an event specified in another subdivision of TBOC §11.051"), and TBOC §11.058(a) ("written consent of all partners to the winding up"). Similarly, if the partnership agreement specifies that the general partner's event of withdrawal is an event requiring winding up, that could be an event requiring a winding up under TBOC §11.051(3) ("an event specified in the governing documents"), TBOC §11.051(4) ("an event specified in this code"), TBOC §11.058(a) ("written consent of all partners to the winding up"), and TBOC §11.058(b) ("an event of withdrawal of a general partner…unless otherwise provided by the partnership agreement"). The TBOC provides that certain events requiring a winding up may be revoked while others may be cancelled. The procedures to accomplish the revocation differ from those required to cancel the event. See TBOC §§11.151, 11.152, and 153.501. Therefore, it is important to be certain of the category into which each event requiring a winding up falls. The parenthetical provision in each of the clauses above is intended to provide that certainty. Consider whether it would benefit your client to provide for a different classification.

B. A Partner's Winding Up or Bankruptcy.

Upon a Partner's winding up or bankruptcy, the Partner and the Partner's successors will from that time have an Assignee's status and will receive distributions to which the Partner is entitled. For purposes of this Agreement, a Partner's "bankruptcy" will be deemed to have occurred upon the happening of any event described in Subsections (4) and (5) of Section 153.155(a) of the TBOC.

C. Withdrawals; Reconstitution.

A technical winding up may occur in accordance with Subsections XV.A.1 and XV.A.5, of this Agreement, but if there is a remaining General Partner, the Partnership is permitted to be reconstituted and continued in accordance with Sections 11.151, 11.152 153.501(a), and 153.501(b) of the TBOC.

1. General Partner May Not Withdraw.

A General Partner may have the power but not the right to withdraw at any time from the Partnership and cease to be a General Partner under the provisions of Section 153.155(b) of the TBOC by giving written notice to the other Partners. Any General Partner who withdraws or ceases to be a General Partner in accordance with Section 153.155(a) of the TBOC before the Partnership's stated term expires violates this Agreement. The Partnership may recover damages from the withdrawing General Partner for breaching this Agreement. The recoverable damages include the reasonable cost of replacing the services the withdrawn Partner was obligated to perform. The Partnership may, in addition to pursuing any remedies otherwise available under applicable law, effect that recovery by offsetting those damages against the amount otherwise distributable to the withdrawing General Partner. The withdrawing General Partner's GP Units may not be converted to LP Units. Upon withdrawal, the GP Units held by the General Partner seeking to withdraw and classified as GP Units must be sold by the withdrawing General Partner and purchased in accordance with Section XII.B.2 of this Agreement.

Comment: If a general partner violates a restriction on its right to withdraw, it may be liable to the partnership for any damages suffered as a result of the wrongful withdrawal. Therefore. it is important to address the consequences of a withdrawal, which are the subject of TBOC §153.158 - 153.162.

2. **Successor General Partner.**

If there are multiple General Partners and one or more General Partner withdraws or ceases to serve for any reason and there is at least one remaining General Partner, the Partnership's business may be continued by the remaining General Partners without amending this Agreement. If a General Partner, serving alone, withdraws or ceases to serve for any reason, then, without amending this Agreement, in the priority and in succession, the following persons will serve as successor General Partners: **Thomas Baird and Cindy Baird** ("Designated Successor General Partners"). The Partnership's business may then continue. Before all multiple General Partners or a sole General Partner serving without a Designated Successor General Partner withdraw, additional General Partners or Designated Successor General Partners may be appointed by **Unanimous Consent**. If a General Partner, serving alone, withdraws or ceases to serve for any reason and there are no Designated Successor General Partners remaining, then without amending this Agreement, all the remaining Partners may continue the Partnership's business and appoint one or more new General Partners effective as of the date the withdrawing General Partner's withdraws. Any Designated Successor General Partner will not have a general partner's duties or liability until the time the successor actually assumes the position as General Partner. A General Partner who ceases to be a General Partner will not be personally liable for the Partnership's debts and obligations incurred following the termination of service as a General Partner. Each newly appointed General Partner will purchase any withdrawing General Partner's GP Units, pro rata, in accordance with Article XII.B.2. Each General Partner must at all times hold GP Units that represent no less than a one-tenth of one percent Percentage Interest in accordance with Article VII of this Agreement.

Comment:
This provision requires a new general partner to be in place before the old general partner is removed. By doing so, the new general partner is in a position to continue the business of the partnership under TBOC §153.501(b) and Section XV.C of this Agreement. If no general partner remained, the continuation of the business would require the approval of all of the limited partners or such lesser percentage as is specified within the partnership agreement. See TBOC §153.501(b)(2).

One of the most critical elements of an FLP for valuation purposes is when is it wound up and when does it liquidate? It is important that the FLP be reconstituted and continue if there is a technical winding up and termination. The TPL's default provisions provide the mechanism to accomplish the favorable valuation discounts. Remember that the FLP always needs multiple general partners or successor general partners at all times.

If a partnership agreement provides that the FLP be wound up when the general partner dies, the IRS may argue that everyone gets their full pro rata share of the liquidation value. When an asset is valued, the primary emphasis on valuing the asset is what will happen in the future. The TPL provides a mechanism for the FLP to be continued even if there is an event that would otherwise trigger a winding up. The expectancy is that the partnership will be reconstituted and continued because it is the other partners' right to do so under the TPL. This is supported by the partnership purposes and the nature of the FLP's term. If a prospective buyer thinks the remaining partners will continue the FLP in accordance with the TPL, the estate may not withdraw from the FLP. The estate is locked into the FLP until the end of its term.

TBOC §11.058(b) provides that an event of withdrawal with respect to a general partner is an event requiring a winding up. Those events may be revoked under TBOC §153.501(b). If, in addition, an event of withdrawal with respect to a general partner is listed in the partnership agreement as an event requiring a winding up and the partnership agreement does not specify otherwise, the same event could be an event requiring a winding up under TBOC §11.051(3), which requires a cancellation under TBOC §153.501(a). Under TBOC §153.501(a), cancellation is supposed to be done within 90 days after the occurrence of the event, while TBOC §153.501(b) permits revocation to occur at any time within one year after the occurrence of the event requiring a winding up. Also, the cancellation under TBOC §153.501(a) is permitted only with the written agreement of all or some other group of partners, while TBOC §153.501(b) permits the remaining general partner to effect the revocation without any written agreement.

Note that the one year period is required by TBOC §153.501(b) while the corresponding provision of the Texas Revised Limited Partnership Act only permitted 90

XVI. WINDING UP OF AFFAIRS, DISTRIBUTION OF ASSETS

A. Liquidating Agent.

1. Liquidation Upon an Event Requiring Winding Up of the Partnership.

If the Partnership is wound up under Sections XV.A.2 or XV.A.3, or if the General Partners have withdrawn and no successors have been chosen in accordance with Section XV.C and the withdrawal event is not cancelled or revoked in accordance with TBOC §153.501(a) or TBOC §153.501(b), a Liquidating Agent must be appointed to commence to wind up the Partnership's affairs and to sell and/or distribute the Partnership's assets. The Partners will continue to share operating Profits and Losses and other items of income, gain, loss, and deduction during the winding up. The Liquidating Agent will proceed, as promptly as practicable without undue sacrifice, to sell and/or distribute all the Partnership's remaining properties. The Liquidating Agent shall have sole discretion to determine whether to liquidate all or any portion of the Partnership's assets and property and the consideration to be received for that property. The Liquidating Agent will use the Liquidating Agent's best judgment to obtain the best price for the Partnership's assets. If appropriate, the Liquidating Agent, in the Liquidating Agent's discretion may, distribute Property to the creditors or Partners in kind in accordance with their Percentage Interest. The Liquidating Agent may be required by the Partners (at the Partnership's expense) to give a bond to assure that the Liquidating Agent faithfully performs the Liquidating Agent's duties. The Liquidating Agent may receive compensation for services as will be agreed upon, payable from the Partnership's assets. The Liquidating Agent may resign at any time by giving 30 days' written notice to the Partners. The Liquidating Agent may be removed at any time by written notice of removal by Unanimous Consent. Upon the Liquidating Agent's death, winding up, removal, or resignation, a successor Liquidating Agent will, within 30 days, be appointed in the same manner as the original Liquidating Agent. The successor Liquidating Agent will have and succeed to all the original Liquidating Agent's rights, powers, and duties. The right to appoint a successor Liquidating Agent will be recurring and continuing for so long as the Liquidating Agent's functions and services are authorized to continue.

Comment: As noted above, it is important to understand the difference between the occurrence of an event requiring a winding up and termination. The partnership needs to continue in existence following the occurrence of an event requiring a winding up in order to complete the liquidation and winding up of the partnership's affairs. If the partnership continues only until the occurrence of an event requiring a winding up, the occurrence of the event and termination must by definition, occur at the same time, which is not practical and creates a question as to what the terminated partnership is during the winding-up phase.

2. Appointing a Liquidating Agent.

If, within 30 days following an event requiring the winding up of the Partnership, no person has agreed to serve as the Liquidating Agent or if, within 30 days after the need for a successor Liquidating Agent arises, no successor has been appointed and accepted appointment as the successor Liquidating Agent, any interested Partner may make application to a State or Federal District Judge to appoint a Liquidating Agent. If any State or Federal District Judge is unwilling, the Local Administrative Judge for the county in which the Partnership's principal office is located may appoint a Liquidating Agent. The Judge, acting in a judicial capacity, will be fully authorized to appoint the Liquidating Agent.

B. The Liquidating Agent's Powers.

Subject to Section XVI.A, the Liquidating Agent will have the powers of the General Partner to the extent necessary to carry out the Liquidating Agent's duties and functions, including the following powers:

- The power to continue to manage any Partnership business during the winding up, including the power to enter into contracts that may extend beyond the winding up and the filing of the certificate of termination with the Secretary of State.
- The power to execute deeds, bills of sale, assignments, and transfers to convey Partnership Property to third parties or to the respective Partners incident to finally distributing the remaining Property (if any). The Liquidating Agent may not, however, impose personal liability upon any Partner or their legal representatives or successors in interest under any warranty of title contained in any instrument.
- The power to borrow funds, in the Liquidating Agent's best judgment, reasonably required to pay any Partnership obligations, and to execute security documents encumbering Property as security for the Partnership's indebtedness. The Liquidating Agent may not, however, create any personal obligation for any Partner or any Partner's successors in interest to repay indebtedness other than from available proceeds from foreclosure or sales of the Property as to which a lien is granted.
- The power to settle, compromise, or adjust any claim asserted to be owing by or to the Partnership, and the right to file, prosecute, or defend lawsuits and legal proceedings in connection with any matters.

C. Liquidating Distributions.

1. Distribution During Winding Up.

The net liquidation sales proceeds, unliquidated Property, and all other Partnership funds will be distributed in the following order:

- to pay all the Partnership's liabilities, other than those to any Partner, including winding up expenses;
- to set up any reserves that the Liquidating Agent may deem reasonably necessary for any contingent or unforeseen liabilities or obligations of the Partnership;

- to pay and discharge any Partnership liabilities to any Partner; and
- after all allocations of income, gains, losses, and deductions in accordance with Article IX, to the Partners to pay the positive balances in their Capital Accounts.

2. Liability for Indebtedness Secured by Assets Distributed in Kind.

If the Partnership makes distributions in kind of Property that secures indebtedness, each Partner receiving the distribution of Property subject to the indebtedness will be severally liable. They will be liable for a share of the indebtedness proportionate to the share of the Property distributed to each Partner. The several liability will be among each Partner but not for the benefit of others. No Partner will, however, be deemed to have assumed any liability on any indebtedness secured by Property distributed to any Partner for which the Partner is not liable under the terms of the instrument creating the indebtedness. Additionally, each Partner's liability to other Partners for indebtedness secured by Property distributed to the Partner will be limited to the value of the Partner's interest in the Property. Indebtedness secured by Property distributed to Partners in kind need not be discharged from the Partnership's liquidation proceeds.

3. No Obligation to Replenish Negative Capital Accounts.

Except as required by nonwaivable provisions of the TPL, no Partner will have any obligation at any time to contribute any funds to replenish any negative balance in its Capital Account.

D. Compliance With Timing Requirements of Treasury Regulation.

If the Partnership is "liquidated" within the meaning of Regulations Section 1.704-1(b)(2)(ii)(g), distributions will be made under this Article XVI to the Partners as provided in Section XVI.C in compliance with Regulations Section 1.704-1(b)(2)(ii)(b)(2).

E. Final Accounting.

Within a reasonable time after the date of the event requiring the Partnership to wind up, the Liquidating Agent must supply to each Partner a statement prepared by the Partnership's accountant that will set forth:

- the Partnership's assets and liabilities as of the date of the event requiring the Partnership to wind up;
- each Partner's portion of distributions in accordance with the winding up process; and
- the amount, if any, retained as reserves in accordance with Section XVI.C.

F. Partnership Termination.

Upon compliance with the distribution plan described in this Article XVI, the Partnership shall cease to exist as a partnership, and the Liquidating Agent shall execute, acknowledge, and cause to be filed a certificate of termination evidencing termination of the Partnership.

G. Rights of Lender.

The rights and powers granted to the Partners and the Liquidating Agent are subject to the rights and powers of the holder of first mortgage liens (if any) against any part of the Property owned by the Partnership.

XVII. ALTERNATIVE DISPUTE RESOLUTION ("ADR"); BINDING ARBITRATION

A. Agreement to Use Procedure.

The Partners have entered into this Agreement in good faith and in the belief that it is mutually advantageous to them. It is with that same spirit of cooperation that they pledge to attempt to resolve any dispute amicably without the necessity of litigation. Accordingly, they agree if any dispute arises between them relating to this Agreement (the "Dispute"), they will first utilize the procedures specified in this Article XVII (the "Procedure") before any Additional Proceedings.

B. Initiation of Procedure.

The Partner seeking to initiate the Procedure (the "Initiating Partner") will give written notice to the other Partners. The notice must describe in general terms the nature of the Dispute and the Initiating Partner's claim for relief. Additionally, the notice must identify one or more individuals with authority to settle the Dispute on the Partner's behalf. The Partners receiving the notice (the "Responding Partner", whether one or more) will have five business days within which to designate by written notice to the Initiating Partner, one or more individuals with authority to settle the Dispute on the Partner's behalf. The individuals so designated will be known as the "Authorized Individuals". The Responding Partner may authorize himself or herself as an Authorized Individual. The Initiating Partner and the Responding Partner will collectively be referred to as the "Disputing Partners" or individually "Disputing Partner".

C. Direct Negotiations.

The Authorized Individuals may investigate the Dispute as they deem appropriate. But they agree to promptly, and in no event later than 30 days from the date of the Initiating Partner's written notice, meet to discuss the Dispute's resolution. The Authorized Individuals will meet at the times and places and with the frequency as they may agree. If the Dispute has not been resolved within 30 days from their initial meeting date, the Disputing Partners will cease direct negotiations and will submit the Dispute to mediation in accordance with the following procedure.

D. Mediator Selection.

The Authorized Individuals will have five business days from the date they cease direct negotiations to submit to each other a written list of acceptable qualified attorney-mediators not affiliated with any Partner. Within five days from the date the list is received, the Authorized Individuals will rank the mediators in numerical order of preference and exchange the rankings. If one or more names are on both lists, the highest ranking person will be designated as the mediator. If no mediator has been selected under this procedure, the Disputing Partners agree jointly to request a State or Federal District Judge of their choosing to supply within ten business days a list of potential qualified attorney-mediators. If they cannot agree upon a State or Federal Judge, the Local Administrative Judge for the county in which the Partnership's principal office is located may supply the list. Within five business days from the date the list is received, the Authorized Individuals will again rank the proposed mediators in numerical order of preference and will simultaneously exchange the list and will select as the mediator the individual receiving the highest combined ranking. If the mediator is not available to serve, they will proceed to contact the mediator who was next highest in ranking until they are able to select a mediator.

E. Mediation Time and Place.

In consultation with the mediator selected, the Authorized Individuals will promptly designate a mutually convenient time and place for the mediation. Unless circumstances require otherwise, the time for mediation may not be later than 45 days after selecting the mediator.

F. Information Exchange.

If any Disputing Partner to this Agreement has substantial need for information in another Disputing Partner's possession in order to prepare for the mediation, all Disputing Partners will attempt in good faith to agree to procedures to expeditiously exchange the information, with the mediator's help if required.

G. Summary of Views.

At least seven days before the first scheduled mediation session, each Disputing Partner will deliver to the mediator and to the other Disputing Partners a concise written summary of its views on the matter in Dispute and the other matters required by the mediator. The mediator may also request that a confidential issue paper be submitted by each Disputing Partner to him or her.

H. Parties to be Represented.

In the mediation, each Disputing Partner will be represented by an Authorized Individual and may be represented by counsel. In addition, each Disputing Partner may, with the mediator's permission, bring the additional Persons as needed to respond to questions, contribute information, and participate in the negotiations.

I. Conduct of Mediation.

1. Mediation Format.

The mediator will determine the format for the meetings. The format must be designed to assure that:

- both the mediator and the Authorized Individuals have an opportunity to hear an oral presentation of each Disputing Partner's views on the matter in dispute; and
- the authorized parties attempt to negotiate to resolve the matter in dispute, with or without the assistance of counsel or others, but with the mediator's assistance.

2. Commitment to Participate in Mediation in Good Faith.

To this end, the mediator is authorized to conduct both joint meetings and separate private caucuses with the Disputing Partners. The mediation session will be private. The mediator will keep confidential all information learned in private caucus with any Disputing Partner unless specifically authorized by the Disputing Partner to disclose the information to the other Disputing Partner. The Disputing Partners agree to sign a document agreeing that the mediator will be governed by Chapter 154 of the Texas Civil Practice and Remedies Code and the other rules as the mediator will prescribe. The Disputing Partners commit to participate in the proceedings in good faith with the intention of resolving the Dispute if at all possible.

J. Termination of Procedure.

1. Procedure to Terminate Mediation.

The Disputing Partners agree to participate in the mediation procedure to its conclusion. The mediation will be terminated by:

- executing a settlement agreement by the Disputing Partners;
- declaring to the mediator that the mediation is terminated; or
- a Disputing Partner declaring in writing that the mediation process is terminated when one full day's mediation session is concluded.

2. If Dispute is Not Resolved.

Even if the mediation is terminated without the Dispute's resolution, the Disputing Partners agree not to terminate negotiations and not to commence any Additional Proceedings before five days following the mediation expire. Any Disputing Partner may, however, commence Additional Proceedings within the five-day period if the Dispute could be barred by an applicable statute of limitations.

K. Arbitration.

The parties agree to participate in good faith in the ADR to its conclusion. If the Disputing Partners are not successful in resolving the dispute through the ADR, then the Disputing Partners agree that the dispute will be settled by arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and judgment upon the award rendered by the arbitrators may be entered in any court having jurisdiction ("Additional Proceedings").

L. Mediation Fees; Disqualification.

The mediator's fees and expenses will be shared equally by the Disputing Partners. The mediator will be disqualified as a witness, consultant, expert, or counsel for any Disputing Partner with respect to the Dispute and any related matters.

M. Confidentiality.

Mediation is a compromise negotiation for purposes of

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Federal and State Rules of Evidence and constitutes privileged communication under Texas law. The entire mediation process is confidential, and no stenographic, visual, or audio record will be made. All conduct, statements, promises, offers, views, and opinions, whether oral or written, made in the mediation's course by any Disputing Partner, their agents, employees, representatives or other invitees and by the mediator are confidential and will, in addition and where appropriate, be deemed privileged. The conduct, statements, promises, offers, views, and opinions will not be discoverable or admissible for any purpose, including impeachment, in any litigation or other proceeding involving the parties. It will not be disclosed to anyone not any Partner's agent, employee, expert, witness, or representative. Evidence otherwise discoverable or admissible is not, however, excluded from discovery or admission as a result of its use in the mediation.

N. Waiver of Exemplary or Punitive Damages.

To the maximum extent permitted by law, except for fraud or gross negligence, each of the Partners knowingly, voluntarily, and intentionally waives any right to consequential exemplary or punitive damages with respect to any Dispute, regardless of the forum for the proceedings.

> **Comment:** A mediation and binding arbitration provision has been included to support the business purposes stated in Article IV of this agreement. This provision helps legitimize the business, non-tax reasons for its existence. In addition, it is an extremely useful provision to have if disputes arise. It is almost a foregone conclusion that an FLP that lasts 50 years or more and encompasses three or four generations of a family will have some disputes arise among the family members. An initial mediation requirement before requiring arbitration is cost effective in many cases. Often, if the parties can be forced to sit down all at one time in an informal manner, their disputes may be settled without the requirement of any additional legal actions.

XVIII. MISCELLANEOUS

A. Notices.

All notices required or permitted to be given pursuant to this Agreement will be in writing.

1. Notice to the Partnership.

If the notice is to the Partnership, it may be delivered in one of the following ways:

- electronically transmitted by facsimile to the fax number published for the Partnership;
- emailed to the email address for the General Partner as reflected on the Partnership records; or
- personally delivered, mailed, first class postage prepaid, or delivered by a nationally recognized express courier service, charges prepaid, to the address of the Partnership's registered office (as reflected on the records of the Secretary of State of the State of Texas).

2. Notice to a Partner.

If the notice is to a Partner, it may be delivered in one of the following ways:

- electronically transmitted by facsimile to the Partner's fax number as reflected in the Partnership records;
- emailed to the Partner's email address as reflected in the Partnership records; or
- to the appropriate address set forth on Exhibit A to this Agreement and as shown on the records of the Partnership.

3. Notice to an Assignee.

If the notice is to an Assignee, it may be delivered in one of the following ways:

- electronically transmitted by facsimile to the Assignee's fax number as reflected in the Partnership records;
- emailed to the Assignee's email address as reflected in the Partnership records; or
- to the Assignee's address shown on the records of the Partnership.

4. When Notice is Deemed Delivered.

Any such notice, when sent in accordance with the above provisions, will be deemed to have been given and received (a) on the day faxed, emailed, or personally delivered, (b) on the third day following the date mailed, or (c) twenty-four hours after shipment by such courier service.

5. Consent.

Each party to this Agreement consents to receiving notice by email or facsimile by the signing of this Agreement.

6. Change of Address.

A Partner or Assignee may change its address by giving notice in writing to the General Partner in the manner set forth in XVIII.A.1 above, stating the new address.

> **Comment:** The requirement to use certified or registered mail, which is frequently seen in notice provisions, is often cumbersome and unnecessary. Consider whether notice by electronic mail is appropriate.

B. Construction.

Whenever the context so requires, the gender of all words used in this Agreement includes the masculine, feminine, and neuter, the singular includes the plural, and conversely. All references to articles, sections, subsections, or subparagraphs are to provisions of this Agreement unless context dictates otherwise.

C. Counterparts.

This Agreement may be executed in several counterparts. All executed counterparts constitute one Agreement binding on all parties, whether or not all parties are signatory to the original or the same counterpart.

D. Attorney Fees.

Subject to Article XVII of this Agreement, if a dispute arises between any Partners and the Partnership or between the Partners themselves, the prevailing party may recover reasonable attorney's fees and court costs incurred.

E. Tax Audit.

If this Partnership is audited by the Internal Revenue Service, the costs and expenses incurred to defend and comply with the audit will be the Partnership's expense. Any audit of any individual Partner will not be deemed to be the Partnership's audit.

F. Binding Nature.

Each and every covenant, term, provision, and agreement contained in this Agreement will be binding upon each of the Partners and their respective heirs, legal representatives, successors, and assigns and will inure to the benefit of each of the Partners. Unless and until properly admitted as a Partner, no Assignee will have any rights of a Partner beyond those provided by the TPL to Assignees or otherwise expressly provided in this Agreement to Assignees.

> **Comment:** Note that this language differs from the boilerplate language concerning assigns in order to effect the concept that an assignee does not succeed to all of the rights of a partner until it is properly substituted. However, this language does bind an assignee so that, for instance, restrictions on transfers of partnership interests are binding on transferees even if they are not admitted as

G. Severance.

If any sentence or paragraph of this Agreement is declared by a court to be void or by the Internal Revenue Service, for the purposes of Code Section 2704, to be noneffective, that sentence or paragraph will be deemed severed from the remainder of the Agreement, and the balance of the Agreement will remain in effect. To the extent applicable, the TPL's default provisions will govern in the place of the severed sentence or paragraph. This provision will not prohibit the Partnership or any Partner from contesting a determination of non-effectiveness of any provision of this Agreement by the Internal Revenue Service.

H. Amending the Agreement.

This Agreement may be modified or amended at any time by a writing signed by all the Partners.

> **Comment:** Absent express authorization to amend the partnership agreement, a unanimous vote of partners is required, which is frequently difficult to obtain. See TBOC §§ 152.208 and 153.003.

I. Applicable Law.

This Agreement and all rights and liabilities of the parties with reference to this Partnership are to be governed by the TPL and all other applicable Texas laws other than its conflicts of laws, rules, and principles.

J. Merger, Conversion, or Interest Exchange.

The Partnership may effect or participate in a merger, conversion, or interest exchange (as such terms are defined in the TBOC) or enter into an agreement to do so (this being a fundamental business transaction as defined under the TBOC) with the consent of the General Partner and of a Majority in Interest of Limited Partners.

> **Comment:**
> TBOC §§10.009(t), 10.056(1), and 10.107(b) require that the partnership agreement authorize a merger, interest exchange, or conversion, respectively, before the partnership can engage in a merger, interest exchange, or conversion. Presumably the mere consent of the partners is insufficient. Therefore, it is easier to provide this authorization mechanism. Note, however, that some practitioners believe it is virtually impossible to give this type of advance blessing because the general authorization does not authorize the "specific" transaction, as possibly required by such provisions of the TBOC.
>
> Dissenters' rights will be available with respect to these types of transactions only if provided for in the certificate of formation or partnership agreement. See TBOC §10.351.
>
> The TBOC provides that a fundamental business transaction is a merger, interest exchange, conversion, or sale of all or substantially all of an entity's assets. This definition allows for the drafter to include a more expansive list of transactions to fall into this category. These transactions typically require a higher degree of approval such as by 70% Percent in Interest.

K. Foreign Qualification.

Before the Partnership begins to conduct business in any jurisdiction other than Texas, the General Partners will cause the Partnership to comply, to the extent procedures are available and those matters are reasonably within the General Partners' control, with all requirements necessary to qualify the Partnership as a foreign limited partnership in that jurisdiction. At the General Partners' request, each Partner will execute, acknowledge, swear to, and deliver all certificates and other instruments conforming with this Agreement's terms that are necessary or appropriate to qualify, continue, and terminate the Partnership as a foreign limited partnership in all jurisdictions in which the Partnership may conduct business.

L. Headings.

The headings used in this Agreement are for convenience only and will not be construed in interpreting this Agreement.

M. Entire Agreement.

This Agreement contains the entire agreement among the Partners with respect to the matters of this Agreement and will supersede and govern all prior agreements, written or oral.

N. Further Action.

The parties to this Agreement will execute and deliver all documents, provide all information, and take or refrain from taking action as may be necessary or appropriate to achieve this Agreement's purposes.

O. Creditors.

No provision of this Agreement will be for the benefit of or enforceable by any creditors of the Partnership or other third parties.

P. Waiver.

No failure by any Partner to insist upon the strict performance of any covenant, duty, agreement, or condition of this Agreement or to exercise any right or remedy consequent upon a breach of this Agreement constitutes waiver of any breach or any other covenant, duty, agreement, or condition.

Q. Offset.

Whenever the Partnership is to pay any sum to any Partner, any amounts that Partner owes the Partnership may be deducted from that sum before payment.

R. Disclosure.

Each Partner acknowledges that he, she, or it:

- was urged in advance by the Attorney who prepared this Agreement to secure separate independent legal counsel in connection with signing and making this Agreement and its effect upon each of them and their marital Property;
- has carefully read and understood this Agreement;
- understands that his or her marital rights in real property may be adversely affected by this Agreement;
- is signing and making this Agreement voluntarily;
- has been provided a fair and reasonable disclosure of the property and financial obligations of the other Party; and
- voluntarily and expressly waives in this writing any right to disclosure of the Property and the other Partners' financial obligations beyond the disclosure provided.

XIX. DEFINITIONS

The use of any of the following defined terms in their uncapitalized form indicates that the words have their normal meaning.

A. Adjusted Capital Account.

"Adjusted Capital Account" is intended to comply with the provisions of Regulations Section 1.704-1(b)(2)(ii)(d) and 1.704-2, and will be interpreted consistently with those provisions. It means, with respect to a Partner, that Partner's Capital Account after:

- crediting to the Capital Account any amount that the Partner is deemed to be obligated to restore in accordance with the penultimate sentence of Regulations Sections 1.704-2(g)(1) and 1.704-2(i)(5);
- crediting to the Capital Account any amount that Partner is unconditionally obligated to contribute to the Partnership under applicable law; and
- debiting to the Capital Account the items described in Regulations Section 1.704-1(b)(2)(ii)(d)(4), (5), and (6).

B. Affiliate.

"Affiliate" means, with respect to any Person, any family member of such first Person or any other Person who is controlled by, under common control with, or in control of such first Person.

Comment: This definition needs to be closely reviewed to determine if it is appropriate for the particular transaction and provision. Sometimes this term is used in a restrictive sense (e.g., there are restrictions on dealings with affiliates unless they are on arm's-length terms) and sometimes it is used in a permissive sense (e.g., transfers of partnership interests are permitted to be made without consent if they are made to affiliates). Therefore, be certain the definition works in all circumstances or modify where

C. Agreement.

"Agreement" means this Agreement of Limited Partnership as amended.

D. Allocation Regulations.

"Allocation Regulations" means Treasury Regulations promulgated under Code Sections 704(b) and 704(e).

E. Appraisal.

"Appraisal" means, unless the context indicates otherwise, a written valuation report by an Appraiser that describes and values the fair market value of an ownership interest in the Partnership.

F. Appraiser.

"Appraiser" means a person or firm qualified to perform business Appraisals of partnerships and ownership interests in the partnerships.

G. Assignee.

"Assignee" means a person who has acquired all or a portion of an interest in a Partnership Interest by assignment as of the date the assignment of the Partnership Interest has become "effective." As used in this Agreement, the assignment of a Partnership Interest becomes "effective" as of the date on which all requirements of an assignment expressed in this Agreement, particularly Article XII, will have been met. An Assignee has only the rights granted under Section 153.251 of the TBOC. An Assignee may not become a partner except as provided in this Agreement or in Section 153.253 of the TBOC.

Comment: See TBOC §§ 153.251 through 153.255. An assignee may not vote, control, manage, compel distribution, or liquidate an FLP. Assigning a partnership interest does not trigger an event of winding up for the FLP. Nor does it entitle the assignee to become a substitute partner unless the partnership agreement otherwise provides. An Assignee's death, bankruptcy, or withdrawal is not an event of winding up for an FLP. If a general partner assigns all of that general partner's general partnership interest, the general partner's status as a general partner may be terminated by a vote of majority-in-interest of the limited partners. An assignee may become a substitute partner only with unanimous consent of the partners or as specified in a written partnership agreement. The value of a partnership interest held by an assignee is normally less than the value of the same interest held by general or limited partners.

H. Built-In-Gain.

"Built-In-Gain" with respect to any Partnership property means:

- as of the time of contribution, the excess of the Gross Asset Value of any Contributed Property over its adjusted basis for federal income-tax purposes; and
- in the case of any adjustment to the Carrying Value of any Partnership property in accordance with Section VIII.B, of this Agreement, the Unrealized Gain.

I. Built-In-Loss.

"Built-In-Loss" with respect to any Partnership property means:

- as of the time of contribution, the excess of the adjusted basis for federal income-tax purposes of any Contributed Property over its Gross Asset Value; and
- in the case of any adjustment to the Carrying Value of any Partnership property in accordance with Section VIII.B of this Agreement, the Unrealized Loss.

J. Capital Contribution.

"Capital Contribution" means with respect to any Partner, the Agreed Value of any property and the cash amount contributed to the Partnership. Any reference in this Agreement to a Partner's Capital Contribution will include a Capital Contribution made by any prior Partner with respect to the Partner's Partnership Interest.

K. Carrying Value.

«"Carrying Value" means:

- with respect to any Contributed Property, the property's Gross Asset Value reduced as of the time of determination by all Depreciation and an appropriate amount to reflect any sales, retirements, or other dispositions of assets included in the property; and
- with regard to other Property, the property's adjusted basis for federal income-tax purposes as of the time of determination.

The Carrying Values will be further adjusted, however, as provided in Article VIII of this Agreement. At the time of adjustment, the property will from that time be deemed to be a Contributed Property contributed as of the adjustment date.

L. Code.

"Code" means the Internal Revenue Code of 1986, as amended.

M. Contributed Property

"Contributed Property" means any property other than cash contributed to the Partnership.

N. Default Interest Rate.

"Default Interest Rate" means the rate per annum equal to the lesser of:

- the Wall Street Journal prime rate as quoted in the Wall Street Journal's money rates section, which is also the base rate on corporate loans at large United States money center commercial banks, as its prime commercial or similar reference interest rate, with adjustments to be made on the same date as any change in the rate; and
- the maximum rate permitted by applicable law.

O. Depreciation.

"Depreciation" means, for each taxable year or other period, an amount equal to the depreciation, amortization, or other cost recovery deduction allowable with respect to an asset for the year or other period. If an asset's Gross Asset Value differs from its adjusted basis for federal income-tax purposes at the beginning of the year or other period, however, Depreciation will be an amount that bears the same ratio to the beginning Gross Asset Value as the federal income-tax depreciation, amortization, or other cost recovery deduction of the year or other period bears to the beginning adjusted tax basis. If the federal income-tax depreciation, amortization, or other cost recovery deduction for the year or other period is zero, however, Depreciation will be determined with reference to the beginning Gross Asset Value using any reasonable method selected by the General Partner.

P. Distributable Cash.

"Distributable Cash" means, at the time of determination for any period (on the cash receipts and disbursements method of accounting), all Partnership cash derived from the conduct of the Partnership's business, including distributions from entities owned by the Partnership, cash from operations or investments, and cash from the sale or other disposition of Partnership property, other than:

- Capital Contributions with interest earned pending its utilization;
- financing or other loan proceeds;
- reserves for working capital; and
- other amounts that the General Partner reasonably determines needs to be retained by the Partnership in accordance with the General Partner's discretion under Article XI.

Comment: One of the factors appraisers look for in an FLP to justify discounts in value is whether the general partner has broad discretion to make distributions. Normally a general partner will not make many distributions and will reinvest the partnership assets. This broad discretion, however, may also cause problems under Code §2036(a). Relying upon the *Byrum* case, it is important to provide some guidance to a general partner as to what cash is available for distribution. The above definition for "Distributable Cash" provides guidance to the general partner as to what funds are available for making distributions.

Q. Family.

"Family" means Thomas Baird, Cindy Baird, and their descendants.

R. Family Assets.

"Family Assets" means all Property owned by the Family, individually or in combination with others, that has been contributed to or acquired by the Partnership.

S. General Partner or General Partners.

"General Partner" or "General Partners" means the Person or Persons designated as General Partners on Schedule A and any successor General Partners in accordance with the terms of this Agreement. "General Partner" or "General Partners" does not, however, include any person who has ceased to be a General Partner in the Partnership.

Comment:
The number and selection of general partners is one of the critical FLP drafting decisions. The following factors are critical in determining whether Code §2704 applies for valuation purposes and whether the FLP will be taxable as a partnership or corporation for federal income-tax purposes:

- whether a general partner is an individual, revocable trust, corporation, LLC, or limited partnership;
- whether there is a single or multiple general partners; and
- whether the state law default provisions are applicable.

T. General Partner Units or GP Units.

"General Partner Units" or "GP Units" means the number of Participating Units reflecting a General Partnership Interest. The GP Units owned by each General Partner are set out on the attached Schedule A, as may be amended.

U. General Partnership Interest.

"General Partnership Interest" means the Partnership Interest owned by a General Partner.

V. Gross Asset Value.

"Gross Asset Value" means:

- with regard to property contributed to the Partnership, the property's fair market value on the date the contribution was made; and
- as to any property the Carrying Value of which is adjusted in accordance with Article VIII, the property's fair market value as of the adjustment date, as the fair market value is determined by the General Partner using any reasonable method.

W. Limited Partner or Limited Partners.

"Limited Partner" or "Limited Partners" means the Person or Persons admitted to the Partnership as original, additional, or substituted Limited Partners as reflected on Schedule A as amended.

X. Limited Partner Units or LP Units.

"Limited Partner Units" or "LP Units" means the number of Participating Units reflecting a Limited Partnership Interest. The LP Units owned by each Limited Partner are set out on the attached Schedule A, as may be amended.

Y. Limited Partnership Interest.

"Limited Partnership Interest" means the Partnership Interest owned by a Limited Partner.

Z. Liquidating Agent.

"Liquidating Agent" means the General Partner who will commence to wind up the Partnership's affairs and to liquidate and sell its properties when there has been an event requiring the winding up of the Partnership without reconstituting the Partnership. If there are no remaining General Partners, a person or committee selected by a Majority in Interest of Limited Partners will be the "Liquidating Agent". "Liquidating Agent" also refers to any successor or substitute Liquidating Agent.
Comment: See TBOC §153.052.

AA. Majority in Interest.

"Majority in Interest" means those Partners who hold GP Units or LP Units that exceed 50% of the Partnership's total outstanding Participating Units.

BB. Majority in Interest of Limited Partners.

"Majority in Interest of Limited Partners" means those Limited Partners who hold LP Units that exceed 50% of the total number of outstanding LP Units in the Partnership.

CC. Participating Units.

"Participating Units" means one or more types of units (or fractional units) each Partner will receive for each $1 (or fractional part of $1) of Gross Asset Value of property contributed by each Partner as reflected on Schedule A, as may be amended.

DD. Partner.

"Partner" means a partner (whether limited or general) of the Partnership. "Partners" means all the Partnership's General and Limited Partners.

EE. Partnership.

"Partnership" means the limited partnership formed under this Agreement, as constituted or amended.

FF. Partnership Interest.

"Partnership Interest" means the ownership interest and rights of a Partner in the Partnership, including the Partner's right to a distributive share of the Partnership's Profits and Losses, distributions, and Property and the right to consent or approve.

GG. Partnership Purposes.

"Partnership Purposes" are those purposes set out in Article IV of this Agreement.

HH. Percentage Interest.

"Partnership Interest" means the ownership interest and rights of a Partner in the Partnership, including the Partner's right to a distributive share of the Partnership's Profits and Losses, distributions, and Property and the right to consent or approve. The Partnership Interest, whether general partnership interest or limited partnership interest, will be an uncertificated ownership interest as defined in Section 1.002 of TBOC.

II. Permitted Transferee.

"Permitted Transferee" means:

1. a Partner's spouse other than a spouse who is legally separated under a decree of separate maintenance or a spouse who is a party to a pending divorce proceeding;
2. a Partner's descendant, including descendants by adoption if the adoption was a court adoption of a minor under five years of age;
3. a Partner's parent or sibling;
4. a descendant of a Partner's sibling including those by adoption as defined above;
5. a trust created for the benefit of anyone in 1. through 4. above;
6. a Person who is a Partner at the time of the transfer;
7. any charitable organization described in each of the following Code sections: Section 170(b)(1)(A), Section 170(c), Section 2055(a) and Section 2522(a); and
8. a charitable remainder trust created under Code Section 664.

Permitted Transferee, upon receiving a transfer of a Limited Partnership Interest, will be an Assignee. A Permitted Transferee who has become an Assignee may become a substitute Limited Partner by Required Consent.

Comment:
This partnership agreement allows certain transferees to become assignees without the consent of the other partners if:

- the transfer occurs by reason of or incident to the transferor partner's death, incompetency, or gift; and
- the transferee is a permitted transferee as defined above.

TBOC §152.251(a) states that unless the partnership agreement states to the contrary, a partnership interest is assignable in whole or in part.

TBOC §153.253(a) states that an assignee of a partnership interest may become a substitute limited partner if all partners consent or the partnership agreement provides. If a permitted transferee is defined as having an assignee's status, the permitted transferee who receives a transfer of a partnership interest will receive only a beneficial interest as an assignee. A permitted transferee may become a substitute limited partner only by receiving required consent.

JJ. Person.

"Person" includes any individual, partnership, limited partnership, joint venture, corporation, limited liability company, trust, estate, custodian, trustee, executor, administrator, nominee, representative, unincorporated organization, sole proprietorship, trust, employee benefit plan, tribunal, governmental entity, department, or agency, or other entity.

KK. Profits and Losses.

"Profits and Losses" means for each fiscal year or other period, an amount equal to the Partnership's taxable income or loss for the year or period, determined in accordance with Code Section 703(a) [for this purpose all items of income, gain, loss, or deduction required to be stated separately in accordance with Code Section 703(a)(1), and any guaranteed payments paid to the General Partner, will be included in taxable income or loss], with the following adjustments:

- Any Partnership income that is exempt from federal income tax and not otherwise taken into account in computing Profits or Losses in accordance with this definition will be added to the taxable income or loss.
- Any Partnership expenditures described in Code Section 705(a)(2)(B) or treated as Code Section 705(a)(2)(B) expenditures in accordance with Regulations Section 1.704-1(b)(2)(iv)(i) and not otherwise taken into account in computing Profits or Losses in accordance with this definition will be subtracted from the taxable income or loss.
- Gain or loss resulting from any Property's disposition with respect to which gain or loss is recognized for federal income tax purposes will be computed by reference to the Carrying Value of the property disposed of, as the case may be, notwithstanding that the property's adjusted tax basis differs from its Carrying Value.
- In lieu of depreciation, amortization, and other cost recovery deductions taken into account in

computing taxable income or loss, there will be taken into account Depreciation for the taxable year or other period.

- If any Property's Carrying Value is adjusted under Article VIII, the adjustment will be taken into account as gain or loss from the asset's disposition for computing Profits or Losses.
- Any items that are specially allocated in accordance with Section IX.B.1.e) of this Agreement will not be taken into account in computing Profits or Losses.

LL. Property.

"Property" means all real and personal property that has been contributed to or acquired by the Partnership and all increases and decreases applicable to the Property.

MM. Qualified Representative.

"Qualified Representative" means, with respect to any Partner who is not a natural person, an authorized officer, partner, director, or agent of such Partner who is not appointed or elected solely or primarily for the purpose of representing such Partner as a Partner and, with respect to any Partner who is a natural person, a Person who has been duly appointed as the legal representative of such Partner due to such Partner's death or mental or physical incapacity.

NN. Regulations.

"Regulations" means Treasury Regulations promulgated under the Code as amended.

OO. 70 Percent in Interest.

"70 Percent in Interest" means those Partners who hold GP Units or LP Units that equal 70% or more of the Partnership's total outstanding Participating Units.

PP. 70 Percent in Interest of Limited Partners.

"70 Percent in Interest of Limited Partners" means those Limited Partners who hold LP Units that equal 70% or more of the total number of outstanding LP Units in the Partnership.

QQ. TBOC.

"TBOC" means, at any time, the Texas Business Organizations Code or, from and after the date any successor statute becomes, by its terms, applicable to the Partnership, such successor statute, in each case as amended at such time by amendments that are, at that time, applicable to the Partnership. All references to sections of the TBOC include any corresponding provision or provisions of any such successor statute.

RR. TLPL.

"TLPL" means the Texas Limited Partnership Law part of the TBOC, as amended and any successor statute. Chapters 151 and 154 of the TBOC govern partnerships generally. Chapter 153 governs limited partnerships only. Various provisions of Title 1 (the "hub") and Chapter 152 apply to limited partnerships as well. The TBOC refers to these provisions collectively as the "Texas Limited Partnership Law". TBOC §1.008(g).

SS. TPL.

"TPL" means, at any time, the provisions of the TBOC (specifically the TLPL and Chapters 6 and 152 of the TBOC) that apply to the Partnership, either by their terms or by election under this Agreement.

Comment: This definition differs from the short title "Texas Limited Partnership Law" found in TBOC §1.008(g). The short title "Texas Limited Partnership Law" only encompasses Chapters 151, 153, and 154 of the TBOC. However, certain provisions of Chapter 152, which governs general partnerships, are made applicable to limited partnerships by TBOC §151.003. This definition avoids any argument that a reference to the Texas Limited Partnership Law is intended to prevent Chapter 152 from supplementing the limited partnership law. This partnership agreement also incorporates the provisions of Chapter 6 of the TBOC, which governs meetings and voting, to the extent the partnership agreement does not provide otherwise. By virtue of TBOC §6.301, those provisions are not applicable to limited partnerships unless provided in the governing documents.

TT. Unanimous Consent.

"Unanimous Consent" means the consent of all Partners.

UU. Unrealized Gain.

"Unrealized Gain" attributable to Property means the excess of the Property's Gross Asset Value over the Property's Carrying Value as of the determination date.

VV. Unrealized Loss.

"Unrealized Loss" attributable to a Property means the excess of the Property's Carrying Value over its Gross Asset Value as of the determination date.

The date of this agreement, for identification purposes, is October ______, 2007.

Acceptance and Approval
By General Partner(s)
OPPORTUNITY INVESTMENTS GP, LLC

By:_______________________________
Thomas Baird, President

Acceptance and Approval
By Limited Partner(s)

____
Thomas Baird

____
Cindy Baird

CERTIFICATE OF ACKNOWLEDGMENT

State of Texas
County of Bell
On October ______, 2007, before me, a Notary Public of the stated State, personally appeared Thomas Baird, President of OPPORTUNITY INVESTMENTS GP, LLC, a Texas limited liability company, personally known to me (or proved to me

on the basis of satisfactory evidence) to be the person whose name is subscribed to the within instrument, and acknowledged that he executed the same on behalf of said entity.

WITNESS MY HAND and official seal.

____
Notary Public, State of Texas

Printed Name:_______________________

Commission Expires:________________

SUBSCRIPTION AND ACCEPTANCE BY LIMITED PARTNER

I, individually or as the authorized representative of a Subscriber/Limited Partner, have subscribed to an interest in the Partnership formed by written contract to which this acceptance is appended, and acknowledged:

- That I have received and reviewed the Agreement with the opportunity and encouragement to seek the advice and consultation of independent legal and tax counsel.
- And confirm my subscription to a Limited Partnership Interest in the Partnership equal to the value of property to be contributed to the Partnership by me as a percentage of the value of all property contributed to the Partnership. I agree to transfer my required capital contribution to the Partnership upon the Effective Date, and upon the General Partner's notice to make the contribution according to my subscribed interest.
- That this subscription agreement and my ownership interest in the Partnership will be subject to the restrictions against transfer stated in the Agreement and the following restriction:

  THE PARTNERSHIP INTERESTS HAVE NOT, NOR WILL BE, REGISTERED OR QUALIFIED UNDER FEDERAL OR STATE SECURITIES LAWS. THE PARTNERSHIP INTERESTS MAY NOT BE OFFERED FOR SALE, SOLD, PLEDGED, OR OTHERWISE TRANSFERRED UNLESS REGISTERED OR QUALIFIED, OR UNLESS AN EXEMPTION FROM REGISTRATION OR QUALIFICATION EXISTS. THE AVAILABILITY OF ANY EXEMPTION FROM REGISTRATION OR QUALIFICATION MUST BE ESTABLISHED BY AN OPINION OF COUNSEL FOR THE OWNER, WHICH OPINION AND COUNSEL MUST BE REASONABLY SATISFACTORY TO THE PARTNERSHIP.

- That I agree to be bound by the terms and conditions of the Agreement and Certificate of Formation.
- That the following disclosures have been made before I executed this subscription agreement:

  - THE PARTNERSHIP'S OWNERSHIP PERCENTAGES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR THE SECURITIES LAWS OF ANY STATE. THE OWNERSHIP PERCENTAGES ARE OFFERED AND SOLD IN RELIANCE ON EXCEPTIONS FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND THE LAWS, AND PARTICULARLY REGULATION D [enacted by the Securities and Exchange Commission effective April 15, 1982, pertaining to certain offers and sales of securities without registration under the Securities Act of 1933.]
  - THE PARTNERSHIP WILL NOT BE SUBJECT TO THE REPORTING REQUIREMENTS OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED, AND WILL NOT FILE REPORTS, PROXY STATEMENTS AND OTHER INFORMATION WITH THE SECURITIES AND EXCHANGE COMMISSION.

Dated and effective October _____, 2006.

____
Thomas Baird, Subscriber
Limited Partnership Interest

____
Cindy Baird, Subscriber
Limited Partnership Interest

State of Texas
County of Bell

On October _____, 2007, before me a Notary Public of said State, personally appeared Thomas Baird, personally known to me (or proved to me on the basis of satisfactory evidence) to be the person whose name is subscribed to the within instrument, and acknowledged that he executed the same.

WITNESS MY HAND and official seal.

____
Notary Public, State of Texas
Printed Name:_______________________
Commission Expires:________________

State of Texas
County of Bell

On October _____, 2007, before me a Notary Public of said State, personally appeared Cindy Baird, personally known to me (or proved to me on the basis of satisfactory evidence) to be the person whose name is subscribed to the within instrument, and acknowledged that she executed the same.

WITNESS MY HAND and official seal.

____
Notary Public, State of Texas
Printed Name:_______________________
Commission Expires:________________

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COMPANY AGREEMENT OF OPPORTUNITY INVESTMENTS GP, LLC

THOMAS C. BAIRD
BAIRD, CREWS, SCHILLER & WHITAKER, P.C.
15 North Main
Temple, Texas 76501
(254)774-8333

18TH ANNUAL ADVANCED DRAFTING:
ESTATE PLANNING AND PROBATE COURSE
Houston, Texas
October 25-26, 2007

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COMPANY AGREEMENT OF

OPPORTUNITY INVESTMENTS GP, LLC

This Company Agreement of *Opportunity Investments GP, LLC* ("Agreement"), dated below, is adopted by the Managers and executed and agreed to, for good and valuable consideration, by the Members.

> **Comment:** "Company agreement" replaces the term "regulations" used in the Texas Limited Liability Company Act ("TLLCA").
>
> This company agreement is for a manager-managed limited liability company ("LLC").

I. ORGANIZATION

A. Formation.

The Company was formed as a Texas limited liability company under and pursuant to the TLLCL and other relevant laws of the State of Texas by the filing of its Certificate of Formation with the Texas Secretary of State.

> **Comment:** LLCs are formed upon the filing of the certificate of formation unless otherwise set out in the certificate of formation. To avoid a problem with an oral Agreement you may want to have this Agreement signed before you file. Certain provisions, like a promise to make contributions, must be in writing and signed to be enforceable. TBOC §101.151.

B. Name.

The Company's name is *Opportunity Investments GP, LLC*. All Company business must be conducted in the Company's name or any other names the Managers may select that comply with applicable law.

> **Comment:** TBOC §5.056 provides the guidelines for naming an LLC. The name of an LLC must contain the phrase "limited liability company" or "limited company," or an

C. Registered Office; Registered Agent; Principal Office; Other Offices.

The Company's registered office must be maintained in Texas at the address of the registered agent. The Company's registered office need not be a place of business of the Company. The Management may change the registered office, registered agent, or both, by making the appropriate filing with the Texas Secretary of State. The Company's principal office will be at the place the Management designates and need not be in Texas. Company records will be maintained at the Company's principal office as required by Section 3.151 of the TLLCL. The Company may have other offices as the Management may designate.

> **Comment:** The registered office must be located at a street address where process may be personally served on the registered agent. The registered office may not be solely a mailbox service or telephone answering service. TBOC 5.201. TBOC 101.501 sets forth the requirement for supplemental records that must be kept at the LLC's principal office: a current list that states the percentage or other interest in the LLC owned by each member and each member of a class or group of membership interests in the LLC; a copy of the LLC's federal, state, and local tax information or income tax returns for each of the six preceding tax years; a copy of the LLC's certificate of formation, including any amendments to or restatements of the certificate of formation; if the company agreement is in writing, a copy of the company agreement, including any amendments to or restatements of the company agreement; an executed copy of any powers of attorney; a copy of any document that establishes a class or group of members of the LLC as provided by the company agreement; and information regarding contributions if that information is not

D. Purposes.

The purpose of the Company is to ______________________________________ and undertake all matters or other purposes for which a limited liability company may be formed under the TBOC.

> **Comment:** Often this section is limited by the phrase "that may be incidental thereto" making its purpose narrower. If the parties desire to place some constraints on the scope of the business this phrase is useful.

E. Certificate of Formation; Foreign Qualification.

A certificate of formation that meets the requirements of the TBOC will be filed with the Secretary of State of the State of Texas and will be amended from time to time as required by the TBOC. Upon the request of the Managers, each Member will immediately execute all certificates and other documents consistent with the terms of this Agreement that the Managers believe are necessary or desirable for the Managers to accomplish all filing, recording, publishing, and other acts as may be appropriate to comply with all requirements to form, operate, qualify, and continue the Company as a (a) limited liability company under the TBOC and the laws of the State of Texas and (b) limited liability company, or a company in which each Member has limited liability in all other jurisdictions where the Company proposes to operate.

F. Term.

In compliance with Section 4.001 of the TLLCL, the Company commenced upon the filing with the Texas Secretary of State the Certificate of Formation, said certificate complying with Section 3.005 of the TLLCL. The Company may not conduct business until the Certificate of Formation has been filed with the Secretary of State of the State of Texas. The Company will be wound up on

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the earlier of (1) the term set in the Certificate of Formation, if any, or (2) any time this Agreement may specify.

> **Comment:** Unless the governing documents state differ-

G. Mergers and Exchanges.

Subject to the requirements of this Agreement, the Company may be a party to a merger, exchange, or acquisition of the type described in Chapter 10 of Title 1 of the TBOC (this being a "fundamental business transaction" as defined under the TBOC).

> **Comment:** The TBOC provides that a fundamental business transaction is a merger, interest exchange, conversion, or sale of all or substantially all of an entity's assets. This definition allows for the drafter to include a more expansive list of transactions to fall into this category. These transactions typically require a higher degree of approval such as approval by the members or a "Required Interest," as defined in this company agreement.

H. No State-Law Partnership.

The Members intend that the Company not be a partnership or joint venture for state-law purposes. Additionally, no Member or Manager will be considered a state-law partner or joint venturer of any other Member or Manager. It is intended that the Company will be considered a partnership for federal income-tax purposes, and the Members will be considered partners for federal income-tax purposes only. This Agreement may not be construed to suggest otherwise.

II. MEMBERS

A. Admission of Members.

1. Initial Members.

The initial Members of the Company are the Persons executing this Agreement as Members as of the Effective Date of this Agreement, each of which is admitted to the Company as a Member effective contemporaneously with the execution by such Person of this Agreement and the formation of the Company.

2. Units and Percentage Interests.

The number of Units held by each Member and the Percentage Interest for each Member is set out on the attached Schedule A.

> **Comment:** Unless the Company Agreement provides otherwise, a person is not required to make a contribution to the company to become a member. TBOC §101.102 (b).

3. Limitations on Members' Rights.

Except as otherwise specifically provided in this Agreement to the contrary, no Member will have the right to:

a. participate in the control of the Company's business affairs;
b. transact any business of or in the name of the Company;
c. have any power or authority to bind or obligate the Company. or
d. require partition of the Company's property or to compel any sale or appraisal of the Company's assets.

4. Additional Members.

After this Agreement is adopted, a Person becomes a new Member:

a. in the case of a Person acquiring a Membership Interest directly from this Company, on compliance with the provisions of this Agreement governing admission of new members, or if this Agreement contains no relevant admission provisions, on the written consent of all Members; and
b. in the case of an assignee of a Membership Interest, as provided in this Agreement, or if this Agreement contains no relevant admission provisions, on the written consent of all Members.

> **Comment:** If the members may only transfer their membership interests to the other initial members and no new members are allowed, you must revise several sections of this company agreement to reflect this drafting provision.

B. Representations and Warranties.

Each Member represents and warrants to the Company and each other Member that:

> **Comment:** The representations and warranties of each member, if included, might also be tailored to address any specific concerns, including, for instance, the nature of title to any property to be contributed by a member to the LLC.

1. If Member is a Corporation.

If that Member is a corporation, it is:

a. duly organized;
b. validly existing;
c. in good standing under the law of the state of its incorporation; and
d. duly qualified and in good standing as a foreign corporation in the jurisdiction of its principal place of business (if not incorporated in that jurisdiction).

2. If Member is a Limited Liability Company.

If that Member is a limited liability company, it is:

a. duly organized;
b. validly existing;
c. (if applicable) in good standing under the law of the state of its organization; and
d. duly qualified and (if applicable) in good standing as a foreign limited liability company in the jurisdiction of its principal place of business (if not organized in that jurisdiction).

3. If Member is a Partnership, Trust, or Other Entity.

If that Member is a partnership, trust, or other entity, it is:

a. duly formed;
b. validly existing;
c. (if applicable) in good standing under the law of the state of its formation; and
d. if required by law is duly qualified to do business and (if applicable) in good standing in the jurisdiction of its principal place of business (if not formed in that jurisdiction).

4. Representation of Members of Entities.

The representations and warranties in clauses , , or above, as applicable, are correct with respect to each trust, partner (other than limited partners), or other members of those entities.

5. Necessary Action Taken by Entities to Perform Obligations.

All necessary actions by the board of directors, shareholders, managers, members, partners, trustees, beneficiaries, or other Persons have been taken to authorize the Member to execute, deliver, and perform its obligations under this Agreement.

6. No Conflicts of Interest.

The Member's obligations under this Agreement do not conflict with any other agreement or arrangement to which that Member is a party or by which it is bound.

7. Nature of Acquisition of Units.

The Member is acquiring Units of the Company for the account of the Member and not with a view to distribution of the Units within the meaning of the Securities Act of 1933, as amended, or any state securities laws. The Member will not transfer the Units in contravention of that act or any applicable state or federal securities laws.

Comment: Because LLC membership interests may be securities, it is likely that a representation of some sort will be necessary to confirm the exemption(s) from registration under federal and state securities laws on which the issuer is relying. The foregoing language should be modified to incorporate the relevant standards for such exemption(s).

8. Managers' Authority.

The Member acknowledges and understands that the Managers are granted broad discretion and authority under this Agreement and that the Managers' exercise of broad discretion and authority may impair the value of the Member's Membership Interest. The Member further acknowledges and understands that the Managers would not cause the Company to issue Membership Interest to the Member if the Managers did not have broad discretion and authority, and the Member agrees not to challenge the Manager's exercise of discretion and authority.

Comment: This language is intended to strengthen a manager's defense against any member who seeks to challenge the manager's broad authority. If this is not the desire of the members, this section should be modified

C. Restrictions on the Disposition of an Interest.

1. Restrictions of Transferability of Interest.

Except as specifically provided in this section, a Disposition of an interest in the Company may not be effected without the consent of **all members**.

Comment: TBOC §101.105 provides that a limited liability company may issue additional membership interests in the company with the approval of all of the members of the company, which differs from the TLLCA, which provides that additional membership interests may be issued upon the vote of a majority of the members.

2. Lack of Free Transferability of Interest.

To the extent possible, this Agreement will be read and interpreted to prohibit the free transferability of interest of any Member. Any attempted Disposition by a Person of any interest or right in the Company other than in accordance with this Section II.C will be null and void *ab initio*.

Comment:
The restrictions on transfer and substitution in this article give members comfort that they will not be forced to be members with someone unacceptable.

Note that the restriction relates to any person and not just to members. This is necessary because of the possibility that someone will own a membership interest as a mere assignee.

If you represent a member who is not a manager, you may want to restrict the ability of the members who are managers to transfer their respective interests in the LLC, because you want the managers economically motivated to manage the LLC. Frequently, the managers are given the right to transfer to an affiliate without the consent of the other members, but consent is needed for all other transfers.

3. Substitute Member's Liability to Company for Contributions.

An assignee who becomes a Member has, to the extent assigned, the rights and powers and is subject to the restrictions and liabilities of a Member under this Agreement and the TLLCL. Unless otherwise provided by this Agreement, an assignee who becomes a Member also is liable for the assignor's obligations to make contributions. But that assignee is not obligated for liabilities unknown to the assignee at the time the assignee became a Member and that could not be ascertained from this Agreement. Whether or not an assignee of a Membership Interest becomes a member, the assignor is not released from the assignor's liability to this Company.

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Comment: Remember that an assignment does not, by itself, cause a substitution. A substitution must be addressed as a matter separate and apart from a mere assignment. Failure to handle this issue properly can result in the "wrong" people being members.

4. **Transfers to a Permitted Transferee.**

Any Member's interest in the Company may be transferred to a Permitted Transferee without any Management or Member consent. The Permitted Transferee will be **an assignee**. The restrictions imposed by this Section do not apply if:

a. the transfer occurs because of or incident to the transferor Member's death, winding up, divorce, liquidation, merger, or termination; and
b. the transferee is a Permitted Transferee.

5. **A Substitute Member's Condition for Admission.**

Subject to the provisions of the following subsections of Section II.C:

a. A Person to whom an interest in the Company is transferred has the right to be admitted to the Company as a Member with the Percentage Interest and the Commitment transferred to that Person if:
   (1) the Member making the transfer grants the transferee the right to be admitted; and
   (2) the transfer is consented to in accordance with this Section II.C.
b. A Permitted Transferee under the circumstances described in this Section II.C has the right to be admitted to the Company as a Member with the Percentage Interest and the Commitment transferred to the Permitted Transferee.

6. **Recognition of Membership Interest Disposition.**

a. **Requirements for Recognition of a Disposition.** The Company may not recognize for any purpose any purported Disposition of a Membership Interest unless:
   (1) the provisions of this Section II.C have been satisfied; and
   (2) the Managers have received, on the Company's behalf, a document executed by both:
      (a) the Member effecting the Disposition (or if the transfer is because of the transferor's death, incapacity, or liquidation, its representative); and
      (b) the Person to which all or part of the Membership Interest is Disposed.
b. **Documentation of a Disposition.** A document approving the Disposition must:
   (1) include the notice address of any Person to be admitted to the Company as a Member and its agreement to be bound by this Agreement;
   (2) set forth the transferring Member's Percentage Interest and Commitments and the receiving Person's Percentage Interest and Commitments after the Disposition;
   (3) contain a representation and warranty that the Disposition was made in accordance with all applicable laws and regulations (including securities laws); and
   (4) if the Person receiving the Disposition is to be admitted as a substitute Member, provide that the representations and warranties in this Agreement are correct with respect to that Person.
c. **Effective Date of a Disposition.** Each Disposition and, if applicable, admission complying with the provisions of this Section II.C is effective as of:
   (1) the first day of the calendar month immediately succeeding the month in which the Management receive the Disposition notification; and
   (2) the date the other requirements of this Section II.C have been met.

7. **Compliance with Securities Law.**

Before a Membership Interest may be Disposed of, the following must occur:

a. either of the following:
   (1) any Membership Interest subject to the Disposition or admission of a substitute Member must be registered under the Securities Act of 1933, as amended, and any applicable state securities laws; or
   (2) the Company must receive a favorable legal opinion that the Disposition or admission is exempt from registration under those laws; and
b. the Company must receive a favorable legal opinion that the Disposition or admission of a substitute Member, when added to the total of all other Dispositions within the preceding 12 months, will not result in the Company's being considered to have terminated under the Code. The Company, however, may waive the requirements of this Subsection II.C7.b.

8. **Liability for Costs Associated with a Disposition.**

The Member effecting a Disposition and any Person admitted as substitute Member in connection with the Disposition must pay for all costs incurred by the Company in connection with the Disposition or admission. Costs may include legal fees incurred in connection with the legal opinions referred to above. The payment must be made on or before the tenth day after the receipt by that Person of the Company's invoice for the amount due. If payment is not made by the date due, the Person owing that amount must pay interest on the unpaid amount from the date due until paid. The past-due amount will bear interest at a rate per annum equal to the Default Interest Rate.

D. **Additional Members.**

Additional Persons may be admitted to the Company as Members and Membership Interests may be created and issued to those Persons and to existing Members at the direction of **unanimous consent of the Members**. The admission or issuance terms, to be determined at the admission date, must specify the Percentage

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Interest and the applicable Commitments. The terms may provide for the creation of different classes or groups of Members. The different classes may have different rights, powers, and duties. The creation of any new class or group must be reflected in an amendment to this Agreement indicating the different rights, powers, and duties. The admission of a new Member also must comply with the requirements described elsewhere in this Agreement. The provisions of this Section II.D do not apply to Dispositions of Membership Interests. The admission of a new Member is effective only after the new Member executes and delivers to the Company a document that includes the new Member's notice address, the new Member's agreement to be bound by this Agreement, and a statement that the representation and warranties required of new members are true and correct with respect to the new Member.

E. Interests in a Member.

1. Restrictions on a Membership Interest Owned by an Entity Member.

An entity Member may not cause or permit an interest, direct or indirect, in itself to be Disposed of that, after the Disposition:

a. the Company would be considered to have terminated within the meaning of Code section 708; or
b. unless the Company consents, that Member will cease to be controlled by substantially the same Persons who control it as of its admission date to the Company.

2. Company's Options to Purchase if Above Restriction is Violated.

If Subsection II.E.1 is violated, the Company will have the option to buy, and on exercise of that option the breaching Member must sell, the breaching Member's Membership Interest. The purchase will be in accordance with Article X as if the breaching Member was a Bankrupt Member.

Comment: This provision limits the disposition of membership interests of entity members that could cause adverse tax consequences.

F. Information.

1. Restrictive Information from Some Members.

Each Member is entitled to access to all information required to be maintained by the Company in accordance with Section 3.153 of the TLLCL. The Members agree, however, that Management may determine that certain information regarding the Company's business, affairs, properties, and financial condition must be kept confidential. The information may need to be kept confidential from some of the Members due to contractual obligations, business concerns, or other considerations. The confidential information may not be provided to some or all other Members because it may not be just or reasonable for those Members or assignees or their representatives to examine or copy that information.

Comment: TBOC §101.502 permits members and assignees of membership interests to examine and copy, "at any reasonable time" and for "a proper purpose" records required to be kept by TBOC §§ 3.151 and 101.501. This provision's purpose is to limit dissemination of information to those who may not be entitled to receive information pertaining to the LLC or to those who the managers may not want to see the information. If representing a member/non-manager, note how restrictive access is to the books and records kept by the managers. It may be prudent to revise any restriction which is designed to protect the manager more than the LLC.

2. Agreement to Keep Information Confidential.

a. The Members acknowledge that from time to time, they may receive information from or regarding the Company in the nature of trade secrets or that otherwise is confidential. Releasing the confidential information may be damaging to the Company or Persons with which it does business. Each Member must hold in strict confidence any information it receives regarding the Company that is identified as being confidential and any written information marked "confidential". The confidential information may not be disclosed to any Person other than another Member or Manager, except for the following disclosures:
   (1) A disclosure compelled by law, but the Member must promptly notify the Management of any request for that information, before disclosing it, if practicable.
   (2) A disclosure to advisers or representatives of the Member or Persons to which that Member's Membership Interest may be Disposed as permitted by this Agreement. This disclosure may be made only if the recipients have agreed to be bound by the provisions of this Section II.F.
   (3) A disclosure of information received from a source independent of the Company that the Member reasonably believes was obtained without breach of any obligation or confidentiality.
b. The Members acknowledge that breach of this Section II.F may cause irreparable injury to the Company for which monetary damages are inadequate, difficult to compute, or both. Accordingly, the Members agree this Section II.F may be enforced by specific performance.

G. Liabilities to Third Parties.

Except as expressly agreed to in writing by a Member or Manager, that Member or Manager will not be liable for the Company's debts, obligations, or liabilities.

Comment:
TBOC §101.114 states "except as and to the extent the company agreement specifically provides otherwise, a member or manager is not liable for a debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court." Lenders, however, may require members to personally sign guaranty agreements to secure indebtedness in the LLC's name. Therefore, this agreement allows a member to be personally liable for certain LLC debts to the extent the member agrees to be contractually liable.

Optional provision: Rev. Proc. 95-10 states that the IRS generally will not rule that an LLC lacks limited liability unless at least one assuming member validly assumes personal liability for all (but not less than all) the LLC's obligations, in accordance with express authority granted in the [TBOC]. The IRS generally will not rule that an LLC lacks limited liability unless the assuming members have an aggregate net worth that, at the time of the ruling request, equals at least 10 percent of the total contributions to the LLC and is expected to continue to equal at least 10 percent of total contributions to the LLC throughout the LLC's life. In the case of an LLC in which the assuming members do not satisfy the safe harbor described in the preceding sentence, close scrutiny will be applied to determine whether the LLC lacks limited liability. In that connection, it must be demonstrated that an assuming member has (or the assuming members collectively have) substantial assets (other than the member's interest in the LLC) that could be reached by a creditor of the LLC. In determining the assuming member's (or assuming members') net worth, the principles contained in Section 4.03 of Rev. Proc. 92-88, 1992-2 C.B. 496, are to be applied.

The optional provision will be seldom used, but it does put LLCs and limited partnerships on equal footing. This option may be helpful if the LLC needs to lack limited liability for classification purposes.

H. Withdrawal.

A Member may not withdraw from the Company.

Comment: This provision tracks TBOC §101.107, which states that a member may not withdraw. The company agreement can modify this general provision.

I. Authority.

No Member (other than a Manager or officer) may act for or on the Company's behalf, contractually bind the Company, or incur any expenditure on the Company's behalf.

Comment: TBOC §101.251and the provisions following use the term "governing authority," which applies to both member-managed and manager-managed LLCs. The TBOC does not vest managers with governing authority unless otherwise indicated that it is vested in members, as the TLLCA did. TBOC §101.254 combines agency principles and TLLCA provisions to state how the LLC can be bound by its "governing authority." If it is desired that the consent of two or more managers or officers is required to contractually bind or obligate the LLC for debts, liabilities, and other obligations, this provision needs to be modified.

J. Classes and Voting.

Unless the Certificate of Formation or this Agreement provide that two or more classes or groups of one or more members is established, there will be one class of members. A Required Interest may elect to establish two or more classes or groups of one or more Members. If two or more classes or groups of one or more Members are established, the following provisions will apply:

1. Rights May Be Senior.

The rights, powers, or duties of a class or group may be senior to those of one or more existing classes or groups of members.

2. Governed by Same Provisions.

Each class or group of members will be governed by the same provisions of this Agreement as pertain to one class or group of members for the following matters:

a. waiver of notices;
b. action by consent without a meeting;
c. quorum requirements;
d. voting in person or by proxy; or
e. any other matter relating to exercising the right to vote.

3. Prompt Notice.

Prompt notice will be given to the Members who have not consented in writing to taking an action under this Agreement that:

a. requires less than the Members' unanimous written consent; and
b. that may be taken without a meeting.

4. Action Includes Amendment of this Agreement or Creating a Class of Membership Interest.

For the purposes of this Section II.J, taking an action includes amending this Agreement or creating, under provisions of this Agreement, a class of Membership Interest that was not previously outstanding.

Comment:
TBOC §101.104 states, "If the company agreement of a limited liability company does not provide for the manner of establishing classes or groups of members or membership interests under Subsection (a)(2), additional classes or groups of members or membership interests may be established only by the adoption of an amendment to the company agreement." Although implicit in the TLLCA, this was not expressed before the TBOC.

This Agreement is structured with one class of members. To accommodate special aspects of a business arrangement, there may also be multiple classes of members. This may arise where there are persons making disproportionate contribution and, on that basis, require disproportionate management rights, differing economic treatment, or both. In these cases, the company agreement will need to be drafted to identify these classes and define their relative rights and obligations under the terms of the company

K. Place and Manner of Meeting.

All Member meetings will be held at the time and place stated in the meeting notice or in an executed waiver of the meeting notice. Members may participate in the meetings by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other. Participating in a meeting will constitute a person's presence at the meeting, except when the person attends the meeting for the purpose of stating that the meeting is not lawfully called or convened. Meetings of the Members may be held in or out of the State of Texas.

Comment: Similar to the TLLCA, the TBOC does not require annual meeting for members. These sections, therefore, generally apply when members call for a meeting as outlined.

L. Conduct of Meetings.

All Member meetings will be presided over by the meeting's chair, who must be a Manager designated by a majority of the Managers. A Member meeting's chair, in the chair's discretion, may determine the order of business and the procedure at the meeting, including regulating the voting manner and the discussion conduct.

M. Special Meetings.

Special Member meetings may be called at any time by the president, Management, or upon the written request of holders of at least ten percent of the Membership Units. The request must state the meeting purposes and the matters proposed to be acted on at the meeting.

N. Notice.

Notice of a meeting must be in writing and state the meeting's place, day, hour, and, in case of a special meeting, the purposes for which the meeting is called. The notice must be delivered not less than ten nor more than 60 days before the meeting date either personally, electronically transmitted by facsimile to the Member's fax machine as reflected in the Company's records, electronically transmitted by email to the Member's email address as reflected in the Company's records, or by mail to each Member entitled to vote at the meeting. Notice may be waived as provided in this Agreement. If mailed, the notice will be deemed to be delivered when deposited, postage prepaid, in the United States mail addressed to the Member at the Member's address as it appears on the Company's records. If personally delivered, faxed, or emailed, the notice will be deemed to be delivered the day the notice was personally delivered, faxed, or emailed.

O. Quorum of Members.

Unless otherwise provided in the Certificate of Formation, the holders of a majority of the Membership Units, represented in person or by proxy, will constitute a quorum at a Member meeting. But in no event will a quorum consist of the holders of less than one-third of the Membership Units of each class. The vote of the holders of a majority of the Membership Units of each class will be the act of the Members' meeting unless the vote of a greater number is required by law, the Certificate of Formation, or this Agreement.

P. Majority Vote; Withdrawal of Quorum.

When a quorum is present at a meeting, the holders of a majority of the Membership Units, present in person or by proxy, will decide the matter brought before the meeting unless a different vote is required by the Certificate of Formation, this Agreement, or the TLLCL. The Members present at a meeting may continue to transact business until adjournment, even if a quorum is no longer present.

Q. Voting of Membership Interest.

Each member, regardless of class, is entitled to one vote per Membership Unit or a fraction of one vote per fraction of Membership Unit on each matter submitted to a vote at a Member meeting. A Member may vote either in person or by proxy executed in writing by the Member or by the Member's authorized attorney-in-fact. No proxy will be valid after 11 months from the date it is executed unless otherwise provided in the proxy. Each proxy is revocable unless the proxy form conspicuously states that the proxy is irrevocable and the proxy is coupled with an interest.

Comment: TBOC § 6.251 and 6.252 have extended to the members the right to create voting trusts and enter into voting agreements.

R. Action Without Meeting.

1. Consent for Action Without Meeting.

Any action required to be taken or that may be taken at a Member meeting may be taken without a meeting, without prior notice, and without a vote, if a consent in writing, setting forth the action taken has been signed by:

a. the holders of all Membership Units for each class entitled to vote with respect to that action, which will have the same force and effect as a unanimous vote of the Members; or
b. if the Certificate of Formation provides, the

holders of Membership Units of each class having not less than the minimum number of votes necessary to take the action at a meeting at which the holders of all Membership Units of each class entitled to vote on the action were present and voted.

Comment: Clients will need to decide whether they want actions to be able to be taken at meetings with less than unanimous consent. Members may want to be able to take action with less than unanimous consent and without authority being given to do so in the certificate of formation, in accordance with TBOC §101.358, which overrides TBOC §6.202 (requiring the authority to be in the certificate of formation). If the members do want that ability, this section will need to be revised.

2. Requirements for Written Consent.

Every written consent must be signed, dated, and delivered by the Member. The consent will become effective at the time and remain effective for the period specified in the consent. A telegram, telex, cablegram, or similar transmission by a Member, or a photographic, photostatic, facsimile, or similar reproduction of a writing signed by a Member, will be regarded as signed by the Member. Prompt notice of the taking of any action by Members without a meeting by less than unanimous written consent must be given to those Members who did not consent in writing to the action.

3. Actions that May be Taken Without a Meeting.

For purposes of this Section II.R, taking an action includes amending this Agreement or creating, under this Agreement, a class of membership interest that did not previously exist.

4. Action by Communications Equipment.

Members may participate in and hold a meeting by means of a conference telephone or similar communications equipment or other suitable electronic communications equipment, including video conferencing technology, or the internet, or a combination of the foregoing, by means of which all Persons participating in the meeting can communicate with each other and participate in the meeting. Participation in the meeting will constitute attendance and presence in person at the meeting, except where a Person participates in the meeting for the express purpose of objecting to the transaction of any business on the ground that the meeting is not lawfully called or convened.

S. Assignment of Membership Interest.

Unless otherwise provided by this Agreement:

- a Membership Interest is assignable in whole or in part;
- an assignment of a Membership Interest does not entitle the assignee to become a Member or to exercise a Member's rights or powers;
- an assignment entitles the assignee to receive distributions the assignor was entitled to, to the extent those items are assigned; and
- until the assignee becomes a Member, the assignor Member continues to be a Member and to have the power to exercise any rights or powers of a Member, except to the extent those rights or powers are assigned.

This Agreement:

- provides that a Member's Membership Units may be evidenced by a certificate of ownership interest issued by this Company;
- provides for the assignment or transfer of Membership Units represented by a certificate of ownership; and
- makes other provisions with respect to the certificate of ownership.

Comment: See TBOC §101.108. If you want to restrict or prohibit assigning a membership interest, this provision must be modified.

T. Distribution in Kind.

No assets will be distributed in kind, regardless of any potential unrealized depreciation or appreciation in respect to the assets. Any in-kind distributions will be made proportionately among the Members in accordance with the percentage of the distributions the Members are entitled to receive, as set out in this Agreement.

Comment: TBOC §101.202 prohibits an in-kind distribution of assets unless the company agreement provides otherwise. Determine what is appropriate for the particular transaction and modify as appropriate.

U. Right to Distribution.

Subject to the TLLCL, at the time a Member becomes entitled to receive a distribution, with respect to a distribution, that Member has the status of and is entitled to all remedies available to a creditor of the Company.

V. Limitation on Distribution.

This Company may not make a distribution to its Members to the extent that, immediately after giving effect to the distribution, it exceeds the Company's fair value. To determine the Company's fair value, all the Company's liabilities must be subtracted from the fair-market value of the Company's assets. In determining liabilities, liabilities to Members with respect to their interests and liabilities for which the recourse of creditors is limited to particular property of the Company is not included. Fair value of property, subject to a liability for which a creditor's recourse is limited, will be included in this Company's assets only to the extent that the property's fair value exceeds that liability.

Comment: TBOC §101.206 mandates a return of a distribution in violation of this section if the member knew the distribution violated the TBOC.

A Member who receives a distribution prohibited under this Agreement has no liability under the TLLCL to return the distribution unless the Member knew that the distribution violated the TLLCL's prohibition. This does not affect any Member's obligation under this Agreement or other applicable law to return the distribution.

W. Additional Restrictions and Option to Purchase a Membership Interest.

In addition to other restrictions on Disposition in this Agreement, the Membership Interest and Disposition of a Membership Interest in the Company are substantially restricted. Neither record title nor beneficial ownership of a Membership Interest may be transferred or encumbered without all Members' consent. This Company is formed by a closely-held group who know and trust one another and who have surrendered certain management rights (in exchange for limited liability) based upon their relationship and trust. Capital is also material to the Company's business and investment objectives and its federal tax status. An unauthorized transfer of a Membership Interest may create a substantial hardship to the Company, jeopardize its capital base, and adversely affect its tax structure. These restrictions on ownership and transfer are not intended as a penalty, but as a method to protect and preserve existing relationships based upon trust and the Company's capital and its financial ability to continue. The following Dispositions are permitted exceptions to the foregoing restrictions:

1. Death of a Member.

The personal representative of a deceased Member's estate, or the deceased Member's contract beneficiary, may exercise all the decedent's rights and powers as a Member. The decedent's Membership Interest in the Company will continue and pass to those entitled to it upon the Member's death. A Member may prepare a written and acknowledged document in which the Member designates one or more beneficiaries of that Member's Membership Interest. That Member's written designation will be binding upon the Company if delivered to the Company before or within at least 60 days after the Member's death.

2. Incapacity of a Member.

The personal representative of an incapacitated Member, acting under a durable power of attorney or Letters of Guardianship, may exercise all of a Member's rights and powers. The personal representative will be entitled to receive distributions of cash or other property from the Company. Neither the Company nor any Manager, officer, or Member will have a duty to inquire as to the application or use of funds delivered to a personal representative.

3. Estate-Planning Transfers.

A Member may also make estate-planning transfers of any part of the Member's Membership Interest. The Certificate of Formation and this Agreement will bind the transferee of any estate-planning transfer to the exact terms and conditions of the Certificate of Formation and this Agreement. The term "estate-planning transfer" means:

a. any transfer made during a Member's life without value, or for less than full consideration;
b. a transfer by way of a marital partition agreement; or
c. a transfer of all or any part of a Membership Interest to a trust whose beneficiaries are a Permitted Transferee.

4. Disputed Transfers.

The Company will not be required to recognize the interest of any transferee who has obtained a purported interest as the result of a transfer of ownership that is not an authorized transfer. If the Membership Interest is in doubt, or if there is reasonable doubt as to who is entitled to a distribution of the income realized from a Membership Interest, the Company may accumulate the income until this issue is finally determined and resolved. Accumulated income will be credited to the capital account of the Member whose interest is in question.

5. Right of the Company to Acquire a Transferee's Membership Interest.

A Transferee's interest may be acquired by the Company upon the terms and conditions described below in Subsections II.W.6 through II.W.12 if:

a. any person or agency acquires a Member's Membership Interest as the result of an order of a court of competent jurisdiction that the Company is required to recognize; or
b. a Member makes an unauthorized transfer of a Membership Interest that the Company is required to recognize.

6. Company's Notice of Intent to Purchase.

The Company may acquire the Membership Interest by giving written notice to the transferee of its intent to purchase within 90 days from the date it is finally determined that the Company is required to recognize the transfer.

7. Time Period to Close After Company Exercises Its Option to Purchase.

The Company must purchase the Membership Interest within 180 days from the first day of the month following the month in which it delivers notice exercising its option. The valuation date for the Membership Interest will be the first day of the month following the month in which notice is delivered.

8. Qualified Appraiser to Determine Fair-Market Value of Membership Interest.

Unless the Company and the transferee agree otherwise, the fair-market value of a Member's Membership Interest is to be determined by the written appraisal of a person or firm qualified to value this type of business. The appraiser selected by the Company must be a member of and qualified by the American Society of Appraisers, Business Valuations Division, to perform appraisals.

9. Date to Close Sale if Company Exercises Its Option to Purchase.

Closing of the sale will occur at the Company's registered office at 10 o'clock A.M. on the first Tuesday of the month following the month in which the valuation report is accepted by the transferee ("closing date"). The transferee must accept or reject the valuation report within 30 days from the date it is

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delivered. If not rejected in writing within the required period, the report will be accepted as written. If rejected, closing of the sale will be postponed until the first Tuesday of the month following the month in which the valuation of the Membership Interest is resolved. The transferee will be considered a nonvoting owner of the Membership Interest. The transferee will be entitled to all items of income, deduction, gain, or loss from the Membership Interest, plus any additions or subtractions from the Membership Interest until closing.

10. Purchase Price May Be Paid by Note.

In order to reduce the burden upon the Company's resources, the Company may, if designated in writing delivered at closing, pay its purchase money obligation in installments. The number of installments may be up to ten equal annual installments. If the Company term is less than ten years, the number of installments will, however, be equal to the number of years remaining in the Company term. The purchase price will bear interest at the General Interest Rate. If Code Sections 483 and 1274A apply to this transaction, the interest rate of the purchase money obligation will be fixed at the interest rate then required by law. The first installment of principal, with accrued interest, will be due on the first day of the calendar year following closing. Subsequent annual installments, with accrued interest, will be due on the first day of each calendar year that follows until the entire amount of the obligation, principal and interest, is fully paid. The Company may prepay any part of the purchase money obligation at any time without penalty.

11. Conditions Under Which the Company May Assign Its Option to Purchase.

Management may assign the Company's option to purchase to one or more of the Members. Before assigning the Company's option, Management must first, however, obtain the affirmative consent of a majority of the holders of the remaining Membership Units. When proper consent is obtained, any rights or obligations imposed upon the Company will instead become, by substitution, the rights and obligations of the Members who are assignees.

12. Restrictions on Voting During a Prescribed Option Period.

Neither the transferee of an unauthorized transfer or the Member causing the transfer may vote during the prescribed option period. If the purchase option is timely exercised, they may not vote until the sale is actually closed.

Comment: Section W works well in situations where you have a close-knit group, usually family members. This provision is similar to what would be used in a family limited partnership and limits voluntary and involuntary assignments of membership interest. This provision also adds additional creditor protection by limiting the rights of creditors to become a member. If an outsider acquires an interest, this provision forces that outsider to sell the interest to the LLC or its members on the terms specified. This provision would not be used if the LLC's purpose is to provide

III. CAPITAL CONTRIBUTIONS

A. Initial Contributions.

Contemporaneously with the execution by the Member of this Agreement, each Member must make the Capital Contributions described for that Member in the Members' organizational minutes and as set forth on the attached Schedule A. In exchange for each contribution, the contributing Member will receive a Membership Unit for each dollar value and a fraction of a Membership Unit for each fraction of a dollar value contributed by that Member.

Comment:
TBOC §101.102 notes that a capital contribution is not required to become a member. Because there is no requirement for a contribution, if one is required by agreement the contribution can be nominal. Any agreement for a capital contribution must be in writing and signed by the person making the promise. TBOC §101.151. This may not be waived or modified by the Company Agreement of the LLC.

The TBOC provides a broad list of remedies for a failure to make the capital contribution that are similar to those provided in the TLLCA. These include the right of forfeiture, as well as any other consequence. TBOC §101.153. Consider the type of damages the LLC or its members want to impose for failure to contribute. Determine the impact of consequential damages for a failure to contribute.

If property in kind is to be contributed, a good description of the property is important as well as the terms and conditions of the contribution such as representations as to the nature of the property, liabilities, or obligations relating to the property, along with any proper pro-ration of those obligations or assumption of contracts relating to the property contributed and the "AS IS, WHERE IS" nature of the contribution, if appropriate.

B. Subsequent Contributions.

Without creating any rights in favor of any third party, each Member must contribute to the Company any additional contributions necessary to meet the Company's operating expenses. The Company's operating expenses include its costs, expenses, obligations, and liabilities, including the costs to operate and maintain the Company's assets. The amount of additional contribution the Member will pay will be in accordance with the Member's Percentage Interest. The additional contributions must be paid in cash on or before the date specified, as later described in this Agreement. If the Member has made a Commitment, a Member is not obligated to

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contribute a total amount that, when added to all Capital Contributions the Member previously made, exceeds that Member's Commitment. Management must notify each Member of the need for Capital Contributions when appropriate. The notice must include a statement in reasonable detail of the proposed uses of the Capital Contributions and a date before which the Capital Contributions must be made. The date may be no earlier than the fifth Business Day following each Member's receipt of its notice. In addition, the notice must state the total Capital Contributions to be made by all Members and the percentage of the total Capital Contributions to be made by each Member.

Comment: If additional contributions are to be made, the nature of the contribution, amount, timing, and conditions of the contribution should be set out in the companyaAgreement. Also, as set out above, the remedies and methods to secure the obligations needs to be addressed. These obligations might also be secured by some method and the remedies for the failure to make a contribution should be addressed.

C. No Additional Contributions.

No member will be required to make any Capital Contributions to the Company beyond those described in this Agreement, otherwise agreed to in writing by the Members from whom such additional Capital Contribution is sought, or as may be required by a non-waivable provision of the TBOC.

D. Failure to Contribute.

1. Company's Remedies if Member Does Not Make Required Capital Contribution.

If a Member does not contribute by the time required any portion of a required Capital Contribution, that Member is a "Delinquent Member". On notice to the Delinquent Member, the Company may exercise one or more of the following remedies:

a. Taking any action (including court proceedings) necessary to obtain payment by the Delinquent Member of the portion of the Delinquent Member's Capital Contribution that is in default. In addition, the Company may collect interest on the delinquent amount at the Default Interest Rate from the date the Capital Contribution was due until the date it is made. Any action taken will be at the Delinquent Member's cost and expense.

b. Permitting the other Members (the "Lending Member" whether one or more), to advance the portion of the Delinquent Member's Capital Contribution that is in default. The Lending Member will advance funds in proportion to their Percentage Interest or other percentages as they may agree. Advancing funds by the Lending Member will have the following results:

(1) The sum advanced constitutes a loan from the Lending Member to the Delinquent Member. Additionally, the sum advanced constitutes a Capital Contribution of that sum to the Company by the Delinquent Member in accordance with the applicable provisions of this Agreement.

(2) The principal balance of the loan and its accrued interest, is due on the tenth day after written demand by the Lending Member to the Delinquent Member.

(3) The loan amount bears interest at the Default Interest Rate from the day the advance is made until the date the loan, and accrued interest, is repaid to the Lending Member.

(4) All distributions from the Company that otherwise would be made to the Delinquent Member (whether before or after the Company is wound up) instead will be paid to the Lending Member. The distributions will be paid to the Lending Member until the loan and all accrued interest have been paid in full. The payments will be applied first to accrued interest and then to principal.

(5) The payment of the loan and accrued interest is secured by a security interest in the Delinquent Member's Membership Interest, as more fully set forth in this section.

(6) The Lending Member may take any action (including court proceedings) necessary to obtain payment from the Delinquent Member of the loan and all accrued interest. Any necessary action taken will be at the Delinquent Member's cost and expense.

c. Exercising a secured party's rights under the Texas Uniform Commercial Code.

d. Exercising any other rights and remedies available at law or in equity.

Comment: See §TBOC 101.153.

2. Delinquent Member Grants Security Interest in Membership Interest.

Each Delinquent Member grants to the Company and each Lending Member a security interest in its Membership Interest and its proceeds under the Texas Uniform Commercial Code. The security interest granted secures payment of all Capital Contributions the Delinquent Member has agreed to make and all loans and accrued interest made by Lending Members to the Delinquent Member. On any default in the payment of a Capital Contribution or a loan or its accrued interest, the Company or the Lending Member, as applicable, has all rights and remedies of a secured party under the Texas Uniform Commercial Code. Each Member must execute and deliver to the Company and the Lending Member (as applicable), upon their request, all financing statements and other instruments necessary to effectuate the preceding provisions of this Section III.C. At the option of a Lending Member or the Management, the original or a copy of this Agreement may serve as a financing statement.

Comment: This provision sets out consequences if a member breaches an enforceable promise. In addition, a security interest is provided as a lien against any delinquent member's membership interest. The security interest retained in this company agreement should be constructive notice to any creditor of the priority of the security interest.

E. Return of Contributions.

A Member is not entitled to the return of any part of its Capital Contributions or to be paid interest with respect to either its capital account or its Capital Contributions. An unrepaid Capital Contribution is not the Company's or any Member's liability. A Member is not required to contribute or to lend any cash or property to the Company to enable the Company to return any Member's Capital Contributions. Except as otherwise provided in this Agreement, no Member will be entitled to priority over any other Member with respect to a return of the Member's Capital Contributions.

F. Advances by Members.

If the Company does not have sufficient cash to pay its obligations, any Members may advance all or part of the needed funds to or on the Company's behalf. The advance must have the consent of the contributing Members and the Management. An advance described in this Section III.F constitutes a loan from the Member to the Company, bears interest at the General Interest Rate from the advance date until the payment date, and is not a Capital Contribution.

Comment: The members may want to specify other terms of any such loans, including payment schedule, security, subordination, etc. The members may also prefer to specify that all members have a right of first refusal to make a loan rather than deferring to the "Management's" discretion

G. Capital Accounts.

1. Capital Maintenance Account Rules.

A capital account must be established and maintained for each Member. Each Member's capital account:

a. will be increased by:
   (1) the amount of money contributed by that Member to the Company;
   (2) the fair-market value of property contributed by that Member to the Company (net of liabilities secured by the contributed property that the Company is considered to assume or take subject to under Code section 752); and
   (3) allocations to that Member of Company income and gain (or items thereof), including income and gain exempt from tax and income and gain described in Treas. Reg. §1.704-1(b)(2)(iv)(g), but excluding income and gain described in Treas. Reg. §1.704-1(b)(4)(i); and

b. will be decreased by:
   (1) the amount of money distributed to that Member by the Company;
   (2) the fair-market value of property distributed to that Member by the Company (net of liabilities secured by the distributed property that the Member is considered to assume or take subject to under Code section 752);
   (3) allocations to that Member of Company expenditures described in Code section 705(a)(2)(B); and
   (4) allocations of Company loss and deduction (or items thereof), including loss and deduction described in Treas. Reg. §1.704-1(b)(2)(iv)(g), but excluding items described in the preceding clause and loss or deduction described in Treas. Reg. §1.704-1(b)(4)(i) or §1.704-1(b)(4)(iii).

2. **Adjustments to or Transfer of Capital Accounts.**

The Members' capital accounts must also be maintained and adjusted as permitted by Treas. Reg. §1.704-1(b)(2)(iv)(f) and as required by Treas. Reg. §1.704-1(b)(2)(iv) and 1.704-1(b)(4). The adjustments to the capital accounts include adjustments to reflect the allocations to the Members of depreciation, depletion, amortization, and gain or loss as computed for book purposes rather than the allocation of the corresponding items as computed for tax purposes, as required by Treas. Reg. §1.704-1(b)(2)(iv)(g). A Member that has more than one Membership Interest will have a single capital account. That capital account will reflect all its Membership Interests, regardless of the class of Membership Interests owned by that Member and regardless of the time or manner in which those Membership Interests were acquired. On the transfer of all or part of a Membership Interest, the transferor's capital account that is attributable to the transferred Membership Interest or any part will carry over to the transferee Member in accordance with Treas. Reg. §1.704-1(b)(2)(iv)(l).

Comment:
Capital accounts are typically used to keep track of the economics of the members for both tax and other business purposes.

The TBOC does not provide a definition of capital account for LLCs – this definition is provided to comport with the requirements of the Code. Capital accounts may also be the basis on which distributions are made if the company agreement and LLC's books and records are silent as to distributions. TBOC §101.203.

IV. ALLOCATIONS AND DISTRIBUTIONS

A. Allocations.

Comment: The following provisions pertaining to allocations and distributions may need to be modified to fit individual situations. If distributions do not parallel allocations, the company agreement must address the discrepancy in the capital accounts. Corresponding provisions of a limited partnership may be helpful in drafting the provisions.

Except as may be required by Code section 704(c) and Treas. Reg. §1.704-1(b)(2)(iv)(f)(4), all the Company's

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items of income, gain, loss, deduction, and credit will be allocated among the Members in accordance with their Percentage Interest.

All items of income, gain, loss, deduction, and credit allocable to any Membership Interest that may have been transferred will be allocated between the transferor and the transferee. The allocations will be based on the portion of the calendar year during which each was recognized as owning that Membership Interest. The allocation will not take into consideration the results of Company operations during any particular portion of that calendar year or whether cash distributions were made to the transferor or the transferee during that calendar year. This allocation must, however, be made in accordance with a method permissible under Code section 706 and the regulations under that Code section.

Comment: The following section will be used only if the drafter wishes to provide for special allocations with a preferred return.

B. Special Allocations.

1. Definitions for Tax Allocations.

a. "Adjusted Capital Account" means the Capital Account established and maintained for each Member, as the same is specially computed after giving effect to the following adjustments:
(1) credit to the Member's Capital Account for any amounts that the Member is obligated to restore in accordance with this Agreement or is deemed to be obligated to restore in accordance with Treasury Regulations Sections 1.704-1(b)(2)(ii)(c), 1.704-2(g)(1) and 1.704-2(i)(5); and
(2) debit to the Member's Capital Account the items described in Treasury Regulations Sections 1.704-1(b)(2)(ii)(d)(4), (5), and (6),
The foregoing definition of "Adjusted Capital Account" is intended to comply with the provisions of Treasury Regulations Section 1.704-1(b)(2)(ii)(d) and will be interpreted consistently with that section.

b. "Agreed Value" means, in the case of any contributions or distributions of property, the fair market value of that property, as that fair market value is determined by the Managers using the reasonable method of valuation as they may adopt.

c. "Built-In Gain" means with respect to any Company property:
(1) the excess of the Agreed Value of any Contributed Property over its adjusted basis for U.S. federal income tax purposes as of the time of contribution; and
(2) in the case of any adjustment to the Carrying Value of any Company property in accordance with Section III.G.2 of this Agreement as a result of a contribution of property in exchange for a Common Share, the Unrealized Gain with respect to that property.

d. "Built-In Loss" means with respect to any Company property:
(1) the excess of the adjusted basis for U.S. federal income tax purposes of any Contributed Property over its Agreed Value as of the time of contribution; and
(2) in the case of any adjustment to the Carrying Value of any Company property in accordance with Section III.G.2 of this Agreement as a result of a contribution of property in exchange for a Membership Interest, the Unrealized Loss with respect to that property.

e. "Carrying Value" means:
(1) with respect to any Contributed Property, the Agreed Value of that Contributed Property reduced as of the time of determination by all Depreciation charged to the Capital Accounts with respect to that Contributed Property and an appropriate amount to reflect any sales, retirements or other dispositions of assets included in that Contributed Property; and
(2) with respect to any other Company property, the adjusted basis of that property for U.S. federal income tax purposes as of the time of determination.
The Carrying Values will be further adjusted as provided in Section III.G.2 of this Agreement.

f. "Depreciation" means, for each Taxable Year or other period, an amount equal to the depreciation, amortization (including in accordance with Sections 195, 197, and 709 of the Code) or other cost recovery deduction allowable with respect to an asset for that period for U.S. federal income tax purposes, except that:
(1) with respect to an asset whose Carrying Value differs from its adjusted basis for U.S. federal income tax purposes and which difference is being eliminated by use of the "remedial method" as defined in Treasury Regulations Section 1.704-3(d), Depreciation for that period will be the amount of the book basis recovered for that period under the rules prescribed in Treasury Regulations Section 1.704-3(d)(2); and
(2) with respect to any other asset whose Carrying Value differs from its adjusted tax basis at the beginning of that period, Depreciation will be an amount that bears the same ratio to the beginning Carrying Value as the U.S. federal income tax depreciation, amortization or other cost recovery deduction for that year or other period bears to the beginning adjusted tax basis.
If, however, the U.S. federal income tax depreciation, amortization, or other cost recovery deduction for the Taxable Year or other period is zero, Depreciation will be determined with reference to the beginning Carrying Value using any reasonable method selected by the Managers.

g. "Nonrecourse Deductions" will have the meaning given that term in Treasury Regulations Section 1.704-2(b)(1). The amount of Nonrecourse Deductions for any Taxable Year equals the excess, if any, of the net increase, if any, in the amount of Partnership Minimum

Gain attributable to Nonrecourse Liabilities during the Taxable Year over the aggregate amount of any distributions during the Taxable Year of proceeds of a Nonrecourse Liability that are allocable to an increase in Partnership Minimum Gain attributable to Nonrecourse Liabilities, determined in accordance with the provisions of Treasury Regulations Section 1.704-2(c).

h. “Nonrecourse Liability” will have the meaning given that term in Treasury Regulations Section 1.704-2(b)(3).

i. “Member Minimum Gain” will have the meaning given the term “partner nonrecourse debt minimum gain” set forth in Treasury Regulations Section 1.704-2(i)(2), and will be computed as provided in Treasury Regulations Section 1.704-2(i)(3).

j. “Member Nonrecourse Debt” will have the meaning as that of “Partner Nonrecourse Debt” in Treasury Regulations Section 1.704-2(b)(4).

k. “Member Nonrecourse Deductions” will have the meaning as that of “Partner Nonrecourse Deductions” in Treasury Regulations Section 1.704-2(i). The amount of Member Nonrecourse Deductions with respect to a Member Nonrecourse Debt for any Taxable Year equals the excess, if any, of the net increase, if any, in the amount of Member Minimum Gain attributable to the Member Nonrecourse Debt during the Taxable Year over the aggregate amount of any distributions during the Taxable Year to the Member that bears the economic risk of loss for the Member Nonrecourse Debt to the extent the distributions are from the proceeds of the Member Nonrecourse Debt and are allocable to an increase in Member Minimum Gain attributable to the Member Nonrecourse Debt determined in accordance with Treasury Regulations Section 1.704-2(i).

l. “Company Minimum Gain” will have the meaning as that of “Partnership Minimum Gain” in Treasury Regulations Section 1.704-2(b)(2), and will be computed as provided in Treasury Regulations Section 1.704-2(d).

m. “Profit” and “Loss” means, for each Taxable Year or other period, an amount equal to the Company’s U.S. federal taxable income or loss, respectively, under Section 703(a) of the Code (but including in taxable income or loss, for this purpose, all items of income, gain, loss or deduction required to be stated separately in accordance with Section 702(a) of the Code), with the following adjustments:

(1) any income of the Company exempt from U.S. federal income tax and not otherwise taken into account in computing taxable income or loss will be added to the taxable income or loss;

(2) any expenditures of the Company described in Section 705(a)(2)(B) of the Code (or treated as expenditures described in Section 705(a)(2)(B) of the Code in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv)(i)) and not otherwise taken into account in computing taxable income or loss will be subtracted from such taxable income or loss;

(3) if the Carrying Value of any Company asset is adjusted in accordance with Section III.G of this Agreement, the amount of the adjustment will be taken into account as gain or loss from the disposition of the asset;

(4) gain or loss resulting from any disposition of any asset of the Company with respect to which gain or loss is recognized for U.S. federal income tax purposes will be computed by reference to the Carrying Value of the asset Disposed of, notwithstanding that the adjusted tax basis of the asset differs from its Carrying Value;

(5) in lieu of the depreciation, amortization, and other cost recovery deductions taken into account in computing the taxable income or loss, there will be taken into account Depreciation for such Taxable Year or other period;

(6) to the extent an adjustment to the adjusted tax basis of any Company asset pursuant to Section 734 of the Code is required in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv)(m)(4) to be taken into account in determining Capital Accounts as a result of a distribution other than in liquidation of a Member’s Membership Interest, the amount of the adjustment will be treated either as an item of gain (if the adjustment increases the basis of the asset) or an item of loss (if the adjustment decreases the basis of the asset) from the disposition of the asset;

(7) any fees and other expenses incurred by the Company to promote the sale of (or to sell) a Membership Interest that can neither be deducted nor amortized under Section 709 of the Code will be treated as an item of deduction; and

(8) excluding any items specially allocated under any provision of this Agreement.

n. “Treasury Regulations” means the income tax regulations, including temporary regulations, promulgated under the Code, as those regulations may be amended from time to time. Any reference in this Agreement to a specific section of the Treasury Regulations will include any corresponding provisions of succeeding, similar, substitute, proposed or final Treasury Regulations.

2. Preferred Return Allocation.

The above notwithstanding, Gross Income (including each item of Gross Income), if any, of the Company for each Fiscal Year or other period will be allocated to the Members until the aggregate cumulative amount allocated to them respectively in accordance with this Section equals the Preferred Return distributed to them respectively in accordance with this Agreement. If for any Fiscal Year or other period Gross Income is less than the amount of the cash distributions of the Preferred Return distributed to the Members in accordance with this Agreement, then additional Gross Income in the amount of the shortfall will be allocated to the

Members in the next succeeding, and if necessary, subsequent Fiscal Years pro rata in accordance with the deficiencies until the total cumulative amount allocated to each Partner in accordance with this Section equals the total cumulative amount of the cash distributions of Preferred Return distributed to the Member in accordance with this Agreement for all Fiscal Years.

3. Regulatory Allocations.

Notwithstanding Section IV.A of this Agreement, the following special allocations shall be made in the following order and priority:

a. **Minimum Gain Chargeback.** If there is a net decrease in Company Minimum Gain during any Taxable Year, each Member will be specially allocated items of Company income and gain for the Taxable Year (and, if necessary, subsequent Taxable Years) in proportion to, and to the extent of, an amount equal to the Member's share of the net decrease in Company Minimum Gain determined in accordance with Treasury Regulations Section 1.704-2(g)(2). Allocations in accordance with the previous sentence will be made in proportion to the respective amounts required to be so allocated to each Member in accordance with the previous sentence. The items to be allocated will be determined in accordance with Treasury Regulations Sections 1.704-2(f)(6) and 1.704-2(j)(2). This Section IV.B.3.a is intended to comply with the minimum gain chargeback requirement in Treasury Regulations Section 1.704-2(f) and will be consistently so interpreted.

b. **Member Minimum Gain Chargeback.** If there is a net decrease in Member Minimum Gain attributable to Member Nonrecourse Debt during any Taxable Year, determined in accordance with Treasury Regulations Section 1.704-2(i)(3), then, except as provided in Treasury Regulations Section 1.704-2(i)(4), each Member who has a share of the Member Minimum Gain attributable to the Member Nonrecourse Debt, determined in accordance with Treasury Regulations Section 1.704-2(i)(5), will be allocated items of income and gain for the Taxable Year (and, if necessary, subsequent Taxable Years) in an amount equal to the Member's share of the net decrease in Member Minimum Gain. Allocations in accordance with the previous sentence will be made in proportion to the respective amounts required to be so allocated to each Member in accordance with the previous sentence. The items to be allocated will be determined in accordance with Treasury Regulations Sections 1.704-(i)(4) and 1.704-2(j)(2). This Section IV.B.3.b is intended to comply with the minimum gain chargeback requirement in Treasury Regulations Section 1.704-2(i) and will be consistently so interpreted.

c. **Qualified Income Offset.** If any Member unexpectedly receives any adjustment, allocation or distribution described in Treasury Regulations Section 1.704-1(b)(2)(ii)(d)(4), (5) or (6), the Member will be specially allocated items of income and gain (consisting of a pro rata portion of each item of income and gain) in an amount and in the manner sufficient to eliminate any deficit in the Member's Adjusted Capital Account as quickly as possible; provided, that an allocation in accordance with this Section IV.B.3.c will be made only if and to the extent that the Member would have a deficit in the Member's Adjusted Capital Account after all other allocations provided in this Article IV have been tentatively made as if this Section IV.B.3.c were not a part of this Agreement. This Section IV.B.3.c is intended to be a "qualified income offset" as that term is used in Treasury Regulations Section 1.704-1(b)(2)(ii)(d) and will be consistently so interpreted.

d. **Stop Loss.** No amount of Loss will be allocated to any Member to the extent that the allocation would cause the Member to have a, or increase the amount of an existing, deficit in the Member's Adjusted Capital Account balance at the end of any Taxable Year. All Loss in excess of the limitation set forth in this Section IV.B.3.d will be allocated among the other Members, who have positive Adjusted Capital Account balances, in proportion to their Sharing Ratios until each Member's Adjusted Capital Account balance is reduced to zero. Thereafter, any remaining Loss will be allocated to the Members in proportion to their relative interests in the Company as required by Section 704(b) of the Code.

e. **Member Nonrecourse Deductions.** Any Member Nonrecourse Deductions for any Taxable Year will be specially allocated to the Member who bears the economic risk of loss with respect to the Member Nonrecourse Debt to which the Member Nonrecourse Deductions are attributable in accordance with Treasury Regulations Section 1.704-2(i)(1).

f. **Nonrecourse Deductions.** Nonrecourse Deductions for each Taxable Year will be allocated among the Members in proportion to their Sharing Ratios.

g. **Section 754 Adjustments.** To the extent an adjustment to the adjusted tax basis of any Company property in accordance with Sections 734(b) or 743(b) of the Code is required, in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv)(m), to be taken into account in determining Capital Accounts, the amount of the adjustment to the Capital Accounts will be treated as an item of gain (if the adjustment increases the basis of the property) or loss (if the adjustment decreases the property) and the gain or loss will be specially allocated among the Members in a manner consistent with the manner in which their Capital Accounts are required to be adjusted in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv)(m).

h. **Curative Allocations.** The allocations set forth in Section IV.B of this Agreement are intended to comply with certain requirements of the Treasury Regulations. It is the intent of the Members that, to the extent possible, the allocations required under Section IV.B of this Agreement will be offset by other allocations under Section IV.B of this Agreement or by special allocations of other Company items of income, gain, loss and deduction in accordance with this Section IV.B.3.h (for the current and subsequent Taxable Years if necessary), in whatever manner the Managers reasonably determine appropriate, so that after the offsetting allocations are made, each Member's Capital Account balance is, to the extent possible, equal to the Capital Account balance the Member would have had if the allocations required under Section IV.B of this Agreement were not part of this Agreement and all Company items were allocated in accordance with Section IV.A of this Agreement.

i. **Other Allocation Rules.**

(1) Profit, Loss and other items of income, gain, loss or deduction will be allocated to the Members in accordance with this Article as of the last day of each Taxable Year; provided, that Profit, Loss and the other items will also be allocated at the time as the Carrying Values of the Company's property are adjusted in accordance with the definition of Carrying Value.

(2) For purposes of determining the Profit, Loss or any other items allocable to any period, Profit, Loss and any other like items will be determined on a daily, monthly, or other basis, as determined by the Manager, using any permissible method under Section 706 of the Code and the Treasury Regulations promulgated under that Code section.

(3) The Members are aware of the income tax consequences of the allocations made by this Article and agree to be bound by the provisions of this Article in reporting their shares of Company income and loss for income tax purposes, except to the extent otherwise required by law.

(4) The Company will, except to the extent the item is subject to allocation in accordance with Section IV.B.3.i(5) below, allocate each item of income, gain, loss, deduction, and credit, as determined for U.S. federal income tax purposes, in the same manner as the item was allocated for purposes of maintaining the Members' Capital Accounts.

(5) The Company, for U.S. federal income tax purposes, will allocate items of income, gain, loss, depreciation, cost recovery, and amortization deductions attributable to any Contributed Property with a Built-In Gain or Built-In Loss in accordance with Section 704(c) of the Code using any method provided under the Treasury Regulations that the Managers select. Similar allocations will be made if the Carrying Value of Company properties subject to depreciation, cost recovery, or amortization are adjusted in accordance with this Agreement upon the issuance of Membership Interest for cash or other property. If an existing Member acquires additional Membership Interests, those allocations will apply only to the extent of its additional Membership Interests. No allocation under Section 704(c) of the Code will be charged or credited to a Member's Capital Account[RTF bookmark end: }_Ref147493693.

C. Distributions.

At least once each year, the Management, in their discretion, will determine to what extent (if any) the Company's cash on hand exceeds its current and anticipated needs. Factors they may consider include the Company's operating expenses, debt service, acquisitions, and a reasonable contingency reserve. If an excess exists, the Management will cause the Company to distribute to the Members, in accordance with their Percentage Interest, an amount in cash equal to that excess.

Unless otherwise provided in this Agreement, the Managers, in their sole discretion, may withhold from any distribution of Distributable Cash or other cash or other property to any Member contemplated by this Agreement any amounts due from the member to the Company, or any other Member in connection with the Company's business to the extent not otherwise paid. If any provision of the Code, the Regulations, or state or local law or regulations requires the Company to withhold any tax with respect to a Member's distributive share of Company income, gain loss, deduction, or credit, the Company will withhold the required amount and pay the same over to the taxing authorities as required by such provision. The amount withheld will be deducted from the amount that would otherwise be distributed to that Member, but will be treated as though it had been distributed to the Member with respect to which the Company is required to withhold. If at any time the amount required to be withheld by the Company exceeds the amount of money that would otherwise be distributed to the Member with respect to which the withholding requirement applies, then that Member will make a Capital Contribution to the Company equal to the excess of the amount required to be withheld over the amount, if any, of money that would otherwise be distributed to that Member and that is available to be applied against the withholding requirement. Each of the Members represent that he, she, or it is not aware of any provision of the Code, the Regulations, or state or local law or regulations that currently require withholding of any tax by the company with respect to the Member.

Comment: The benefit of setting a reserve is to retain capital in the LLC to avoid a need for future capital calls from the members. This may be particularly important where there is a question as to the ability of a member to perform. Reserves can be addressed in a number of ways. This language leaves the decision to the manager with some options. This can also be set with built in formulas, such as a multiple of the monthly operating expenses or a set dollar amount, or a multiple of a list of certain fixed obligations such as debt services, taxes, insurance, or any combination. In a seasonal business, this might also take into consideration seasonal needs of the business.

The need to maintain a reserve is arguably greater if the LLC does not provide for additional capital contributions. If you represent a member who does not control management decisions, you may want some restrictions on the ability of the managers to establish a reserve. Some examples of restrictions include linking the reserve to actual binding commitments that exist on the date the reserve is established that will come due within a specified period of time, capping the reserve at a specified percentage of cash flow for some period, or relying upon a multiple of monthly operating expressed with a capital reserve budge

From time to time the Management also may cause the Company's property other than cash to be distributed to the Members. The distribution must be made in accordance with their Percentage Interest and may be made subject to existing liabilities and obligations. Before distribution is made, the Members' capital accounts will be adjusted as provided in Treas. Reg. §1.704-1(b)(2)(iv)(f).

If Management elects, distributions of profits, losses, or return of capital may be withheld to accomplish the Company's business purposes as may be established from time to time.

Comment:
This provision may be modified to fit the business objectives of any LLC and its members. The last provision may be helpful to a member whose economic rights of the member's membership interest have been subjected to a charging order by a judgment creditor. TBOC §101.204 allows for distributions only when the "governing authority" declares them, whereas the TLLCA provided that distributions would be as set out in the company agreement.

Unless an election has been made to check the box for federal income taxes and to treat the entity differently, LLCs are pass-through entities for federal income tax purposes. There may be taxable income allocated to a member without a corresponding distribution. The members may want to consider a special "tax" distribution that addresses this concern.

Distributions may vary for each transaction. In certain cases, they may be as set out above; in others, they may provide a priority return to certain members before others participate, or be distributed according to a member's percentage interest. Careful attention should be given to these provisions to confirm that they reflect your client's intent. In certain circumstances, it may be appropriate to even make a distinction as to the character of the "Distributable Cash" relating to the distribution, such as an arrangement which distributes "Distributable Cash" (e.g. distributions from capital transactions) made in accordance first on the basis of "Unreturned Capital". By way of example:

"a) First, to each of the Members in an amount equal to the "tax liability" attributable to the income allocated to the Member under Article IV, which tax liability shall be calculated by applying to that income, the highest marginal tax rate applicable to income of the character allocated to any one Member as reported by the Company for Federal Income Tax purposes;

"b) Second, an amount equal to all accrued but unpaid Preferred Return shall be distributed to the Members in proportion to amount of the Preferred Return which has been calculated upon their Unreturned Capital;

"c) Third, an amount equal to all Unreturned Capital Contribution shall be distributed to the Members; and

"d) Fourth, any remaining Distributable Cash Flow shall be distributed to the Members pro rata in accordance with their Percentage Interest."

Members may want to consider requiring distributions on a regular basis.

Distributions have been structured based upon Percentage Interest not Units. Separating "Percentage Interest" from "Units" will allow for voting to remain the same (on a per unit basis) while the allocation of "Profits and Losses" and the methods of distributions are based upon the "Percentage Interest" (which may vary from time to time depending on the terms of the company agreement).

The TLLCA provided that the distributions would be as set out in the company agreement. TBOC §101.204 provides that, absent agreement to the contrary in the company agreement, it will be determined by the governing authority.

V. MANAGEMENT

Comment: As noted above, management under the TBOC rests with the "governing authority". The certificate of formation must state if the LLC will be managed by members or managers. Consider modifying the list of specific management actions below to fit the client's situation. The particular enumerated powers listed here have been included for the convenience of third parties who may look to this agreement to determine a manager's authority.

A. **Management by Managers.**

Comment: In accordance with TBOC §101.252, where a certificate of formation indicates an LLC will be managed by managers, the managers have the right to manage and conduct the business of the LLC.

1. **Management of Company Affairs.**

The Company will be managed by Managers in the manner setout in this Agreement. The Company will have one or more Managers who will have the full, complete, and exclusive authority to manage and control the business, affairs, and properties of the Company; to make all decisions regarding those matters; and to perform any and all other acts or activities customary or incident to the management of the Company's business, all subject to any restrictions imposed by applicable law or expressly imposed by this Agreement.

Comment: This structure sets out a classic limited partnership management structure with "Management" acting like a general partner and the members acting like limited partners. This may not be the desired structure. If the "Management" is intended to be nothing more than representatives of the members much of this language may be unnecessary, except to state where majority will rule and where a "Required Interest" may be required. The parties might also consider if the structure should be more like a corporate structure with the "Management" taking on the traditional role of the board of directors with all of the powers to operate the LLC, including the delegation of authority to Officers they may elect or appoint, from time to time, such as a chief executive officer, president, vice president, secretary, treasurer, or any other officer positions as they may create.

2. **Powers of Managers.**

Except for situations in which Member approval is required by this Agreement or by nonwaivable provisions of applicable law, and subject to the provisions of Section V.B, the Managers may make all decisions and take all actions for the Company, including the following:

a. entering into and performing contracts, agreements, and other undertakings binding the Company that may be necessary to further the Company's purposes;
b. opening and maintaining bank and investment accounts and arrangements, drawing checks and other orders for the payment of money, and designating individuals with authority to sign or give instructions with respect to those accounts and arrangements;
c. maintaining the Company's assets in good order;
d. collecting sums due the Company, settling claims, prosecuting and defending lawsuits, and handling matters with governmental agencies;
e. to the extent that Company funds are available, paying the Company's debts and obligations;
f. acquiring, utilizing for Company purposes, and disposing of any Company asset;
g. borrowing money or otherwise committing the Company's credit for Company activities and voluntary prepayments or debt extensions;
h. selecting, removing, and changing the authority and responsibility of lawyers, accountants, and other advisers and consultants;
i. obtaining insurance for the Company, including general liability, bodily injury, and property damage insurance, in amounts that are available and that are generally carried by similar entities; and
j. determining distributions of Company cash and other property
k. exercising the voting rights of the Company on account of its ownership in any other Person; provided, however, that if the action to be voted on is one that, if taken by the Company itself, would require the approval of the Members, such approval will be required before the Managers exercise such voting rights to approve the action.

Comment: The need for these specific powers has generally been justified on the basis of convenience, so that persons looking to the LLC for authority for certain major acts would know these actions could be taken without the need for member approval and would not have to rely upon the general statement of authority set out in the initial section of the company agreement. This may not be necessary but seems to remain as a personal preference for some to make clean this authority. Also consider modifying the list to add actions specific to the particular transaction.

3. **Restrictions on Managers' Powers.**

The Managers may not cause the Company to do any of the following without complying with the applicable requirements set forth below:

a. Sell, lease, exchange or otherwise dispose of all or substantially all the Company's assets (with or without good will), other than in the regular course of the Company's business, without obtaining the approval of a Required Interest. The Managers may, however, by pledge, mortgage, deed of trust, or trust indenture, encumber all or substantially all the Company's assets in the regular course of business without consent.
b. Be a party to a merger, exchange, or acquisition without complying with the applicable procedures of the TLLCL.
c. Amend or restate the Certificate of Formation without complying with the applicable procedures of the TLLCL.
d. Do any act in violation of this Agreement.
e. Admit a Person as a Member except as otherwise expressly permitted by this Agreement.
f. Possess Company property or assign its rights in Company property, other than for a Company purpose.
g. Cause the Company to hire or retain any Person who is a partner or an Affiliate of a Member to provide any services or products for sums that are greater than the fair market value for similar products or services performed on a substantially similar basis.

4. **Reliance on Authority**

In its dealings with the Company, a third party may rely on the authority of the Management to bind the Company without reviewing the provisions of this Agreement or confirming compliance with the provisions of this Agreement.

Comment: This provision is intended to give comfort to a third party relying on the authority of the "Management" but may be detrimental to the members. See TBOC §101.254, which provides authority as well.

B. Actions by Managers; Committees; Delegation of Authority and Duties.

1. **Standards of Performance.**

Except as otherwise provided in this Agreement, the Management will perform its duties with respect to the Company and will devote such time and effort to the Company's business and operations as the Management believes is reasonably necessary to manage the Company's affairs prudently but only to the extent that the Company has the funds available to permit the Managers to perform such duties. The Managers and their respective affiliates and all officers, directors, employees, and agents acting in that capacity, will not be liable to the Company or its Members for any losses sustained or liabilities incurred as a result of any act or omission of such Person if they acted (on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the Company) (in good faith and with fair dealing toward the Company and in a manner it believed to be in, or not opposed to, the Company's interests). If a question arises as to a Manager regarding the Manager's liability in connection with the Manager's duties under the Agreement to the Company or another Member of the Company, the Managers will have no more duty or liability in connection with those duties than if the Managers were acting as a member of the board of directors of a Texas corporation that was carrying out the duties and responsibilities of the corporation.

Comment: A standard of performance by the managers is not required. The members who are not managers may, however, desire to have a statement included in the company agreement that addresses the responsibility of the managers. If a standard is set out in the company agreement, the provision should be coordinated with the provisions governing indemnification of the managers to avoid inconsistencies results. TBOC §101.401 makes clear that the company agreement may expand or restrict any duties, including fiduciary duties that may be owned by a member, officer, or other person to the LLC.

2. **Ways Through Which Managers May Act.**

In managing the Company's business and affairs and exercising its powers, the Managers must act:

a. collectively through meetings and written consents consistent as may be provided or limited in other provisions of this Agreement;
b. through committees pursuant to Subsection V.B.3; and
c. through Managers to whom authority and duties have been delegated pursuant to Subsection V.B.4.

3. **Committees.**

The Managers may, from time to time, designate one or more committees, each of which will be comprised of one or more Managers. The committee, to the extent provided in a resolution, the Certificate of Formation, or this Agreement, will have and may exercise all the authority of the Managers, subject to the limitations set forth in the TLLCL. At every committee meeting, the presence of a majority of all its members will constitute a quorum. The affirmative vote of a majority of the members present will be necessary for adopting any resolution. The Managers may dissolve any committee at any time, unless otherwise provided in the Certificate of Formation or this Agreement.

4. **Officers.**

a. **Appointment of Officers.** The Management may designate one or more Persons who may or may not be Managers or Members to be officers of the Company. No officer need be a Texas resident or a Member. Any officers designated will have the authority and perform the duties as the Management may delegate to them. The Management may assign titles to particular officers. Unless the Management decide otherwise, if the title is one commonly used for officers of a business corporation formed under the TBOC, assigning the title constitutes delegation to the officer of the authority and duties normally associated with that office. Each officer will hold office until the officer's successor is designated and qualifies, the officer dies, the officer resigns, or the officer is removed in the manner later provided in this Agreement. Any number of offices may be held by the same Person. The salaries or other compensation, if any, of the Company's officers and agents will be fixed by the Managers.
b. **Resignation or Removal of Officer.** Any officer may resign as an officer at any time. The resignation must be made in writing and will take effect at the time specified in the written resignation. If no time is specified, the resignation will take effect at the time the Management receive it. Accepting a resignation is not necessary to make it effective, unless the resignation expressly provides that it is necessary. The Management may remove any officer as an officer, with or without cause. The removal, however, will be without prejudice to the removed Person's contract rights, if any. Designating an officer will not of itself create contract rights. Any vacancy occurring in any Company office may be filled by Management.

Comment: TBOC §3.104 (a) does not require removal to be in the best interest of the entity and applies to all entities, including LLCs.

c. **Third Parties.** Any Person dealing with the

Company, other than a Member, may rely on the authority of any Manager or officer in taking any action in the Company's name. They will not need to inquire into the provisions of this Agreement or with their compliance, regardless of whether the action actually is taken in accordance with this Agreement.

5. Voting Rights of a Manager.

Each Manager will have one vote on each matter that is presented to the Managers.

Comment:
The parties will need to decide if the LLC's management structure is intended to follow the "partnership" model where each manager is a representative of a member of the same voting rights of the member they represent or elected as a management team, much like a board of directors with voting rights that do not correlate to the membership voting rights of any one Member.

Alternative: Partnership structure – "Each Manager will have the number of votes on any matters presented to or to be determined by the Managers under this Agreement which correlates to the number of Units held by the

C. Powers of Managers.

Every Manager is an agent of this Company for the purpose of its business. The act of a Manager, including executing in the Company's name any instrument for apparently carrying on in the usual way the Company's business, binds the Company. The Company is not, however, bound by a Manager's act if the Manager acting lacks the authority to act for this Company and the person with whom the Manager is dealing has knowledge of the fact that the Manager does not have the authority.

D. Quorum; Majority Vote.

At all Manager meetings a majority of the Managers will constitute a quorum for transacting business unless a greater number is required by the TLLCL, the Certificate of Formation, or this Agreement. The act by a majority of the Managers present at any meeting at which a quorum is present will be the Managers' act unless the act of a greater number is required by the TLLCL, the Certificate of Formation, or this Agreement. If a quorum is not present at any Manager meeting, the Managers present at the meeting may adjourn the meeting, without notice, other than announcement at the meeting, until a quorum is present.

Comment: Note that the decisions of the managers may be based upon a majority of those present at the meeting at which a quorum is present. This may be less than a

E. Interested Persons and Independent Investments.

1. Interested Persons.

Comment: TBOC §101.255 governs interested-persons transactions if it is not addressed wholly in the company agreement. Parties will want to pay particular attention to this section and verify their intent is captured.

a. **Conflicts of Interests.** For purposes of this section, an "Interested Person" is any Member, Manager, or officer of the Company who acts as an agent on the Company's behalf and who may have a conflict of interest with the Company. If the provisions set forth in the three paragraphs following this paragraph are true, no contract or transaction will be void or voidable solely because:

(1) it is between this Company and any Interested Person;

(2) it is between this Company and any other limited liability company, corporation, partnership, association, or other organization in which any of its Interested Persons are associated or have a financial interest;

(3) the Interested Person associated with the other entity is present at or participates in the meeting or committee that authorizes the contract or transaction; or

(4) the Interested Persons' votes are counted for the purpose of attending or participating in that meeting.

The material facts as to the relationship or interest and as to the contract or transaction must be disclosed or known to the Company. The Company must authorize the contract or transaction in good faith by the affirmative vote of the disinterested Management, even though the Persons constituting the disinterested Management is less than a quorum.

The material facts as to the relationship or interest and as to the contract or transaction must be disclosed or known to the Persons entitled to vote on the matter. The contract or transaction must be specifically approved in good faith by the Management.

The contract or transaction must be fair as to this Company as of the time it is approved by Management.

b. **Interested Persons May be Counted in Determining Quorum.** Interested Persons may be counted in determining the presence of a quorum at a meeting that authorizes the contract or transaction.

c. **Non-Exclusive.** This provision may not be construed to invalidate any contract or transaction that would be valid in the absence of this provision.

Comment: TBOC §101.255 generally governs contracts with parties related to the LLC to the extent not addressed by the company agreement. The parties should consider how strict the policy of the LLC should be for contracts with related parties and set out these terms in the company

2. **Members' Personal Investments.**
It is expressly understood that each Member may invest their personal assets for their own account. They may conduct their personal affairs and investments without regard to whether they constitute a Company "opportunity."

3. **Members May Engage in Independent Business Ventures.**

A Member may engage in or possess an interest in any other business or venture of any nature and description. They may act independently or with others, including ones in competition with the Company, with no obligation to offer to the Company or any other Member the right to participate. Neither the Company nor its Members have by virtue of this Agreement any right in the independent venture or its income or profits.

F. Compensation for Management.

The Management must diligently and faithfully devote the time to the Company's management necessary to serve the Company's purposes. They will perform all their duties in accordance with this Agreement and the TLLCL. Each Person participating in Management or providing services to the Company may be reasonably compensated for services rendered to the Company. This compensation will be a guaranteed payment. Additionally, they will be reimbursed all reasonable and necessary business expenses incurred in the Company's administration. A Required Interest may adjust the compensation based upon performance and dedication of time to the Company's business. If the Company's cash flow is insufficient to pay the compensation, the unpaid portion of the compensation may be deferred and bear interest at the Default Interest Rate. Payments for services rendered to the Company will not be a return on invested capital, but will be paid as compensation for services rendered. Reasonable compensation must comply with Code section 704(e), if applicable, and will be measured by the time required in the Company's administration, the value of property under the Management's administration, and the responsibilities assumed in the discharge of the duties of office.

Comment: If the managers are to receive compensation, the company agreement should expressly provide for the amount or method for calculating the amount and the timing and conditions as to payment. There are several methods by which compensation can be computed. In some cases the fee might be fixed, a percentage of the assets under management, a percentage of the gross income or net income, or incentive based. If the fee structure is complex, it may not be appropriate to set it out as a simple definition, but it might be described in the body of the company agreement in necessary detail.

G. Number and Term of Office.

The number of Managers will be the number set forth in the Certificate of Formation. Each Manager will continue as a manager until the Manager's earlier death, winding up, bankruptcy, resignation, or removal. Managers may or may not be Members. The number of Managers may be increase or decreased from time to time by amendments to this Agreement only with the vote of the Required Interest, but no decrease will have the effect of shortening the terms of any incumbent Manager. Any Manager's position to be filled by reason of an increase in the number of Managers will be filled by election of a Required Interest.

H. Classification of Managers.

This Agreement may provide that the Managers will be divided into either two or three classes. Dividing the Managers into classes must be approved by a Required Interest. Each class must be as nearly equal in number as possible. The office terms for the first class of Managers will expire at the first annual Members meeting after their election. The office terms for the second class of Managers will expire at the second annual meeting after their election. And the office terms for the third class of Managers, if any, will expire at the third annual meeting after their election. If this classification of Managers is implemented, the whole number of the Company's Managers need not be elected annually. In addition, at each annual meeting after the classification, the number of Managers equal to the number of the class whose term expires at the time of the meeting will be elected to hold office until the second succeeding annual meeting, if there be two classes, or until the third succeeding annual meeting, if there be three classes.

I. Election.

Each manager will be elected by the vote of those Members holding a majority of the Membership Units, represented in person or by proxy, at a meeting of Members at which a quorum is present.

J. Removal.

Any Manager may be removed, with or without cause, by a Required Interest. The vacancy caused by the removal may be filled by a Required Interest.

K. Resignations.

Any Manager may resign at any time. The resignation must be made in writing and will take effect at the time specified in the written resignation. If no time is specified, the resignation will be effective at the time the Management receives it. Accepting a resignation is not necessary to make it effective unless the resignation expressly provides that it is necessary.

L. Vacancies.

Any vacancy occurring in the Managers may be filled by a Required Interest. A Manager appointed to fill a vacancy will serve in place of the Manager's predecessor.

M. Place and Manner of Meetings.

Manager Meetings, regular or special, may be held either within or without Texas. Managers may participate in the meetings by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other. Participation in a meeting as provided in this Section V.M will constitute presence in person at the meeting, except where a person participates in the meeting solely to object that the meeting is not lawfully called or convened.

N. Regular Manager Meeting.

A regular Manager meeting may be held at the time determined by resolution of the Management.

O. Special Meeting of Managers.

Any Manager may call a special Manager meeting. The special meeting will be held at the time specified in the meeting notice. Except as otherwise expressly provided by the TLLCL, the Certificate of Formation, or this Agreement, neither the business to be transacted at, nor the purpose of, any special meeting need be specified in a notice or waiver of notice.

P. Notice of Manager Meetings.

All Manager meetings will be held upon five-days' written notice. The notice must state the meeting date, place, and hour. The notice must be delivered to each Manager, either personally or by mail. If all the Managers execute a waiver of notice of the meeting time and place, no meeting notice will be required. The meeting will be held at the time and place specified in the waiver of notice. Attendance of Managers at any meeting will constitute a waiver of notice of the meeting, except where the Managers attend a meeting solely to object that the meeting is not lawfully called or convened.

Comment: TBOC §101.352 changes the default rule of notice requirements for manager meetings. Special attention should be paid to this section if the company agreement does not specifically detail notice requirements. Notice must state the purpose of specially called meetings, unless the company agreement provides otherwise.

Q. Minutes of Meeting.

The Managers must keep regular Minutes of its proceedings. The Minutes must be placed in the records of the Company.

R. Action Without Meeting.

Any action required by the TLLCL or that may be taken at a Manager meeting may be taken without a meeting if those Mangers whose consent is necessary to take the action give their written consent. The consent will have the same force and effect as a unanimous vote at a meeting. For purposes of this section, a telegram, telex, cablegram, or similar transmission by a Person or a photographic, photostatic, facsimile, or similar reproductions of a writing signed by a Person will be regarded as signed by that Person. In any request for consent or approval from another Manager, the requesting Manager or Managers may specify a response period, ending no earlier than the fifth day following the date on which the Manager whose consent or approval is sought receives the request. If the receiving Manager does not respond by the end of this period, it will be deemed to have not consented to or approved the action set forth in the request. The signed consent or a signed copy must be placed in the Company records.

S. Approval or Ratification of Acts or Contracts by Members.

The Managers may submit to the Members, for their approval, any act or contract, which must be approved by a Required Interest to be valid or binding.

T. Waiver of Liability for Certain Actions.

A Manager or officer, director, or employee will be liable, responsible, or accountable to the Company in damages or otherwise for any act or omission performed or omitted by the Manager in connection with the Manager's acts carried out on behalf of the Company, specifically including the person's sole, partial, or concurrent negligence; provided, however, the Manager or officer, director, or employee will be liable for any act of fraud, willful misconduct, or gross negligence conducted towards the Company.

U. Proxies

Managers are entitled to vote by and through a Person holding valid written proxy. A telegram, telex, cablegram, or similar transmission by the Manager, or a photographic, photostatic, facsimile, e-mail, or similar reproduction of a writing executed by the Manager, will be treated as an execution in writing for the purposes of this Agreement. No proxy will be valid after 11 months from the date of its execution unless otherwise provided in the proxy. Each proxy will be revocable unless expressly provided in the proxy to be irrevocable and unless otherwise made irrevocable by law. Each proxy will be filed with the Secretary of the Company before the time of the meeting to which the proxy applies.

Comment: This is a new right granted to managers under TBOC §101.357. Consider whether it would be preferable to prohibit the use of proxies by managers.

VI. INDEMNIFICATION

A. Parties Indemnified.

The Company agrees to indemnify, defend, and hold harmless each of the following:

- The Members, Managers, and officers of the Company, as well as their officers, managers, members, partners, owners, employees, and agents (the "Indemnified Person"), if any, from and against all Claims they may incur as a result of having been, being, or threatened to be made a named defendant or respondent in a proceeding because the Indemnified Person is or was a Member, Manager, or officer in the Company or is performing or had performed the obligations of the Member, Manager, or officer with respect to the Company, specifically including claims based on or arising from the Indemnified Person's sole, partial, or concurrent negligence, but excluding any items incurred as a result of acts of gross negligence or willful or intentional acts against the Company.
- Each Indemnified Person from and against all Claims the Person may incur as a result of appearing as a witness or other participation in a proceeding that involves or affects the Company.
- Each Indemnified Person from and against all Claims the Person may incur as a result of hav-

ing performed or performing services for the Company, specifically including claims based on or arising from the Indemnified Person's sole, partial, or concurrent negligence.

B. Right to be Reimbursed.

The rights of an Indemnified Person under this Article VI include the right to be paid or reimbursed by the Company for reasonable expenses incurred in defending any proceeding in advance of its final disposition.

C. If Claim for Indemnification Is Not Paid In Full.

If a claim for indemnification or advancement of expenses under this Article VI is not paid in full by the Company within 90 days after a written claim has been received by the Company, the Person seeking a remedy under this Article VI may at any time thereafter bring suit against the Company to recover the unpaid amount of the claim, and if successful in whole or in part, the Person seeking a remedy under this Article VI will also be entitled to be paid the expenses of prosecuting the claim.

D. Rights Survive Termination of Status as an Indemnified Person.

The right of any Indemnified Person under this Article VI will survive the termination of that Person's status as an Indemnified Person, the termination of this Agreement, and the winding up and termination of the Company.

E. In the Event of Death.

In the event of the death of a Person seeking a remedy under this Article VI, the right under this Article VI will inure to the benefit of the Person's heirs, executors, administrators, and personal representatives.

F. Rights Not Exclusive.

The rights conferred in this Article VI will not be exclusive of any other right that a Person seeking a remedy under this Article VI may have or later acquire under any statute or resolution of Members or Managers' agreement or otherwise.

Comment:
Certain rights to indemnification for LLCs are governed by Title 1, Chapter 8, of the TBOC. LLCs are not constrained by limits that might otherwise apply to corporations. This duty to indemnify has been drafted in a manner that is expansive.

If you represent a member who is not a manger, you may want to consider limiting the obligations of the LLC to indemnify the managers, as contemplated by TBOC

VII. CERTIFICATES OF OWNERSHIP INTEREST

A. Issuing Certificates of Ownership Interest.

The Company has the option to issue certificates of ownership interest in a form determined by the Company representing all Membership Units to which Members are entitled. If the Company exercises this option, certificates in the form determined by the Company shall be delivered representing all Membership Units to which Members are entitled. The certificates will be consecutively numbered and will be entered in the Company's books as they are issued. Each certificate will state on its face the holder's name, the class of membership, the number of Membership Units, and other matters required by the TLLCL or that Management may deem appropriate. They must be signed by a Company Manager or officer.

B. Replacement of Lost or Destroyed Certificate of Ownership Interest.

The Management may direct a new certificate of ownership interest to be issued in place of any certificate alleged to have been lost or destroyed. The holder (or the holder's authorized legal representative) of the lost or destroyed certificate must sign an affidavit to the fact that the certificate of ownership interest is lost or destroyed.

C. Transfer of Membership Interest.

Before a certificate of ownership interest may be transferred, a Member or assignee must comply with the requirements of a Disposition of Membership Interest. Additionally, the certificate must be endorsed and accompanied by proper evidence of succession, assignment, authority to transfer, and necessary consents to transfer. Once these requirements have been met and the certificate of ownership interest is surrendered for transfer to the Company or its transfer agent, the Company must issue a new certificate to the person entitled to the new certificate, cancel the old certificate, and record the transaction upon its books.

VIII. TAXES

A. Tax Returns.

The tax-matters partner as defined in Section VIII.C, must have prepared and file any necessary federal and state income-tax returns for the Company. Additionally, the tax-matters partner must make the elections described in Section VIII.B. Each Member must furnish to the tax-matters partner all pertinent information in the Member's possession relating to Company operations necessary to enable the Company's income-tax returns to be prepared and filed.

B. Tax Elections.

Neither the Company nor any Member or Manager may make an election for the Company to be excluded from the application of the provisions of Subchapter K of Chapter I of Subtitle A of the Code or any similar provisions of applicable state law. Nor may this Agreement be construed to sanction or approve that type election. The tax-matters partner must make the following elections on the appropriate tax returns:

- to adopt the calendar year as the Company's fiscal year;
- to adopt the cash method of accounting and to keep the Company's books and records on the income-tax method;
- to elect, on any Member's written request, to adjust the basis of Company properties in accordance with Code section 754 if:
    - a distribution of Company property as

  - described in Code section 734 occurs; or
  - a transfer of a Membership Interest as described in Code section 743 occurs;
- to elect to amortize the Company's organizational and start-up expenses under Code section 195 ratably over a period of 60 months as permitted by Code section 709(b); and
- any other election the tax-matters partner may deem appropriate and in the Members' best interests.

C. Tax-Matters Partner.

A majority of the Managers who are Members must designate one Manager that is a Member to be the "tax-matters partner" of the Company in accordance with Code section 6231(a)(7). If there is no Manager that is a Member, the tax-matters partner will be a Member that is designated as the tax-matters partner by a Required Interest. The tax-matters partner must take the necessary action to cause each other Member to become a "notice partner" within the meaning of Code section 6223. The tax-matters partner must give prompt notice to all Members of all significant matters or communications it receives in its capacity as tax-matters partner. The tax-matters partner may not take any action contemplated by Code sections 6222 through 6232 without the consent of a Required Interest.

D. State, Local, or Foreign Income or Franchise Taxes.

If state or foreign income or franchise taxes become applicable to the Company, the principles and procedures of this Article VIII will apply to those taxes. References to the Code or Treasury Regulations will be deemed to refer to corresponding provisions that may become applicable under state, local, or foreign income or franchise tax statutes and regulations.

Comment: Article VIII of this agreement is included to make clear who will be making tax elections, who will be responsible for preparing and executing federal and state income-tax returns, and who will be dealing with the IRS.

IX. NOTICE

A. Method.

If the TLLCL, the Certificate of Formation, or this Agreement requires a notice to be given to any Person, and no provision is made as to how the notice must be given, it may not be construed to mean personal notice. The notice must be given in writing or in any other method permitted by law. Ways notice may be given to Persons include the following:

1. **By Mail.**
   If mailed, the notice must be postage prepaid and addressed to the Person at the address appearing on the Company's books. Any notice required or permitted to be given by mail will be deemed given at the time it is deposited in the United States mails.

2. **By Telegram.**
   If sent by telegram, the notice must be prepaid and will be deemed to have been given when the telegram is delivered to the telegraph company.

3. **By Facsimile.**
   If given by facsimile, the notice must be addressed to the Person at the facsimile address appearing on the Company's books, which Person consents to notice by facsimile by the signing of this Agreement. Any notice required or permitted to be given by facsimile will be deemed given when transmitted.

4. **By Email.**
   If emailed, the notice must be addressed to the Person at the email address appearing on the Company's books, which Person consents to notice by email by the signing of this Agreement. Any notice required or permitted to be given by email will be deemed given when transmitted.

B. Waiver.

If the TLLCL, the Certificate of Formation or this Agreement requires notice to be given, a waiver of the notice in writing will be equivalent to the giving of the notice. The waiver must be signed by the Persons entitled to the notice and will be valid whether it is signed before or after the time stated in the notice. Attendance of a Person at a meeting constitutes a waiver of notice of the meeting, except where a Person attends the meeting solely to object that the meeting is not lawfully called or convened.

X. BANKRUPTCY OF A MEMBER

Subject to Section XI.A.3, if any Member becomes a Bankrupt Member, the Company has the option to purchase the Bankrupt Member's Membership Interest. The Bankrupt Member or its representative must sell its Membership Interest to the Company if the Company exercises this option to purchase. The Company may exercise its option to purchase by notifying the Bankrupt Member (or its representative) before the 180th day after receiving notice of the event causing the Member to become a Bankrupt Member. The purchase price must be an amount equal to the fair-market value of the Bankrupt Member's Membership Interest. The fair-market value of the Bankrupt Member's Membership Interest will be determined by agreement by the Bankrupt Member (or its representative) and Management. If there is no agreement by the 30th day after the option is exercised, either party, by notice to the other, may require that the fair-market value be determined by an appraiser. The appraiser must be an independent appraiser and must be specified in that notice. A Person receiving the notice has ten days from its receipt to object to the appraiser designated in the notice. If an objection is made and the parties fail to agree on an appraiser, either party may petition the United States District Judge, senior in service for the District or Division, to designate an appraiser. The determination of the appraiser, however designated, is final and binding on all parties. The Bankrupt Member and the Company must each pay one-half the appraisal costs. The purchaser may pay the fair-market value in four equal cash installments. The first installment will be due on closing. The remaining installments (together with accrued interest at the General Interest Rate) will be due on each of the first three anniversaries of the closing. The purchase price paid to the Bankrupt Member or its representative in accordance with this Article X is in complete liquidation and satisfaction of all the rights and interests of the Bankrupt Member and its representative (and of all Persons claiming by, through, or under the Bankrupt Member and its representative). This liquidation and satisfaction of all rights and interests includes any Membership Interest, any rights in specific Company property, and any rights against the Company and (insofar as the Company's affairs are concerned) against the Members. It constitutes a compromise to which all Members have agreed pursuant to Section 101.154 of the TLLCL.

XI. WINDING UP and DISTRIBUTION OF ASSETS

A. Winding Up.

The Company's affairs will be wound up on the first to occur of the following:

1. **The written consent of all Members.**
2. **The period fixed in the Certificate of Formation for the Company's duration expires.**
3. **Entry of a judicial decree of winding up of the Company under Section 11.314(2) of the TLLCL.**

Subject to Section 11.056 of the TLLCL, the Company will not, however, wind up its affairs under any other provision of Section 11.051 of the TLLC not stated in this Section XI.A.

> **Comment:** TBOC §11.052 does not require a certain means for such notice, whereas the TLLCA required notice via registered or certified mail. This means notice can be provided electronically.

B. Liquidation and Termination.

1. Liquidating Agent.

Upon an event requiring the winding up of the Company, the Management must act as Liquidating Agent or may appoint one or more Members as Liquidating Agent. The Liquidating Agent must proceed diligently to wind up the Company's affairs and make final distributions as provided in this Agreement and the TLLCL. Liquidation costs will be borne by the Company. Until final distribution, the Liquidating Agent must continue to operate the Company properties with all of the Management's power and authority. The steps to be accomplished by the Liquidating Agent are as follows:

a. As promptly as possible after an event requiring the winding up of the Company and again after final liquidation, the Liquidating Agent must have a proper accounting prepared of the Company's assets, liabilities, and operations. The accounting must be prepared by a recognized firm of certified public accountants. It must be through the last day of the calendar month in which the date of the event requiring the winding up of the Company occurs or the final liquidation is completed, as applicable.

b. The Liquidating Agent must mail notice to each known creditor of and claimant against the Company in the manner described in Section 11.052 of the TLLCL.

> **Comment:** The mere occurrence of an event of winding up does not "terminate" the LLC. The following provisions cover what needs to be done to comply with the TBOC.

c. The Liquidating Agent must pay, satisfy, or discharge from Company funds all the Company's debts, liabilities, and obligations. The Company's obligations the Liquidating Agent must pay include all expenses incurred in liquidation and any advances described in Section III.F. If a debt, liability, or obligation is not paid, the Liquidating Agent must make adequate provision to pay and discharge it. Adequate provision includes establishing a cash escrow fund for contingent liabilities in the amount and for the term the Liquidating Agent reasonably determines.

d. All the Company's remaining assets will be distributed to the Members as follows:

(1) The Liquidating Agent may sell any or all Company property, including to Members. Any resulting gain or loss from each sale will be computed and allocated to the Members' capital accounts.

(2) With respect to all Company property that has not been sold, the fair-market value of that property must be determined. The Member's capital accounts must be adjusted to reflect the unrealized income, gain, loss, and deduction inherent in the Company's property that has not been previously reflected in the capital accounts. The adjustment to the capital accounts will be allocated among the Members as if there were a taxable disposition of that property for the fair-market value of that property on the distribution date.

(3) Company property will be distributed among the Members in accordance with the Members' positive capital account balances. The capital account balances are determined after taking into account all capital account adjustments for the Company's taxable year during which the Company's liquidation occurs (other than those made because of this clause). Those distributions will be made by the end of the Company's taxable year during which the Company's liquidation occurs (or, if later, 90 days after the liquidation date).

2. Distributions Upon Liquidation.[

All distributions in kind to the Members will be subject to each distributee's liability for costs, expenses, and liabilities incurred or committed to before the end of the winding up process. Those costs, expenses, and liabilities will be allocated to the distributee in accordance with Section XI.B. Distribution of cash or property to a Member in accordance with this Section XI.B constitutes a complete return to the Member of its Capital Contributions. Additionally, it constitutes a complete distribution to the Member of its Membership Interest and all the Company's property. It also constitutes a compromise to which all Members have consented within the meaning of Section 101.154 of the TLLCL. To the extent that a Member returns funds to the Company, it has no claim against any other Member for those funds.

C. Deficit Capital Accounts.

Upon the Company's winding up, the Members will not be obligated to contribute a deficit amount, if any, to the Company to bring a Member's capital account balance to zero, and the deficit will not be a Company asset if:

- to the extent that the deficit in any Member's capital account is attributable to the Company's deductions and losses (including noncash items such as depreciation); or
- to the extent that the deficit in any Member's capital account is not attributable to distributions of money in accordance with this Agreement to all Members in proportion to their respective Percentage Interest.

D. Certificate of Termination.

Once the Company assets are all distributed and on completion of the winding up process as provided in this Agreement and the TLLCL, the Management or an "authorized Member" must file a certificate of termination with the Texas Secretary of State. They will cancel any other filings made in accordance with Section I.E and take any other actions necessary to terminate the Company. An authorized Member will be a Member or Members appointed by the Management.

Comment: The TBOC requires the listing of the governing persons and the simple affirmative statement that the entity has followed the requirements of the TBOC with respect to the winding up process. See TBOC §11.101. Also note that TBOC §101.552 includes supplemental termination provisions for LLCs that change some of the consent levels required under the TLLCA for events such as the revocation of a voluntary dissolution. The consent is changed from unanimous to majority in that scenario; however, the cancellation of an event requiring a winding up requires unanimous consent of the members.

XII. ALTERNATIVE DISPUTE RESOLUTION ("ADR"); BINDING ARBITRATION

A. Agreement to Use Procedure.

The Members have executed this Agreement in good faith and in the belief that they are mutually advantageous to them. It is with that same spirit of cooperation that they pledge to attempt to resolve any dispute amicably without litigation. Accordingly, they agree if any dispute arises between them relating to the Company or this Agreement ("Dispute"), they will first utilize the procedures specified in this article ("Procedure") before any Additional Proceedings.

B. Initiation of Procedure.

The Member seeking to initiate the Procedure ("Initiating Member") must give written notice to the other Members. The notice must describe in general terms the nature of the Dispute, the Initiating Member's claim for relief, and identify one or more individuals with authority to settle the Dispute on the Initiating Member's behalf. The Members receiving the notice ("Responding Member", whether one or more) have five business days within which to designate by written notice to the Initiating Member, one or more individuals with authority to settle the Dispute on their behalf. The individuals so designated will be known as the "Authorized Individuals". The Responding Member may designate himself or herself as an Authorized Individual. The Initiating Member and the Responding Member will be collectively referred to as the "Disputing Members" or individually "Disputing Member".

C. Direct Negotiations.

The Authorized Individuals may investigate the Dispute as they deem appropriate. But they agree to promptly, and in no event later than 30 days from the date of the Initiating Member's written notice, meet to discuss the Dispute's resolution. The Authorized Individuals will meet at the times and places and with the frequency as they may agree. If the Dispute has not been resolved within 30 days from the date of their initial meeting, the Disputing Members must cease direct negotiations and must submit the Dispute to mediation in accordance with the following procedure.

D. Selection of Mediator.

The Authorized Individuals will have five business days from the date they cease direct negotiations to submit to each other a written list of acceptable, qualified attorney-mediators not affiliated with any of the Members. Within five days from receiving the list, the Authorized Individuals must rank the mediators in numerical order of preference and exchange the rankings. If one or more names are on both lists, the highest ranking person will be designated as the mediator. If no mediator has been selected under this procedure, the Disputing Members agree jointly to request a State or Federal District Judge of their choosing to supply within ten business days a list of potential qualified attorney-mediators. If they cannot agree upon a State or Federal District Judge, the Local Administrative Judge for the county in which the principal office of the Company is located will supply the list. Within five business days after receiving the list, the Authorized Individuals must again rank the proposed mediators in numerical order of preference and simultaneously exchange the list. They will select as the mediator the individual receiving the highest combined ranking. If the mediator is not available to serve, they must proceed to contact the mediator who was next highest in ranking until they are able to select a mediator.

E. Time and Place of Mediation.

In consultation with the mediator selected, the Authorized Individuals must promptly designate a mutually convenient time and place for the mediation. Unless circumstances require otherwise, the time may not be later than 45 days after the mediator is selected.

F. Exchange of Information.

If any Disputing Member has substantial need for information in another Disputing Member's possession in order to prepare for the mediation, all Disputing Members must attempt in good faith to agree to procedures for expeditiously exchanging the information. They may use the mediator's help to expedite information exchange if necessary.

G. Summary of Views.

Each Disputing Member must deliver to the mediator and to the other Disputing Members a concise written summary of its views on the matter in Dispute and other matters required by the mediator. The summary must be submitted at least seven days before the first scheduled session of mediation. The mediator may also request that a confidential issue paper be submitted to the mediator by each Disputing Member.

H. Parties to be Represented.

In the mediation, each Disputing Member must be represented by an Authorized Individual and may be represented by counsel. With the mediator's permission, each Disputing Member may bring any additional Persons needed to respond to questions, contribute information, and participate in the negotiations.

I. Conduct of Mediation.

The mediator must determine the format for the meetings. The format must be designed to assure that both the mediator and the Authorized Individuals have an opportunity to hear an oral presentation of each Disputing Member's views on the matter in dispute. The format must be designed so that the Authorized Individuals attempt to negotiate a resolution of the matter in dispute, with or without counsel or assistance, but with the mediator's assistance. To this end, the mediator is authorized to conduct both joint meetings and separate private caucuses with the Disputing Members. The mediation session will be private. The mediator will keep confidential all information learned in private caucus with any Disputing Member unless specifically authorized by the Disputing Member to disclose the information to the other Disputing Member. The Disputing Members agree to sign a document agreeing that the mediator is be governed by the provisions of Chapter 154 of the Tex. Civ. Prac. & Rem. Code and any other rules the mediator may prescribe. The Disputing Members commit to participate in the proceedings in good faith with the intention of resolving the Dispute if at all possible.

J. Termination of Procedure.

1. When Mediation May be Terminated.

The Disputing Members agree to participate in the mediation procedure to its conclusion. The mediation may be terminated:

a. by the Disputing Members signing a settlement agreement;
b. by the mediator's declaration that the mediation is terminated; or
c. by a Disputing Member's written declaration to the effect that the mediation process is terminated at the conclusion of one full day's mediation session.

2. When Additional Proceedings May be Commenced.

Even if the mediation is terminated without resolving the Dispute, the Disputing Members agree not to terminate negotiations and not to commence any Additional Proceedings until five days after the mediation expires. Any Disputing Member may, however, commence Additional Proceedings within the five-day period if the Dispute may be barred by an applicable statute of limitations.

K. Arbitration.

The parties agree to participate in good faith in the ADR to its conclusion. If the Disputing Members are not successful in resolving the dispute through the ADR, the Disputing Members agree that the Dispute will be settled by arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and judgment upon the award rendered by the arbitrators may be entered in any court having jurisdiction ("Additional Proceedings").

L. Fees of Mediation; Disqualification.

The mediator's fees and expenses will be shared equally by the Disputing Members. The mediator will be disqualified as a witness, consultant, expert, or counsel for any Disputing Member with respect to the Dispute and any related matters.

M. Confidentiality.

Mediation is a compromise negotiation for purposes of Federal and State Rules of Evidence. It constitutes privileged communication under Texas law. The entire mediation process is confidential. No stenographic, visual, or audio record may be made. All conduct, statements, promises, offers, views, and opinions, whether oral or written, made during mediation by any Disputing Member, their agents, employees, representatives or other invitees and by the mediator are confidential and will, in addition and where appropriate, be deemed privileged. The conduct, statements, promises, offers, views, and opinions may not be discoverable or admissible for any purpose, including impeachment, in any litigation or other proceeding involving the parties. It may not be disclosed to anyone not an agent, employee, expert, witness, or representative of any of the Members. Evidence otherwise discoverable or admissible, however, is not excluded from discovery or admission because of its use in the mediation.

N. Waiver of Exemplary or Punitive Damages.

To the maximum extent permitted by law, except for fraud or gross negligence, each of the Members knowingly, voluntarily, and intentionally waives any right to consequential exemplary or punitive damages with respect to any Dispute, regardless of the forum for the proceedings.

XIII. GENERAL PROVISIONS

A. Books and Records.

1. Books and Records Company is Required to Keep.

The Company must maintain the books and records provided by the TLLCL and those it deems necessary or desirable. All books and records provided for by the TLLCL will be open to the Member's inspection to the extent expressly provided by the TLLCL, and not otherwise. The Managers, if any, may examine all the books and records at all reasonable times. The Company must keep and maintain the following records in its principal office in the United States or make them available within five days after receiving a written request as specified in the TLLCL:

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a. a current list that states:
   (1) each Member's name and mailing address;
   (2) the percentage or other interest in the Company each Member owns; and
   (3) if one or more classes or groups are established under the Certificate of Formation or this Agreement, the names of the Members who are Members of each specified class or group;
b. copies of the federal, state, and local information or income-tax returns for the Company's six most recent tax years;
c. a copy of the Certificate of Formation and this Agreement, all amendments or restatements, executed copies of any powers of attorney, and copies of any document that creates, in the manner provided by the Certificate of Formation or this Agreement, classes or groups of members;
d. unless contained in the Certificate of Formation or this Agreement, a written statement of:
   (1) the amount of the cash contribution and a description and statement of the agreed value of any other contribution the Member has made and agrees to make in the future as an additional contribution;
   (2) the times at which additional contributions are to be made or events requiring additional contributions to be made;
   (3) events requiring the Company's affairs to be wound up; and
   (4) the date on which each member in the Company became a Member; and
   (5) correct and complete books and records of account of the Company.

Comment: See comments previously noted and TBOC §§ 101.501 and 101.502 regarding supplemental recordkeeping requirements. If the parties do not want the minutes of meetings of the members or managers or committees to be a part of the records available for review, these can be excluded. TBOC §3.151(b).

2. Form in Which Records Are to Be Kept.

The Company must maintain its records in written form or in another form capable of conversion into written form within a reasonable time.

3. Principal Office Address to be Made Available to the Members.

The Company must keep in its registered office and make available to Members on reasonable request the street address of its principal United States office in which the required records are maintained or will be available.

4. Examination of Books and Records.

A Member or an assignee of a Membership Interest may examine and copy required records and other information regarding the Company's business, affairs, and financial condition as are just and reasonable for them to examine and copy. The Member or assignee must request to examine and copy the records in writing. The written request must state the purpose. The Member or assignee may examine and copy the records in person or by a representative, at their own expense, at any reasonable time, and for any proper purpose.

Comment:
The LLC is required to provide to members and former members access to the LLC's books and records pursuant to TBOC §§ 3.151, 3.152, and 3.153. Under certain circumstances, managers may believe that a member's access to the LLC's records could be detrimental to the LLC, particularly if the member is a competitor or is otherwise likely to use the information to disadvantage the LLC. TBOC §3.153.

If you represent a member who is not a manager, you may want to limit the ability of the managers to restrict access to the books and records of the LLC if you are concerned the restriction is more to protect the managers than the LLC.

TBOC §3.152 adds a right for governing persons to have appropriate and adequate access to those books and records set out in TBOC §3.153 or otherwise reasonably related to the persons services.

5. Records Company Must Provide Without Charge.

On written request by any Member or an assignee of a Membership Interest made to the person and address designated in this Agreement, the Company will provide to the requesting Member or assignee without charge true copies of:
a. the Certificate of Formation, this Agreement, and all amendments or restatements; and
b. any tax returns described in the TLLCL.

B. Amendment or Modification.

Comment: TBOC §101.053 provides that all members must agree to amend the company agreement unless otherwise provided for in the certificate of formation or company agreement. Clients may prefer to go with the default rule in this section.

This Agreement may be amended only by a written instrument adopted by the Managers and executed and agreed to by a Required Interest, subject to the following:
- An amendment reducing a Member's Percentage Interest or increasing its Commitment (other than to reflect changes otherwise provided by this Agreement) is effective only with that Member's consent.
- An amendment reducing the required Percentage Interest or other measure for any consent or vote in this Agreement is effective only with the consent or vote of Members having the Percentage Interest or other measure required before the amendment.
- Amendments of the type described in Section

II.D may be adopted as provided in that section.

C. Checks, Notes, Drafts, Etc.

All checks, drafts, or other orders for payment of money, notes, or other evidences of indebtedness issued in the name of or payable to the Company must be signed or endorsed by a designated person appointed by the Management. The designated person may be an officer, Manager, Member, or other person as may be designated.

D. Reliance on Third Party Reports.

In connection with the discharge of their duties under the terms of this Agreement, or the exercise of their powers, Managers, committee members, and officers of the Company will have the right to rely upon information, opinions, reports, and statements, including financial statements and other financial data concerning the Company or another Person presented by an officer, employee, legal counsel, certified public accountant, investment banker, committee of which they are not a member, or other Person they reasonably believe possess professional expertise in the matter, unless they have knowledge of matters that would make this reliance unwarranted.

Comment: This concept has been added from the TBCA language to protect the governing parties. TBOC §§ 3.102 and 3.105.

E. Headings.

The headings used in this Agreement have been inserted for convenience only and do not constitute matter to be construed in interpretation.

F. Construction.

Whenever the context requires, the gender of all words used in this Agreement includes the masculine, feminine, and neuter; and the singular includes the plural, and conversely. All references to articles, sections, and subsections refer to articles, sections, and subsections of this Agreement. If any portion of this Agreement is invalid or inoperative, then, so far as is reasonable and possible, the remainder of this Agreement will be considered valid and operative, and effect will be given to the intent manifested by the portion held invalid or inoperative.

G. Entire Agreement; Supersedure.

This Agreement constitutes the entire agreement of the Members and their affiliates relating to the Company. They supersede all contracts or agreements made before with respect to the Company, whether oral or written.

H. Effect of Waiver or Consent.

The Company may give an expressed or implied waiver or consent to a specific breach or default by a Person of that Person's obligation to the Company. Any specific waiver or consent is not however, a waiver or consent to any other breach or default in the Person's performance of their same or other obligations to the Company. A Person's failure to complain of any Person's acts or to declare any Person in default with respect to the Company does not waive that Person's rights with respect to that default until the applicable statute-of-limitations period has run.

I. Binding Effect.

Subject to the restrictions on Dispositions set forth in this Agreement, this Agreement is binding on and inure to the benefit of the Members and their respective heirs, legal representatives, successors, and assigns.

J. Governing Law; Severability.

THESE AGREEMENT IS GOVERNED BY AND WILL BE CONSTRUED IN ACCORDANCE WITH TEXAS LAW. If a direct conflict occurs between the provisions of this Agreement and the Certificate of Formation or any mandatory provision of the TLLCL, the Certificate of Formation or the TLLCL will control.

K. Further Assurances.

Each Member must execute and deliver any additional documents and perform any additional acts necessary to effectuate this Agreement and the transactions contemplated by this Agreement.

L. Notice to Members of Provisions of this Agreement.

By executing this Agreement, each Member acknowledges that it has actual notice of all provisions of this Agreement and all provisions of the Certificate of Formation.

M. Counterparts.

This Agreement may be executed in any number of counterparts with the same effect as if all signing parties had signed the same document. All counterparts will be construed together and constitute the same instrument.

N. Conflicting Provisions.

To the extent that one or more provisions of this Agreement appear to be in conflict with one another, the Management may choose which of the conflicting provisions are to be enforced. Wide latitude is given to the Management in interpreting the provisions of this Agreement to accomplish the Company's purposes and objectives. The Management, in its discretion, may apply this Agreement in a manner to be in the Company's best interest, even if the interpretation or choice of conflicting provisions to enforce is detrimental to one or more Members.

XIV. DEFINITIONS

Terms not defined below have the meanings given them. The following terms have the following meanings:

A. Affiliate.

"Affiliate" means a person that, directly or indirectly, through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified or who is an Associate of the person. For the purpose of this definition, "control," "controlling," "controlled by" and "under common control with" means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. "Associate" means (1) a corporation, partnership, limited liability company, or other business entity of which the person is an officer, owner, partner, member, or manager or is, directly or indirectly, the beneficial owner of 10 percent or more of any beneficial interest; (2) any trust or other estate in which the person has a substantial beneficial interest or as to which the person serves as trustee or in a similar capacity; and (3) any relative or spouse of the person who is a officer, owner, partner, member, or manager or is, directly or indirectly, the beneficial owner of 10 percent or more of any beneficial interest in the person.

Comment: Consider use of the Securities Act definition if a corporate model is adopted. In addition, consider the threshold levels for control.

B. Bankrupt Member.

"Bankrupt Member" means (except to the extent a Required Interest consents otherwise) any Member that:

a. makes a general assignment for the benefit of creditors;
b. files a voluntary bankruptcy petition;
c. becomes the subject of an order for relief or is declared insolvent in any federal or state bankruptcy or insolvency proceedings;
d. files a petition or answer seeking for the Member a reorganization, arrangement, composition, readjustment, liquidation, winding up, or similar relief under any law;
e. files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against the Member in a proceeding of the type described in subclauses through of this Section XIV.B; or
f. seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of all or any substantial part of the Member's properties; or

any member:

a. against which a proceeding seeking reorganization, arrangement, composition, readjustment, liquidation, winding up, or similar relief under any law has been commenced and 120 days have expired without dismissal; or
b. with respect to which, without the Member's consent or acquiescence, a trustee, receiver, or liquidator of all or any substantial part of the Member's properties has been appointed and 90 days have expired without the appointments having been vacated or stayed, or 90 days have expired after the date of expiration of a stay, if the appointment has not previously been vacated.

C. Business Day.

"Business Day" means any day other than Saturday, Sunday, or days when national banking associations in Texas are closed.

D. Capital Contribution.

"Capital Contribution" means any contribution by a Member to the Company's capital.

E. Certificate of Formation.

"Certificate of Formation" means the certificate of formation (including amendments) for this limited liability company filed with the Texas Secretary of State.

F. Code.

"Code" means the Internal Revenue Code of 1986 and any successor statute, as amended.

G. Commitment.

"Commitment" means, subject in each case to adjustments on account of Dispositions of Membership Interests permitted by this Agreement:

- in the case of a Member executing this Agreement as of the date of this Agreement or a Person acquiring that Membership Interest, the amount specified for that Member to contribute in cash or property to this Company; and
- in the case of a Membership Interest issued in accordance with this Agreement, the promise to contribute cash or property to this Company established in accordance with this Agreement.

H. Company.

"Company" means *Opportunity Investments GP, LLC*, a Texas Limited Liability Company.

I. Default Interest Rate.

"Default Interest Rate" means a rate per annum equal to the lesser of the following:

- three percent plus a varying rate per annum that is equal to the Wall Street Journal prime rate as quoted in the money rates section of the Wall Street Journal that is also the base rate on corporate loans at large United States money center commercial banks, from time to time as its prime commercial or similar reference interest rate, with adjustments in that varying rate to be made on the same date as any change in that rate; and
- the maximum rate permitted by applicable law.

J. Delinquent Member.

"Delinquent Member" means a Member who does not contribute a required Capital Contribution or any portion of a required Capital Contribution by the required time.

K. Dispose, Disposing, or Disposition.

"Dispose", "Disposing", or "Disposition" means a sale, assignment, transfer, exchange, mortgage, pledge, grant of a security interest, or encumbrance, including dispositions, by operation of law.

L. General Interest Rate.

"General Interest Rate" means a rate per annum equal to the lesser of the following:

- the Wall Street Journal prime rate as quoted in the money rates section of the Wall Street Journal that is also the base rate on corporate loans at large United States money center commercial banks, from time to time as its prime commercial or similar reference interest rate, with adjustments in that varying rate to be made on the same date as any change in that rate; and
- the maximum rate permitted by applicable law.

M. Lending Member.

"Lending Member" means any Member who advances all or a portion of a Delinquent Member's Capital Contribution.

N. Liquidating Agent.

"Liquidating Agent" means the Management who will commence to wind up the Company's affairs and to liquidate and sell its properties when there has been an event requiring the winding up of the Company without reconstituting the Company. If there are no remaining Management, a person or committee selected by a Required Interest will be the "Liquidating Agent". "Liquidating Agent" also refers to any successor or substitute Liquidating Agent.

O. Management.

"Management" means **all managers**.

P. Manager.

"Manager" means any Person named in the Certificate of Formation as a manager and any Person elected as a manager in accordance with this Agreement. A manager does not include any Person who has ceased to be a manager of the Company.

Q. Member.

"Member" means any Person executing this Agreement or admitted to the Company as a member in accordance with this Agreement. A Member does not include any Person who has ceased to be a Member in the Company.

Comment: This Agreement is structured with one class of Members. To accommodate special aspects of a business arrangement, there may also be multiple classes of Members. This may arise where there are persons making disproportionate contribution and, on that basis, require disproportionate management rights, differing economic treatment, or both. In these cases, the company agreement will need to be drafted to identify these classes and define their relative rights and obligations under the terms of the company agreement. TBOC §3.002.

R. Membership Interest.

"Membership Interest" means, at any time, the interest of a Member in the Company, including the right to receive distributions of Company assets and the right to receive allocations of income, gain, loss, deduction, or credit of the Company, but does not include the voting rights or management rights reserved to the Members under the terms of this Agreement (or the right to vote the Units relating to the voting rights or management rights reserved to the Members) until the holder of the Membership Interest has been admitted to the Company as a Member as to that Membership Interest.

Comment: This generally tracks the definition of "membership interest" found in TBOC §1.001(54). This definition reinforces the fact that a membership interest includes only the economic rights – not management and other non-economic rights. Management and other non-economic rights are conferred by virtue of member status and not by mere ownership of a membership interest. Note that the last phrase of the above section in this company agreement does not follow the TBOC. The last phrase is intended to incorporate those management rights into the terminology once the requirements for admission as a Member has been completed, which is intended to avoid any gap in what is transferred when a practitioner, using common terminology, addresses the sale and acquisition of all of the "membership interest."

S. Membership Units.

"Membership Units" means one or more types of units a Member receives for property contributed by that Member. A Member will receive one Membership Unit for each $1 of gross asset value of property contributed by that Member and a fraction of a Membership Unit for each fraction of a dollar of gross asset value of property contributed by that Member.

T. Percentage Interest.

"Percentage Interest" of a Member means the portion of the Company's total Membership Units owned by that Member.

Comment: The Percentage Interest is the method for allocating the economics benefits and obligations for the LLC. This company agreement provides for a fixed percentage interest throughout the term of the company agreement. This will change from time to time based upon conditions in the company agreement (such as a shift in participation in profits after a set threshold return to certain members has been met). Where profits and losses will be shared on a disproportionate basis at times during the term of the company agreement, the members who are to receive a special treatment may also be denominated as a special class and the profits and losses allocated to that class, in proportion to their percentage interest or in the alternative percentage interest, need to be disassociated from units and set up on a separate exhibit or grid that will change as allocations change.

U. Permitted Transferee.

"Permitted Transferee" means:

a. a Member's spouse other than a spouse who is legally separated under a decree of separate maintenance or a spouse who is a party to a pending divorce proceeding;
b. a Member's descendant, including descendants by adoption if the adoption was a court adoption of a minor under five years of age;
c. a Member's parent or sibling;

d. a descendant of a Member's sibling including those by adoption as defined above;
e. a trust created for the benefit of anyone in through of this Section XIV.U;
f. a Person who is a Member at the time of the transfer;
g. any charitable organization described in each of the following Code sections: Section 170(b)(1)(A), Section 170(c), Section 2055(a) and Section 2522(a); and
h. a charitable remainder trust created under Code Section 664.

Comment: This definition is intended to provide a definition for those persons who will be permitted transferees under the terms of the company agreement, and, therefore, not subject to the vote of the members. This is a broad definition of related parties. Often the parties will want to keep this to a small group.

V. Person.

"Person" includes an individual, partnership, limited partnership, limited liability company, foreign limited liability company, trust, estate, corporation, custodian, trustee, executor, administrator, nominee or entity in a representative capacity.

Comment: The following definitions of "Preferred Return" and "Rate of Return" are to be used only if the drafter is providing for special allocations with a preferred return.

W. Preferred Return.

"Preferred Return" means, with respect to any Member, an amount calculated as a cumulative, non-compounded per annum rate equal to the Rate of Return on the average daily balance of the Unreturned Capital of the Member.

Comment:
On occasion, certain members (sometimes referred to as carried members) will contribute only a minimal portion of the aggregate capital contributions while others contribute a larger proportionate share. In this situation, a provision requiring a preferred return to those who have contributed a larger proportionate share may be incorporated into the company agreement. This might be structured as a preferred return of earnings or a special allocation of gross revenues.

In certain circumstances, this preferred return structure might be established by setting up a Class A and Class B membership structure that provides special management rights to the class that has made a disproportionate contribution to the LLC.

X. Rate of Return.

"Rate of Return" means ___________% per annum.

Comment: As noted above, if certain members contribute disproportionately greater capital, they may require a rate of return on their excess capital until it has been returned. This raises an interesting question: What is the definition of a return of the contributed capital? See comment on "Unreturned Capital" below.

Y. Required Interest.

"Required Interest" means those members who hold Membership Units that exceed 50% of the Company's total Membership Units. Those Members holding more than 50% of the Company's total Membership Units will have a majority in interest in both the Company's capital and profits. The majority in interest of the profits is based on any reasonable estimate of profits from the date of an event requiring the winding up of the Company to the Company's filing of the certificate of termination.

Z. TBOC.

"TBOC" means the Texas Business Organizations Code and any successor statute, as amended.

AA. TLLCL.

"TLLCL" means the Texas Limited Liability Company Law, part of the TBOC, as amended and any successor statute. Title 3 of the TBOC, which has only one chapter (101), governs limited liability companies. Various provisions of Title 1 (the "hub") apply to limited liability companies as well. The TBOC refers to these provisions collectively as the "Texas Limited Liability Company Law". TBOC §1.008(e).

Comment: The following definition of "Unreturned Capital" is to be used only if the drafter is providing for special allocations with a preferred return.

BB. Unreturned Capital

"Unreturned Capital" means the Capital Contribution made to the Company by a Member, based on the Agreed Value of the property contributed, where appropriate, less those sums previously distributed to such Member other than (i) the Preferred Return and (ii) tax distributions.

Comment: This term is used to determine the net result of capital contributions made by a member less the amount of capital returned to the member, as is often the basis upon which a Preferred Return is computed. Often there is discussion over what distributions should and should not be included in this calculation as an earlier return of capital (reducing that amount upon which the return is calculated). By way of example, there is often debate at to whether a "tax distribution" should be calculated as a part of this return since this is not really a return of money to the contributing member, but a distribution to cover the surcharge on the available cash that must be paid to the government. For example, a member contributes $100 upon which the member has already paid tax, and the LLC returns $100, which is subject to a pass-through tax liability associated with it of $15. Has the member received back $100 or $85 of capital?

The undersigned, being all the initial Members and Managers, as specified in the Certificate of Formation, certify that the foregoing Agreement was unanimously adopted by the Members and Managers. This Agreement is effective ______, 2007.

Thomas C. Baird, Member-Manager

Cindy Baird, Member-Manager, Secretary

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COMMENTS CONCERNING TEXAS FRANCHISE TAX

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the State Bar of Texas or the Section of Taxation.

These comments were prepared by individual members of the Committee on State and Local Taxation (the "Committee"). Principal responsibility was exercised by David Colmenero, Matt Larsen, Alyson Outenreath, and Jeff Slade. The Comments were reviewed by and substantive contributions were made by Geoff Polma, Cynthia Ohlenforst, Christine Mondrick, Charles Pulman and Charolette Noel. They were also reviewed by Dan Baucum of the Section's Committee on Government Submissions.

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

Contact Persons:

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

Matthew Larsen
matthew.larsen@bakerbotts.com
(214) 953-6673

Alyson Outenreath
alyson.outenreath@tklaw.com
(214) 969-1741

Jeffrey M. Slade
jeff.slade@haynesboone.com

Geoffrey Polma
gpolma@lockeliddell.com
(214) 740-8644

Date: April 28, 2009

TAX SECTION OF THE STATE BAR OF TEXAS
STATE AND LOCAL TAX COMMITTEE
COMMENTS TO HOUSE BILL 3[1]

I. EXECUTIVE SUMMARY

The following comments are submitted in response to a request for comments from Speaker of the House John Strauss and Representative Jose Menendez in connection with the 2009 Texas Regular Legislative Session.

Following is a summary of our comments:

A. Passive Entities

1. Distributive Shares of Partnership Income: We recommend that the Legislature amend the Texas Tax Code to clarify that distributive shares of partnership income qualify as passive income for purposes of the passive entity rules, regardless of the underlying nature of the income.

2. Joint Operating Agreements/Contract Operators: We recommend that Section 171.0003 be amended to clarify that the operator of a mineral property for purposes of Section 171.0003 is the operator named in the Joint Operating Agreement, unless such operator duties have been assigned to a "contract" operator, in which case the "contract" operator would be considered the operator of the subject mineral property for purposes of Section 171.0003.

B. Compensation Deduction

1. Employer Share of Employment Taxes: We recommend that the Tax Code be amended to address whether an employer's share of social security and Medicare payments are deductible as compensation.

C. Total Revenue

1. Exclusion by a Taxable Entity of Income Generated by a Passive Entity: To prevent possible double taxation, we recommend that the Legislature amend Section 171.1011 to expressly recognize that a taxable entity may exclude from total revenue its distributive share of a passive entity's revenue that was generated by a lower tier taxable entity, regardless of whether the passive entity directly or indirectly owned the lower tier taxable entity.

2. Exclusion of Flow-Through Funds – Mandated by Contract: We recommend the Legislature amend Section 171.1011(g) to permit a dollar-for-dollar exclusion of all flow-through funds that are mandated by contract to be distributed to non-affiliated entities. This

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[1] Citations to "Sections" in these Comments refer to Chapter 171 of the Texas Tax Code Ann., as amended by H.B. 3, 79th Leg., 3rd C.S. (2006) ("HB3"), effective for franchise tax reports due on or after January 1, 2008.

amendment would protect many service providers from being subject to a disproportionately high tax burden.

3. Exclusions of Flow-Through Funds-Paid to Natural Persons: We recommend the Legislature clarify whether excludable sales commissions can be paid to a person who receives the commission as an independent contractor but who may be an employee in some other capacity.

4. Royalties and Dividends: We recommend adding additional language relating to foreign royalties and dividends subtractions to make Sections 171.1011(c)(1)(B)(ii) and 171.1011(c)(2)(B)(ii) consistent with the treatment of such dividends under the Comptroller's new margin tax apportionment rules and the earned surplus provisions of the old franchise tax.

5. Health Care Institutions and Heath Care Providers: We recommend the Legislature clarify that the exclusion for qualifying payments received by health care providers and health care institutions will apply in full where – as is common – an affiliate of the provider or institution receives the qualifying payments on behalf of the provider or institution.

6. Dividends Received by Partnerships: We recommend the Legislature add a new Section 171.1011(c)(2)(B) to clarify that partnerships that receive dividends are permitted a deduction comparable to that provided to corporations. Our recommendation avoids inconsistent treatment of corporations and partnerships and ensures income is not subject to double taxation.

D. Combined Reporting

1. Controlling Interest of Nonprofit Corporations: We recommend that the definition of a controlling interest for combined reporting purposes be amended to address nonprofit corporations that are taxable entities but that do not have any stock or membership interests.

E. Tax Rates

1. Definition of Utility for Purposes of 0.5 Percent Rate: We recommend the Legislature clarify that only utilities that serve the public at large are excluded from the 0.5 percent rate.

2. Definition of Utility for Purposes of 0.5 Percent Rate: Only if the recommendation in 1, above, is not adopted, we recommend the Legislature amend Section 171.002(c)(3) to clarify that the incidental and negligible provision of utilities does not disqualify a taxable entity from the 0.5 percent rate.

3. Retail Trade and Wholesale Trade: We recommend that the Legislature clarify that a taxable entity engages in wholesale or retail trade so long as it engages in activities generally described in the Standard Industrial Classification Manual's description of 'Wholesale Trade – The Division as a Whole' (Division F) or 'Retail Trade – The Division as a Whole' (Division G). Our recommendation would allow taxable entities that clearly engage in wholesale or retail activities, but that do not neatly fit within a specific subdivision of Division F or Division G, to

be classified as a wholesaler or retailer if they engage in activities generally described by Division F or Division G.

F. Exemption From Tax for Noncorporate Entities

1. LLCs Wholly-Owned by I.R.C. § 501(c)(3) Charitable Entities: We recommend the Legislature correct a "gotcha" procedural quirk in Texas franchise tax law where LLCs wholly-owned by I.R.C. § 501(c)(3) charitable entities, which are exempt from federal income tax, are currently not also exempt from Texas franchise tax.

II. COMMENTS

A. Passive Entities (Section 171.0003)

1. Distributive Shares of Partnership Income

a. Language at Issue

Section 171.0003(a)(2)(B) provides that "distributive shares of partnership income" are considered "passive" income to the extent that such distributive shares of income are greater than zero. On the other hand, Section 171.0004 identifies the criteria for determining whether income is derived from an active trade or business and Section 171.0003(b)(1) provides that rent is not "passive" (*i.e.*, that it is derived from an active trade or business).

b. Recommendation

We recommend that Section 171.0003 be amended by adding a new subsection (c) that reads as follows: "(c) For purposes of Subsection (b) and the determination under Section 171.0004, items of income received by an entity treated as a partnership for federal income tax purposes shall not be treated as directly earned by the partners or owners of such entity."

c. Explanation

Pursuant to Section 171.0003(b)(1), rental income received by a partnership is not considered passive income; thus rental income generally will be taxable to a partnership that directly owns rental real property. In recently proposed changes to her rules, the Comptroller has proposed that the non-passive character of rental income earned by a partnership be imputed to the partners of the partnership. In other words, distributive shares of partnership income that are attributable to rent would not be considered "passive." Such a rule appears to undermine the Legislature's intention that distributive shares of partnership income are considered passive income.

We recommend that the Legislature amend the statute to reflect clearly that rental income (or any other income) earned by a partnership will not, for purposes of determining whether an entity is a passive entity, be imputed to the partners of the partnership. In other words, "distributive shares of partnership income" are "passive" income to the partners regardless of the underlying nature of that income.

2. Joint Operating Agreements and Contract Operators

a. Language at Issue

Section 171.0003(a)(2)(D) provides that "royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests" are considered passive income for purposes of the passive entity exception from Texas franchise tax under Section 171.0003. Section 171.0003(b)(2) provides that the following income is considered income from conducting an active trade or business, and therefore does not qualify as passive income for purposes of Section 171.0003(a)(2): "income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement."

b. Recommendation

We recommend that the Legislature amend Section 171.0003 by adding a new Subsection (c) that provides: "For purposes of determining the operator of a mineral property under Section 171.0003, the operator shall be the operator named in the Joint Operating Agreement, unless such operating duties have been contractually assigned in writing, in which case the operator shall be such contract operator."

c. Explanation

Under the provisions of Sections 171.0003(a)(2)(D) and (b)(2), mineral interest income cannot be considered passive income for purposes of Section 171.0003 if a partnership is the operator of the subject mineral property or is in a combined group for Texas franchise tax purposes with the operator. It is common practice in the oil and gas industry for operators of mineral properties to be "contract" operators, meaning that such operators received their operator rights via an assignment of such duties rather than being the named operator in the subject Joint Operating Agreement. In alignment with this common practice, the Texas Railroad Commission respects the "contract" operator as the operator of the subject mineral property rather than the named operator in the Joint Operating Agreement. To be consistent with industry practice and other Texas agencies, we recommend that Section 171.0003 be amended to clarify that the operator of a mineral property for purposes of Section 171.0003 is the operator named in the Joint Operating Agreement, unless such operator duties have been assigned to a "contract" operator, in which case the "contract" operator would be considered the operator of the subject mineral property for purposes of Section 171.0003.

B. Compensation Deduction (Section 171.1013)

1. Employer Share of Employment Taxes

a. <u>Language at Issue</u>

Section 171.1013(b)(2) allows a compensation deduction for the cost of benefits provided to officers, directors, owners, partners, and employees, "to the extent deductible for federal income tax purposes." Comptroller Rule 3.589(d), however, excludes certain items from the term "compensation." Specifically, Comptroller Rule 3.589(d)(3) excludes from the term "compensation" an employer's share of payroll taxes.

b. <u>Recommendation</u>

We recommend that Section 171.1013(b)(2) be clarified to address whether employer contributions for social security and Medicare are deductible benefits.

c. <u>Explanation</u>

Employer contributions for social security and Medicare are deductible for federal income tax purpose. Since this is a mandatory cost imposed on employers relating to their employees, and such costs are deductible by the employer for federal income tax purposes, one could reasonably interpret the Tax Code as permitting a franchise tax deduction for such amounts any time a taxpayer elects to deduct compensation. However, the statute does not directly address this issue. Given that the Comptroller's interpretation does not permit a deduction for such amounts, we believe the Legislature should determine if its intent was to permit a deduction for these type costs and, if so, to clarify the statute to specifically state so.

C. Total Revenue (Section 171.1011)

1. Exclusion by a Taxable Entity of Income Generated by a Passive Entity

a. <u>Language at Issue</u>

Section 171.1011(e) provides that "[a] taxable entity that owns an interest in a passive entity shall exclude from the taxable entity's total revenue the taxable entity's share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity."

b. <u>Recommendation</u>

We recommend Section 171.1011(e) be amended as follows: "[a] taxable entity that owns an interest in a passive entity shall exclude from the taxable entity's total revenue the taxable entity's share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity <u>whether or not the taxable entity generating such margin is owned directly by the passive entity</u>."

c. Explanation

Our recommendation clarifies that the net income generated by the margin of a taxable entity with a passive entity owner will not be subject to multiple layers of tax in the hands of an indirect owner merely because a passive entity exists between the indirect owner and the taxable entity. For example, taxable LLC is owned by Partnership 1, which is in turn owned by passive Partnership 2, which is in turn owned by taxable Corporation. It is unclear whether Corporation's distributive income from passive Partnership 2, which was originally earned by LLC, will be considered to be "generated by the margin of" taxable LLC for purposes of Section 171.1011(e) because passive Partnership 2 does not own taxable LLC directly. Our recommendation makes clear that the net income of passive Partnership 2 was generated by taxable LLC, thus avoiding the taxation of the same revenue again at the corporation level.

2. Exclusion of Flow-Through Funds – Mandated by Contract

a. Language at Issue

Section 171.1011(g) provides "[a] taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), only the following flow-through funds that are mandated by contract to be distributed to other entities:" (i) sales commissions to non-employees, including split-fee real estate commissions; (ii) the tax basis under the Internal Revenue Code of securities underwritten; and (iii) certain subcontracting payments handled by a taxable entity to provide services, labor or materials in connection with the design, construction, remodeling or repair of improvements or the location of the boundaries of real property.

b. Recommendation

We recommend Section 171.1011(g) be amended to read "[a] taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), ~~only the following~~ flow-through funds that are mandated by contract to be distributed to an entity not affiliated with the taxable entity <u>on a dollar-for-dollar basis (including dollar-for-dollar reimbursements received in respect of previous distributions to other entities that are mandated by contract). Such excluded flow-through funds shall include, but not be limited to</u>, (1) sales commissions to non-employees. . . ."

c. Explanation

Many service providers make remittances for services, taxes, or other items for their customers under an agreement that the customer will provide the funds for these items, either upfront or as a reimbursement for the remittance. Including such remittances in a taxable entity's taxable margin can produce significant distortions. For example, if a travel agent purchases a $1,000 airline ticket for a customer and charges a $50 commission, the travel agent's true taxable margin on the transaction – receipts prior to the deduction of any expenses relating to that transaction or the expenses of operating the agency generally – is the $50 commission. Intuitively, the margin tax on this transaction should be no more than 0.7% (70% of total revenue multiplied by the 1% margin tax rate) of $50, or $0.35. However, if the travel agent cannot exclude the $1,000 customer payment for the airline ticket from gross revenue, the margin tax on the transaction will be 0.7% of $1,050, or $7.35, for an effective tax of almost 15% of true *gross* income. Certain taxable entities, such as advertising agencies, ticket brokers, event planners, credit card processors, auctioneers, homeowners' associations, and many other agents, brokers, and service providers, are subject to this potentially punitive result. Our proposed solution would allow an exclusion for receipts earmarked by contract for payment to a third party. The requirement that such receipts be paid to a third party on a dollar-for-dollar basis is intended to prevent service charges from being treated by contract as reimbursements of general operating expenses. The Legislature might direct the Comptroller to promulgate rules regarding whether a distribution or reimbursement for a distribution is made on a dollar-for-dollar basis to further address potentially abusive transactions. A similar dollar-for-dollar reimbursement requirement is currently used in the property management company carve-out to the sales tax on real property services. 34 Tex. Admin. Code § 3.356(n) The former franchise tax's rules and interpretive authorities regarding the exclusion of agency reimbursements from receipts might also serve as a guide.

This expansion of the flow-through-funds exclusion is necessary because it will often be unclear whether dollar-for-dollar flow-through funds that are appropriately excluded from a taxpayer's margin for the reasons described in the previous paragraph may be excluded from total revenue under Tax Code § 171.1011(c)(1)(A), (c)(2)(A), or (c)(3). As a matter of practice, some service providers exclude customer payments for such items from gross income on federal income tax reports (as opposed to including the customer payment in gross income and then deducting it). In many such cases, however, it will be difficult for a taxpayer to provide federal income tax authority supporting an exclusion of the payment from federal gross income and thus from total revenue – the IRS has had little incentive to contest these cases or otherwise generate authority on the issue because the federal income tax result is generally the same whether the customer payment is excluded or deducted from gross income or deducted. The Comptroller, however, has suggested that she may contest whether a flow-through item has been properly excluded from a taxpayer's federal gross income, even where the IRS has not challenged the exclusion. The Comptroller has specifically identified a landlord's contractual reimbursements from tenants of property taxes and insurance as examples of flow-through funds that should not be excluded from the landlord's federal gross income and should therefore be included in the landlord's total revenue under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), regardless of how the landlord actually reports the reimbursements for federal income tax purposes. Unless the flow-through funds exclusion is expanded to cover these types of dollar-for-dollar flow-through funds, there will be no way to protect a large class of low profit margin service providers from being subject to a disproportionately high tax burden.

3. Exclusions of Flow-Through Funds – Paid to Natural Persons

a. Language at Issue

Section 171.1011(g) states that a taxable entity shall exclude from its total revenue, to the extent included therein, certain flow-through funds that are mandated by contract to be distributed to other entities, including (i) sales commissions to non-employees, including split-fee real estate commissions; (ii) the tax basis under the Internal Revenue Code of securities underwritten; and (iii) certain subcontracting payments handled by a taxable entity to provide services, labor or materials in connection with the design, construction, remodeling or repair of improvements or the location of the boundaries of real property.

b. Recommendations

We recommend amending the exclusion for sales commissions to clarify whether excludable sales commissions can be paid to a person who receives the commission as an independent contractor but who may be an employee in some other capacity. The following language may be appropriate if in fact an exclusion is available under those circumstances: "sales commissions that are not paid as employee compensation, including split-fee real estate commissions . . ."

c. Explanations

The phrase "sales commissions to nonemployees" leaves open the question of whether excludable sales commissions can ever be paid to a person who receives the commission as an independent contractor, but who may hold an employee position in some other capacity. For example, corporate officers are deemed to be employees by statute for federal income tax purposes. 26 U.S.C. § 3121(d). If that same person engages in activities described by Section 171.1011(l)(1) and receives a sales commission separate and apart from wages the person receives as an officer, is the sales commission paid to that person excludable from the taxable entity's total revenue?

4. Royalties and Dividends

a. Language at Issue

Sections 171.1011(c)(1)(B)(ii) and 171.1011(c)(2)(B)(ii) provide "foreign royalties and foreign dividends, including amounts determined under Section 78 or Sections 951-964, Internal Revenue Code" may be subtracted from total revenue to the extent included in total revenue.

b. Recommendation

We recommend the following language be added to the end of Sections 171.1011(c)(1)(B)(ii) and 171.1011(c)(2)(b)(ii) "foreign royalties and foreign dividends, including amounts determined under Section 78 or Sections 951-964, Internal Revenue Code as well as royalties and dividends from a subsidiary, associate, or affiliated corporation that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the United States."

c. Explanation

It is our understanding the intent of the foreign royalties and dividends exclusion in Section 171.1011 of the Texas Tax Code was to provide a similar exclusion to that available under the earned surplus component of the former franchise tax. Under the franchise tax as it existed prior to House Bill 3, Tax Code Section 171.110(a)(1) provided for an exclusion from the earned surplus component of the tax that included language substantially similar to our recommended amendment. This amendment would also be consistent with the Comptroller's new margin tax apportionment rules. Rule 3.591(e)(8)(B)(i) provides an exclusion from both Texas receipts and receipts everywhere for dividends received from "a subsidiary, associate, or affiliated taxable entity that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the United States." Without our amendment, dividends from such entities would be included in a dividend recipient's total revenue but excluded from gross receipts in determining the recipient's apportionment factor – a distortive result.

5. Health Care Institutions and Health Care Providers

a. Language at Issue

Section 171.1011(p)(2) provides that a health care institution includes specific types of facilities, including a hospice, a hospital, a birthing center, etc. Section 171.1011(p)(3) provides that a 'Health care provider' means a taxable entity that participates in the Medicaid program, Medicare program, Children's Health Insurance Program (CHIP), state workers' compensation program, or TRICARE military health system as a provider of health care services.

b. Recommendation

We recommend Section 171.1011(n) be amended as follows:

(n) Except as provided by Subsection (o), a taxable entity that is a health care provider shall exclude from its total revenue:

(1) to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), ~~the total amount of payments the health care provider received~~ any item of total revenue arising out of professional services provided:

(A) under the Medicaid program, Medicare program, Indigent Health Care and Treatment Act (Chapter 61, Health and Safety Code), and Children's Health Insurance Program (CHIP);

(B) ~~for professional services provided~~ in relation to a workers' compensation claim under Title 5, Labor code; and

(C) ~~for professional services provided~~ to a beneficiary rendered under the TRICARE military health system; and"

In connection with the above recommendation, we recommend Section 171.1011(p)(2) be amended as follows: "Health care institution' means the following institutions, and any entity included in a combined group with such institution that receives payments arising out of services provided by such institution:"

We also recommend the following language be added to the end of Section 171.1011(p)(3): "A health care provider includes a member of a combined group that receives payments arising out of services provided by a health care provider that is a member of the combined group."

c. Explanation

Due to the nature of the insurance industry, in many situations, the entity that actually provides health care services will not directly receive the associated payment. Often, entities that provide these services use affiliates to receive payments. The intent of the statute is to exclude from total revenue payments for health care services rendered under an enumerated list of government programs – rigid requirements regarding the mechanisms by which such payments are received would not appear to further this intent. Our recommendation furthers the statutory intent by extending the exclusion to qualifying affiliates that receive payments arising out of qualifying services. Because it is possible that the use of a payment entity might result in the provider and/or payment entity recognizing items of total revenue in ways that might arguably not be covered by the current statutory exclusion for "payments" from qualifying sources, we recommend using the phrase "total revenue arising out of professional services provided." This should ensure that revenue recognized by either the provider or the payment entity on account of the services will be excluded.

6. Dividends Received by Partnerships

a. Language at Issue

Section 171.1011(c)(2)(B) fails to include a provision similar to Section 171.1011(c)(1)(B)(ii) that would allow an entity taxed as a partnership for federal income tax purposes to exclude from total revenue dividend income allowed as a deduction on Internal Revenue Service Form 1120, Schedule C, to the extent such a deduction would be allowed were the partnership taxed as a corporation for federal income tax purposes.

b. Recommendation

We recommend the addition of new Section 171.1011(c)(2)(B)(vi) to allow entities taxed as partnerships for federal income tax purposes to subtract "to the extent included in Subsection (c)(2)(A), dividend income reportable on lines 6a and 6b, Internal Revenue Service Form 1065, Schedule K, to the extent a deduction for such income would be allowed under Section 171.1011(c)(1)(B)(iv) if the taxable entity were treated as a corporation for federal income tax purposes."

c. Explanation

Currently, corporations are permitted a deduction from total revenue for deductions reported on Form 1120, Schedule C to the extent the corresponding dividend income is included in total revenue. Entities taxed as partnerships for federal income tax purposes are not eligible for a federal dividends-received deduction and will therefore report no such deductions on a federal income tax return. However, because entities taxed as partnerships for federal income tax purposes and entities taxed as corporations for federal income tax purposes are treated identically for margin tax purposes, a partnership should be allowed to exclude any dividends that the partnership could have deducted if it were a corporation. Not permitting partnerships a similar exclusion would lead to the problem the exclusion for C corporations seeks to avoid – namely, the total revenue of the partnership would include income already subject to margin tax in the hands of another taxable entity. Our recommendation would avoid this inconsistency and provide similar treatment for partnerships and corporations.

D. Combined Reporting

1. Controlling Interest of Nonprofit Corporations

a. Language at Issue

Section 171.0001(8) defines "controlling interest" as "(A) for a corporation, either more than 50 percent, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50 percent, owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation".

b. Recommendation

We recommend that Section 171.0001(8) be amended to address nonprofit corporations that are taxable entities but that do not have any stock or membership interest. We recommend that Section 171.0001(8) be amended as follows: "(A) (I) for a corporation, either more than 50 percent, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50 percent, owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation, or (II) for a nonprofit corporation that does not have stock or membership interests, possessing direct or indirect control over the appointment of more than 50 percent of the board of directors or persons responsible for the day-to-day management of the corporation;"

c. Explanation

A nonprofit corporation organized under Texas law or the laws of another state may not satisfy the requirements to be exempt from the franchise tax. Accordingly, such a nonprofit corporation is considered a taxable entity.

Under Section 22.151 of the Texas Business Organizations Code and Section 2.08 of the Texas Non-Profit Corporations Act, a Texas nonprofit corporation is not required to have any shareholders or members. Under the current statutory language of Texas Tax Code Section 171.0001 and the rules of the Texas Comptroller, it is not possible to determine whether a nonprofit corporation that is a taxable entity is required to file as part of a combined group with other taxable entities even if the nonprofit corporation is directly controlled by the same persons that have a "controlling interest" (as defined in Section 171.0001(8)(A)) in a for-profit corporation. Under our recommended amendment to Section 171.0001(8), a nonprofit corporation that is a taxable entity and has no stock or membership interests will be required to file as part of a combined group with a taxable entity that controls the board of directors or persons responsible for the day-to-day management of the nonprofit corporation.

E. Tax Rates

1. Definition of Utility for Purposes of 0.5 percent Rate

a. Language at Issue

Section 171.002(c)(3) provides that a taxable entity that qualifies for the 0.5 percent rate cannot "provide retail or wholesale utilities, including telecommunications services, electricity, or gas" (the "utilities exclusion").

b. Recommendation

We recommend amending Section 171.002(c)(3) to provide that a taxable entity that qualifies for the 0.5 percent rate cannot "provide retail or wholesale utilities, including telecommunications services, electricity, or gas, to the public at large."

c. Explanation

Section 171.002(c)(3) does not specify what it means to provide retail or wholesale utilities. Based on the wording of the utilities exclusion and on our understating of the legislative purposes behind it, it is likely that the exclusion was intended to apply only to entities viewed as utilities in the traditional sense – *i.e.*, entities that service the general public. Without making this explicit, however, the utilities exclusion might be applied to a wide variety of entities not traditionally viewed as utilities, including entities classified as utilities for limited regulatory purposes) for example, the owners of certain types of gas pipelines), entities making incidental or ancillary sales of telecommunications, electricity or gas, and entities selling electricity or gas solely to manufacturers or other industrial users. Our proposed language would limit the utilities exclusion to local distribution companies and retail electric and telecommunications providers.

The colloquial wording of the utilities exclusion – *i.e.*, the use of the term "provide utilities" – suggests that a non-technical, common meaning interpretation of the statute would be most appropriate. Utilities are generally defined as goods and services (such as light, power, and water) provided by a public utility. *See* American Heritage College Dictionary, 3d Edition (1993) and Webster's 9th New Collegiate Dictionary (1986). West's Encyclopedia of American Law (2005) defines a "public utility" as a "business that furnishes an everyday necessity – such as water, electricity, natural gas, or telephone services – to the public at large." Thus, the common, ordinary meaning of the term "provide utilities" – and that most likely intended by the Legislature – is the furnishing of telecommunications, electricity or gas to the public at large by an entity commonly viewed as a public telecommunications, electricity, or gas utility.

This interpretation would be consistent with the application of the only other Texas tax statute using similar language – the miscellaneous gross receipts tax on utility companies. A "utility company" for purposes of this tax is a company that owns or operates a "gas or water works," "water plant," "electric light or electric power works," or "light plant" used for "local sale and distribution located within an incorporated city or town in this state," or that is a "retail electric provider" that makes local sales within a Texas city or town. Tax Code § 182.012(1). Such a utility company is subject to the miscellaneous gross receipts tax on its "business done in an incorporated city or town," and taxable "business" is defined as "the *providing* of gas, electric light, electric power, or water." Tax Code §§ 182.021(2); 182.022(b) [emphasis added]. The fact that the Legislature used similar language in Tax Code § 171.002(c)(3) (*i.e.*, "does not provide . . .utilities, including telecommunications, electricity or gas suggests that the Legislature intended § 171.002(c)(3) to refer to the same types of taxpayers – utilities that serve the public at large such as local distribution utilities and retail electric providers – to which Chapter 182 applies.)

Our recommendation is also consistent with one of the primary policies underlying the utilities exclusion. The 0.5% rate reduces the burden a gross revenues tax would impose on retailers and wholesalers due to their relatively high gross revenue and relatively low profit margins. Traditional regulated utilities are somewhat immune from these low margin concerns because they can pass the tax through to their customers via mandatory ratemaking proceedings. Other entities that make incidental sales of telecommunications, electricity, or gas (such as resellers of excess telecommunications capacity or cogeneration facilities that resell excess electrical capacity to the grid) – or who sell electricity or gas to industrial users under market-based, heavily negotiated contracts – cannot pass the tax on to their customers through ratemaking.[2]

Failure to adopt our proposed recommendation may lead to the disparate treatment of taxable entities that are otherwise in substantially similar positions both economically and functionally. The utilities exclusion does not apply to the sale of other products, such as crude oil, that are not provided by utilities to the public at large. This is so even though the wholesale markets for gas and crude oil are similar – many of the same entities make wholesale sales of both products, and both products are often purchased by manufacturers as components of manufactured products. It is unlikely that the Legislature intended that non-public utility taxpayers that sell gas to other sellers and to manufacturers would be subject to a higher tax rate than taxpayers that make sales of crude oil to similar buyers.

2. Definition of Utility for Purposes of 0.5 Percent Rate

a. <u>Language at Issue</u>

Section 171.002(c)(3) provides that for purposes of taxable entities that qualify for the 0.5 percent rate that "the taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity, or gas."

[2] Deregulated retail electric and telecommunications providers that service the general public may also not be able to pass the tax through via ratemaking, but – in contrast to the other entities discussed in this sentence – the Legislature has considered and rejected a proposed carveout from the utilities exclusion for such retail providers. The engrossed version of HB 3928, 80th Legislature (2007) contained the following new Section 171.002(c)(2), which was rejected: "A taxable entity that is a retail electric provider and that does not provide and is not affiliated with an entity that provides transmission and distribution utility service is primarily engaged in retail or wholesale trade."

b. Recommendation

Only if the recommendation in 1, above, is not adopted, we recommend that language be added to Section 171.002(c)(3) to clarify that the incidental and negligible provision of utilities does not disqualify a taxable entity from the 0.5 percent rate.

c. Explanation

Many businesses in Texas, including businesses primarily engaged in retail and wholesale trade, resell excess telecommunications capacity. It is unlikely that Section 171.002(c)(3) was intended to entirely preclude businesses primarily engaged in retail or wholesale trade from qualifying for the 0.5 percent rate simply because they might make incidental sales of excess telecommunications or other utilities.

3. Retail Trade and Wholesale Trade

a. Language at Issue

Section 171.0001(12) provides "'Retail trade' means the activities described in Division G of the 1987 Standard Industrial Classification Manual . . ." Section 171.0001(18) similarly provides "'Wholesale trade' means the activities described in Division F of the 1987 Standard Industrial Classification Manual . . ."

b. Recommendation

We recommend that Sections 171.0001(12) be amended to read as follows: "'Retail trade' means the activities described in Division G of the 1987 Standard Industrial Classification Manual, including those activities described in the Manual's description of 'Retail Trade – the Division as a Whole.'"

We recommend that Sections 171.0001(18) be amended to read as follows: "'Wholesale trade' means the activities described in Division F of the 1987 Standard Industrial Classification Manual, including those activities described in the Manual's description of 'Wholesale Trade – the Division as a Whole.'"

c. Explanation

The introduction to the SIC Manual states that the manual is intended to cover "the entire field of economic activities." The SIC Manual breaks down this field of economic activities into 11 "divisions" of activities, each of which are further broken down into "major groups" classified by 2-digit codes, which in turn are divided into 3-digit "industry groups" and then into 4-digit "industries." Many of these "industries" are described very specifically. Importantly, however, each business "establishment" which is capable of being classified in a division must be classified in an industry within that division. This is made clear in the instructions for classifying entities within the SIC Manual's final division, Division K, "Nonclassifiable Establishments." The SIC Manual provides that an entity may be treated as "nonclassifiable" only if it "cannot be classified in any other industry. Establishments which can be classified in a division should be classified in the most appropriate industry within that division." SIC Manual, p.422. Accordingly, an establishment must first be classified within one of Divisions A-J (if possible), after which it should be assigned to the closest possible industry fit within that division.

For each division, the SIC Manual provides a "Division as a Whole" overview of the activities of businesses intended to be classified within that division. Many businesses in Texas (for example, marketers of natural gas) engage in activities which are clearly retail or wholesale activities as contemplated by the SIC Manual's "Division as a Whole" overviews of these activities, but do not fit neatly with a Division F or Division G four digit industry code, three digit, industry group, or a two digit major group. Consistent with this guidance, the proposed amendment makes clear that an establishment will not be excluded from classification under Divisions F or G so long as its activities fall within the general description of the division.

4. Texas Franchise Tax Exemption for Certain Noncorporate Entities

a. Language at Issue

To establish an exemption for Texas franchise tax purposes, Section 171.063(b) provides that "a corporation is entitled to an exemption under this section based on the corporation's exemption from the federal income tax if the corporation files with the comptroller evidence establishing the corporation's exemption." Section 171.063(c) then states "[a] corporation's exemption under Subsection (b) of this section is established by furnishing the comptroller with a copy of the Internal Revenue Service's letter of exemption issued to the corporation." Section 171.088, which was added to the Texas Tax Code by H.B. 3, provides that the following entities are exempt from Texas franchise tax: "An entity that is not a corporation but that, because of its activities, would qualify for a specific exemption under this subchapter if it were a corporation, qualifies for the exemption and is exempt from the tax in the same manner and under the same conditions as a corporation."

b. Recommendation

We recommend that Section 171.088 be amended to provide that LLCs wholly-owned by I.R.C. § 501(c)(3) charitable organizations, which under the Internal Revenue Code are automatically exempt from federal income tax without any exemption application required to be filed with the Internal Revenue Service, are also exempt from Texas franchise tax. This can be achieved by amending Section 171.088 to read as follows: "An entity that is not a corporation but that, because of its activities, would qualify for a specific exemption under this subchapter if it were a corporation, qualifies for the exemption and is exempt from the tax in the same manner and under the same conditions as a corporation. Notwithstanding the provisions of Section 171.063(b), the provisions of this Section 171.088 shall apply to allow an exemption from Texas franchise tax for limited liability companies wholly-owned by charities exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code if such limited liability company provides to the comptroller the parent charity's tax-exempt determination letter issued by the Internal Revenue Service and the governing documents of the limited liability company showing that such limited liability company is organized for the sole purpose of carrying out the charitable activities of the parent charity."

c. Explanation

The Internal Revenue Service issued Priv. Ltr. Rul. 200134025 (Aug. 27, 2001) in 2001, where it ruled that an LLC whose sole member is a tax-exempt I.R.C. § 501(c)(3) organization is treated as a disregarded entity (*i.e.* ignored and treated as it does not even exist) for federal income tax purposes, and since the tax-exempt I.R.C. § 501(c)(3) organization accordingly treats the operations and finances of the LLC as its own for tax purposes, the Internal Revenue Service would not require the LLC to file a separate application for tax-exempt status to obtain its own tax-exempt determination letter. The rationale for this ruling by the Internal Revenue Service is that since (i) the LLC is formed solely to carry out the charitable activities of the parent charity, and (ii) the LLC is ignored as a separate entity and treated as simply existing as part of the parent charity, then the LLC comes under the umbrella of the parent charity's tax exemption and the IRS does not require the LLC to obtain its own tax-exempt determination letter. However, the Comptroller's current policy regarding LLCs wholly-owned by I.R.C. § 501(c)(3) organizations is in disconnect with federal law, which we believe creates an unfair "gotcha" for Texas charities. See Tex. Comp. Rul. 200106899L (June 21, 2001). This "gotcha" is created because the Comptroller requires a tax-exempt determination letter from the Internal Revenue Service in order to obtain a Texas franchise tax exemption, but as discussed above, LLCs wholly-owned by I.R.C. § 501(c)(3) charities are not required (and may not even be able) to obtain such a tax-exempt determination letter from the Internal Revenue Service. The end result is that the Comptroller's requirement is one that may be impossible to satisfy. Key differences exist under the Texas franchise tax laws that exist today, since amendment by H.B. 3, which requires this disconnect between Texas tax law and federal law to be eliminated. First, the prior Texas Limited Liability Company Act upon which Tex. Comp. Rul. 200106899L was based was unclear if an LLC could be formed with a nonprofit purpose. With the adoption of the Texas Business Organizations Code ("TBOC"), which became effective January 1, 2008, Texas law made clear that LLCs can now be formed for nonprofit purposes. Second, under H.B. 3, Texas franchise tax law now requires combined group reporting. For example, H.B. 3 requires determination of deductions, reduced tax rates, discounts, etc. on a combined group basis. To be consistent, the determination of charitable exemptions also should be made on a combined group basis. Without the recommended change, Texas charities will be subject to Texas franchise tax simply because they formed as an LLC (which is specifically allowed under the TBOC) rather than a corporation. We do not believe this is an intended result of the Legislature.

WEST 6359277.1

SECTION OF TAXATION
State Bar of Texas

Texas Society of
CPA Certified Public Accountants

October 31, 2008

Honorable Susan Combs
Texas Comptroller of Public Accounts
P.O. Box 13528
Austin, Texas 78711

RE: Definition of Net Distribute Income Definition

Dear Comptroller Combs:

The Section of Taxation of the State Bar of Texas ("SBT") and the State Tax Committee, Texas Society of Certified Public Accountants ("TSCPA") commend your efforts and those of your staff to adopt and enforce rules relating to the revised franchise tax as adopted under House Bill 3, 79th Legislature, 2006 and amended by House Bill 3928, 80th Legislature, 2007.

In addition to serving the public interest, one of the expressed goals of the TSCPA is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas. The views expressed herein are written on behalf of the State Tax Committee of the TSCPA. The committee has been authorized by the TSCPA Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the TSCPA Board of Directors or Executive Board and should not be construed as representing the views or policy of the TSCPA.

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

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENTAL SUBMISSIONS OF THE STATE BAR OF TEXAS SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE SECTION OF TAXATION MEMBERS WHO PREPARED THEM.

SECTION OF TAXATION
State Bar of Texas

Texas Society of Certified Public Accountants

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

Very truly yours,

Donna R. Rutter
Chair, State Tax Committee
Texas Society of Certified Public Accountants

Daniel J. Micciche
Chair, Section of Taxation
State Bar of Texas

SECTION OF TAXATION
State Bar of Texas

Texas Society of
CPA Certified Public Accountants

These comments are presented on behalf of the State Tax Committee of the Texas Society of Certified Public Accounts ("TSCPA") and the Section of Taxation of the State Bar of Texas. Members of the State Tax Committee of the Texas Society of Certified Public Accountants and the Section of Taxation of the State Bar of Texas who have contributed to this letter are as follows:

Donna Rutter, Chair, State Tax Committee, Texas Society of CPAs
David E. Colmenero, Chair, State and Local Tax Committee, Tax Section,
State Bar of Texas
Geoff Polma, Council Member, Tax Section, State Bar of Texas.
Matt Larsen, Vice Chair, State and Local Tax Committee, Tax Section,
State Bar of Texas
Alyson Outenreath, Vice Chair, State and Local Tax Committee, Tax Section,
State Bar of Texas
Kathy Applegate
Daniel Baucum
George M. Carefoot
John Farris
Ira Lipstet
Daniel J. Micciche
Christi Mondrik
Charolette F. Noel
Cynthia Ohlenforst
Mike Williams

The Committee on Governmental Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Daniel Baucum is Chair of COGS, and Cynthia Ohlenforst reviewed these comments on behalf of COGS.

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

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If you would like to contact someone to discuss the contents of this letter, please contact either of the persons below:

Donna Rutter
Chair, State Tax Committee,
Texas Society of CPAs
(817) 200-2151
drutter@hlbllp.com

David E. Colmenero
Chair, State and Local Tax Committee,
Section of Taxation
Texas State Bar
(214) 749-2462
dcolmenero@meadowscollier.com

I. INTRODUCTION

We recognize the complexity of the multiple issues the revised franchise tax has presented for the Comptroller's staff and commend the efforts of your staff during this challenging transition period between passage of the legislation, implementation of rules and policy and filing of the first tax returns. We appreciate the time and consideration demonstrated by your staff as we try to resolve many of these issues together. It is our intent to present items for consideration that may help and support you and your staff during the implementation phase of the revised franchise tax.

There are two separate issues we would like to present for your consideration. The first relates to the compensation deduction and the second issue relates to the definition of distributive shares of partnership income when a component of such flow-through income contains rental income generated by a taxable entity.

II. NEGATIVE NET DISTRIBUTIVE INCOME WITHIN THE COMPENSATION DEDUCTION

A. BACKGROUND

For franchise tax reports due on or after January 1, 2008, Texas Tax Code ("TTC") [1] §171.101 allows a taxable entity to elect to deduct compensation from total revenue to determine its taxable margin.[2] Compensation is defined to include (among other things) net distributive income ("NDI") from partnerships, trusts, corporations and limited liability companies treated as S corporations for federal income tax purposes and limited liability companies treated as partnerships for federal income tax purposes as long as the NDI is received by a natural person.[3] Recently released draft Comptroller Rule 3.589 defines NDI as the net amount of income, gain, deduction, or loss relating to a

[1] Hereinafter, all section references are to the TTC unless otherwise provided.
[2] Tex. Tax Code §171.101(a)(1)(B)(ii)(b).
[3] Tex. Tax Code §§ 171.1013(a)(1) and (2).

pass-through entity or disregarded entity reportable to the owners for the tax year of the entity.[4]

In a joint committee meeting between the Comptroller, the TSCPA and the State and Local Tax Committee of the State Bar Tax Section on June 13, 2008, the Comptroller's Policy staff explained the Comptroller's position on how the concept of distributive income should be applied where a pass-through or disregarded taxable entity generates negative NDI (*i.e.*, a loss). As we understood the Comptroller's position, a pass-through or disregarded taxable entity that elects to deduct compensation must include negative NDI in its compensation deduction. This would effectively involve subtracting a negative number in computing an entity's compensation deduction amount.

The Comptroller's staff agreed that the consequence of this interpretation would mean that a pass-through or disregarded entity with negative NDI that elects to deduct compensation would have to reduce or eliminate its compensation by the distributive share of negative NDI allocable to its natural person owners.

On June 19, 2008, the Frequently Asked Question ("FAQ") section of the Comptroller's website was updated to reflect this policy.[5] The FAQ section states: "If an entity elects to subtract compensation in computing its margin it must include all compensation as defined in TTC 171.1013. If NDI is a negative number, then we will treat it as a negative number in computing compensation."

We believe that this interpretation of TTC §171.1013 may not properly reflect legislative intent for the reasons stated below. We therefore suggest that the Comptroller's office reconsider its position on this very important issue.

B. STATUTORY LANGUAGE

When the compensation deduction from total revenue is elected and used in calculating taxable margin, TTC § 171.1013 states the following:

> (a) Except as otherwise provided by this section, "wages and cash compensation" means the amount entered in the Medicare wages and tips box of Internal Revenue Service Form W-2 or any subsequent form with a different number or designation that substantially provides the same information. The term also includes, to the extent not included above:

[4] Rule 3.589(b)(5).

[5] *See* FAQ No. 11 relating to compensation and Rule 3.589.

(1) net distributive income from a taxable entity treated as a partnership for federal income tax purposes, but only if the person receiving the distribution is a natural person;

(2) net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes, but only if the person receiving the distribution is a natural person;

(3) stock awards and stock options deducted for federal income tax purposes; and

(4) net distributive income from a limited liability company treated as a sole proprietorship for federal income tax purposes, but only if the person receiving the distribution is a natural person..."[6]

The wage and cash compensation amount is capped at $300,000 per person. The compensation amount also includes benefits. The statute provides some examples to assist taxpayers in determining what to deduct as benefits. This list of allowable benefits includes the following, to the extent deductible for federal income tax purposes:[7]

- Employer contributions to employee health savings accounts;
- Worker's compensation benefits;
- Health Care, such as health insurance benefits;
- Employer contributions made to employee's heath savings accounts; and
- Retirement contributions to 401(k) plans and other deferred compensation plans.

C. <u>THE COMPTROLLER'S RULES</u>

"Net distributive income" while referenced within the revised franchise tax statute above, was never defined in the statute. After the proposed rules for the revised franchise tax were published in the September 14, 2007 issue of the *Texas Register*, the Comptroller's office was asked to clarify the definition of "net distributive income." In the December 28, 2007 issue of the *Texas Register*, the Comptroller's office published the adopted final administrative rules along with the preliminary statements containing summaries of comments from various industry groups, professional societies, and individuals on the earlier proposed versions of the rules and the Comptroller's responses to those comments.[8] Subsequently, the Comptroller's office defined net distributive income as it relates to the compensation deduction as follows:

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[6] Tex. Tax Code § 171.1013(a).
[7] Tex. Tax Code §171.1013(b)(2).
[8] 32 Tex. Reg. 10013-10053, http://www.sos.state.tx.us/texreg/pdf/backview/1228/1228adop.pdf

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"Net distributive income—The net amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable to the owners for the tax year of the entity."[9]

The Comptroller's office used identical language in defining net distributive income when determining amounts included for total revenue.[10]

D. NET DISTRIBUTIVE INCOME FOR COMPENSATION DEDUCTION PURPOSES SHOULD NOT BE CONSTRUED TO INCLUDE NEGATIVE AMOUNTS

The Comptroller's definition of distributive income for purposes of total revenue accurately picks up profit and loss. But we do not believe that the same definition can be easily used for purposes of determining the amount of a taxpayer's compensation deduction amount. Specifically, we believe that NDI for purposes of the compensation deduction should be construed to include only positive NDI amounts. This approach seems more consistent with the applicable rules of statutory construction and the overall legislative intent underlying the enactment of TTC § 171.1013. The following explains the basis for our position.

Total revenue under the Texas franchise tax statute is premised on federal income tax concepts, including tax classifications and amounts reported as income on IRS Forms 1120, 1120S, 1065, and 1041. A corporate taxpayer, for example, must compute total revenue by using amounts reported on lines 1c and 4 through 10 of the federal Form 1120. Other taxable entities compute their total revenue by reference to similar line items on the applicable federal income tax returns.[11]

These federal income tax return line item amounts include items of income and deduction from lower-tier entities. For this reason, we can understand why the Comptroller would define NDI to include the net amount of income, gain, deduction, or loss relating to a lower-tier entity *for purposes of computing total revenue*.

However, the different context in which NDI is used in determining an entity's compensation deduction amount suggests that a different approach should apply. Case law makes clear that a statute must be construed in the context of the entire statute of which it is a part and that statutory terms should be accorded their plain and common meaning.[12] In construing the term NDI, a court of law would likely find it particularly

[9] Rule 3.589(b)(5).
[10] Rule 3.587(b)(7).
[11] For S corporations, lines 1c, 4 and 5 on IRS Form 1120S pg.1; lines 3a and 4 through 10 on Schedule K, IRS Form 1120S; and amounts reportable as income on line 17, IRS Form 8825. For entities electing partnership status and filing IRS Form 1065, lines 1c, 4, 6, and 7; lines 3a and 5 through 11 on IRS Form 1065, Schedule K; line 17 on IRS Form 8825; and line 11, plus line 2 or line 45, from IRS Form 1040, Schedule F
[12] *Continental Cas. Ins. Co. v Functional Restoration Assocs.*, 19 S.W.3d 393, 398 (Tex. 2000).

noteworthy that the term exists for purposes of determining the amount of a *deduction* and more specifically, the amount of the entity's "wage and cash compensation" amount. This context should therefore guide the Comptroller in defining NDI. Case law also makes clear that the ultimate objective in construing any statutory term is to give effect to the Legislative intent.[13]

1. **The Comptroller's Treatment of Negative NDI For Compensation Deduction Purposes Does Not Appear to Adequately Account for the Context in Which the Term Exists Nor Does it Appear Consistent with the Plain Meaning of the Statute**

The Comptroller's treatment of negative NDI for compensation deduction purposes may fail at the outset because, in this context, the TTC refers to NDI in creating a deduction, not a revenue item. Carried to its logical conclusion, a negative NDI, if included in the compensation amount, would actually increase rather than reduce a taxable entity's tax base. This would most clearly be the case for an entity whose only compensation amount is its owners' distributive share of income. The Legislature clearly intended the compensation deduction to be just that – an amount *deducted* in arriving at taxable margin. The Legislature could not have intended to create a deduction that would have the effect of increasing, rather than decreasing an entity's tax base – particularly where an entity's tax base is increased by the same item that the Legislature intended to be a deduction.

Moreover, the plain language of the statute suggests that the term NDI should not be construed to include a negative amount for purposes of determining the amount of wage and cash compensation. The concepts of wages, cash and compensation, very plainly contemplate remuneration in the positive sense. To be sure, *Webster's Dictionary* defines the term "compensation" in relevant part as "Payment, remuneration."[14] It defines the terms "wages" as "a payment usually of money for labor or services usually according to contract and on an hourly, daily, or piecework basis . . . ."[15] *Blacks Law Dictionary* defines the term "compensation" as "remuneration and other benefits received in return for services rendered . . . ."[16] It also defines the term "wages" as payment for labor or services . . . ."[17] These concepts suggest positive remuneration for services rendered. Indeed, it would be fairly unusual for someone to be "compensated" in the negative for labor or services.

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[13] *See id.*
[14] WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY pg. 268 (1987).
[15] WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY pg. 1324 (1987).
[16] BLACK'S LAW DICTIONARY pg. 301 (8th ed. 2004).
[17] BLACK'S LAW DICTIONARY pg. 1610 (8th ed. 2004).

2. The Comptroller's Treatment of Negative NDI May Not Conform to Federal Income Tax Law Concepts, Which Are Extensively Incorporated into the Texas Tax Code

Also significant is the concept of compensation and wages for federal income tax purposes.[18] Throughout the TTC are numerous and extensive references to the Internal Revenue Code ("IRC"). Indeed, TTC § 171.1013 begins with a reference to wage and compensation reported on IRS Forms W-2.[19] Specifically, the TTC states that " 'wages and cash compensation' means the amount entered in the Medicare wages and tips box of the Internal Revenue Service Form W-2 or any subsequent form with a different number or designation that substantially provides the same information." Clearly, therefore, the IRC and its construing authority are at the very least relevant in construing the relevant statutory concepts for purposes of the compensation deduction amount.

The U.S. Treasury Regulations define "compensation for services" to include a varied and broad range of items.[20] Included in the list is "compensation for services *on the basis of a percentage of profits* . . . ."[21] Notably absent from the list is any allocable share of loss.[22] In fact, including pass-through losses in the definition of compensation for federal income tax purposes would be contrary to other important federal income tax concepts, partly because it would effectively permit a taxpayer to fully offset income with losses that might otherwise be subject to limitations.

Moreover, the reference to Medicare wages and tips as reported on IRS Form W-2 suggests that the Legislature contemplated exclusively positive amounts because only positive income can ever be reported for Medicare purposes.[23] If a taxpayer were able to report negative amounts of compensation for employment tax purposes, the IRS could owe a taxpayer employment tax rather than the other way around. Federal tax concepts clearly do not permit this result.

The concept of self-employment income for federal self-employment tax likewise recognizes that negative amounts of income do not reflect compensation. The allocation of income from a pass-through entity generally reflects a form of compensation subject to federal self-employment tax.[24] Under federal law, however, a person receiving self-employment income from a flow-through entity is not subject to self-employment tax on

[18] *See* IRS "Instructions for Forms W-2 and W-3," and IRS Publication 15 (2008), (Circular E), Employer's Tax Guide, as examples of commonly held definitions of wages and other compensation.
[19] Tex. Tax Code § 171.1013(a).
[20] *See* Treas. Reg. §1.61-2(a)(1).
[21] *See id.*
[22] *See id.*
[23] IRS "Instructions for Forms W-2 and W-3," page 10.
[24] *See* IRC §§ 1401, 1402(a).

a "negative" amount.[25] In those instances, the IRS will treat the self-employment income amount as zero income for self-employment tax purposes.[26]

For the above reasons, federal law makes clear that negative NDI does not constitute "wages and compensation" for federal income tax purposes. This fact likewise suggests that it may not be appropriate to regard negative NDI as wage and cash compensation for Texas franchise tax purposes either.

3. Including Negative NDI in the Calculation of Compensation May Provide Small Businesses with Economic Disadvantages That Are Inconsistent With the Statute

Our understanding of the Comptroller's policy for negative NDI as explained by the Policy staff is that negative NDI should reduce existing items included in the computation of compensation. In situations where an individual wholly owns a taxable entity treated as a flow-through entity for federal income tax purposes, negative NDI could reduce cash compensation and benefits below zero. In this instance, if the taxable entity elected the compensation deduction, the entity's taxable margin would be more than the gross receipts of the taxable entity. Thus, the taxable entity would effectively be precluded from electing the compensation deduction. Instead of being able to deduct compensation amounts otherwise allowable, the business would be limited to the 30% alternative revenue offset deduction.

The Comptroller's position seems particularly detrimental to small businesses because they are the most likely to have natural person owners who directly participate in the operations of their business. The revised franchise tax includes numerous provisions that are clearly designed to avoid unnecessary detrimental consequences to small business. One of the clearest examples is in the tax discounts for small businesses included in TTC § 171.0021. Another is in the E-Z computation and rate provisions available to businesses with revenues of $10M or less. The compensation deduction provisions likewise include a provision designed to benefit small employers who are first time providers of health care benefits in TCC § 171.1013(b-1). Thus, the Comptroller's position on Negative NDI for compensation deduction purposes may be contrary to the apparent legislative policy of recognizing the challenges faced by small businesses and structuring the Tax Code to avoid any undue burdens on those businesses.

E. <u>Determination of Taxable Margin</u>

The revised franchise tax is based upon the determination of taxable margin as computed by the lesser of either 70% of total revenue[27] or determining total revenue from

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[25] *See* IRC § 1402(b)(2) (net earnings from self-employment of less than $400 do not constitute self-employment income).
[26] *See id.*, Section A, Line 1; Section B, Line 4c.

its entire business and subtracting, if eligible, a cost of goods sold deduction[28] or a compensation deduction.[29] TTC § 171.101 provides further guidance in determining taxable margin by stating the following:

> (c) In making a computation under this section, an amount that is zero or less is computed as zero.

By following the guidance provided under TTC 171.101, a taxable entity starts with total revenue and deducts either 30% of revenue, cost of goods sold, or compensation. If any one of the deduction amounts is less than zero, the amount is computed as zero. This statutory approach likewise suggests that a negative net distributive income amount should be treated as zero and not deducted against other forms of wages, compensation or other net distributive income to reduce the amount of actual compensation and certainly not to increase taxable margin.

F. RECOMMENDATION

For the above reasons, we recommend that the Comptroller's Rules be amended to state that negative NDI should be treated as zero for purposes of determining the amount of a taxpayer's compensation deduction.

III. DEFINITION OF FLOW-THROUGH INCOME

A. BACKGROUND

The Comptroller's Office recently published the following question and answer on the FAQ section of the Texas Comptroller's website:[30]

> Question: Does rental income retain its character when included in the distributive income from a partnership?
>
> Answer: Rental income does not lose its character as rent when it flows from a partnership to the partner and therefore does not qualify as passive income.

As discussed below, we believe this policy statement may be viewed as contrary to a natural reading of the relevant statutory provisions. We also believe it may be contrary to other indicia of legislative intent and may lead to undesirable tax policy. Furthermore, we believe the rationale underlying the Comptroller's position may not be supportable. Finally, we believe that the policy may raise constitutional issues.

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27 Tex. Tax Code § 171.101(a)(1)
28 Tex. Tax Code § 171.101(a)(1)(B)(ii)(a)
29 Tex. Tax Code § 171.101(a)(1)(B)(ii)(b)
30 *See* FAQ No. 12, relating to Passive Entities and Rule 3.582.

Accordingly, we respectfully request that the Comptroller amend its FAQs to state that rental income does not retain its character as rent when included in the distributive income from a partnership because the entire amount of a partner's distributive share of partnership income qualifies as passive income regardless of the character of the income earned at the lower-tier partnership level.[31]

B. STATUTORY LANGUAGE

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

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

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

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

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

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

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

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

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

[31] When reference is made to the lower-tier partnership or flow-through entity, this would include either a partnership or LLC taxed as a partnership for federal income tax purposes

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

(b) The income described by Subsection (a)(2) does not include:

(1) rent; or

(2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.

C. STATUTE IS UNAMBIGUOUSLY WRITTEN

1. **Regardless of the underlying character of flow-through income, the application of multiple principles of statutory construction suggests that flow-through income is still passive income under a natural reading of TTC Sections 171.0003(a)(2) and 171.0003(a-1)**

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

TTC § 171.0003(a)(2) treats as passive income flow-through income from investments in other entities, such as "income from a limited liability company"[32] and "distributive shares of partnership income to the extent that those distributive shares of income are greater than zero."[33] No provision of the TTC modifies or supplements this language to recharacterize any portion of the federal gross income received from a limited liability company or partnership as non-passive. Accordingly, the statute on its face unambiguously suggests that distributive income from a partnership or limited

[32] Tex Tax Code § 171.0003(a)(2)(A).
[33] Tex. Tax Code § 171.0003(a)(3)(A).

liability company is passive income, and does not state any circumstances in which all or part of the distributive income from a partnership or limited liability company should be recharacterized as nonpassive. When a statute's meaning is unambiguous, it should be interpreted according to its natural language.[34]

Each provision of a statute must be construed in the context of the entire statute of which it is a part.[35] TTC § 171.0003(a)(2) gives effect to the mandate of TTC § 171.0003(a-1). The latter provision specifies that an item of income otherwise categorized as passive income pursuant to TTC § 171.0003(a)(2) cannot be deemed active income. There is nothing in the statute that changes this result, regardless of the underlying nature of the activities conducted by those other lower-tier entities that ultimately give rise to such flow-through income. Accordingly, the most reasonable reading of TTC § 171.0003 as a whole appears to be that rental income earned by a flow-through entity does not retain its character as rental income in the hands of the flow-through entity's owners for purposes of determining whether the owners are passive entities.

In the same vein, it is a maxim of statutory construction that statutes should not be interpreted in a manner "that will render the statute meaningless."[36] The Comptroller's position, if applied consistently, appears to treat all flow-through income (not just rental income) as though it were earned directly by the flow-through entity's owners. In other words, the distributive income received by a partner from a partnership or a member from an LLC would be parsed as passive or active income based on the underlying sources. No part of the income would be passive merely because it was received from the partnership or LLC. Accordingly, following the rationale of the Comptroller's position set out in the FAQ noted above appears to render meaningless the designation of "income from a limited liability company" and "distributive shares of partnership income" as distinct types of passive income as specifically allowed by TTC § 171.0003. As discussed below, there does not appear to be any evidence that the Legislature intended this "look-through" approach. In addition, the Comptroller's position leads to undesirable tax policy.

2. **Consistent with statutory language, the legislative history does not indicate any intent that revenue generated by a flow-through entity should retain its underlying character in the hands of the flow-through entity's owners.**

We are unable to locate any legislative history indicating that the Legislature intended to apply a "look-through" or "aggregate" approach in determining whether

[34] *In re Entergy Corp.*, 142 S.W.3d 316, 322 (Tex. 2004).
[35] *Continental Cas. Ins. Co,* 19 S.W.3d at 398.
[36] *Texas Orthopedic Ass'n v. Texas State Bd. of Podiatric Medical Examiners*, 2008 WL 678526 (Tex. App. – Austin 2008).

income is passive. To the contrary, the consistent treatment of partnerships (and other flow-through entities for federal income tax purposes) as separate entities in other franchise tax contexts suggests that the Legislature intended to use a separate entity approach in determining whether an entity's income is passive.[37] Accordingly, the Comptroller's proposed diversion from the separate entity conceptual overlay and use of a partnership aggregate theory does not appear to be supported by legislative intent.

If the Legislature had intended this result, it would likely have specified the result directly. For example, in lieu of the language of TTC §§ 171.0003(a)(2)(A) and (B) currently at issue, the Legislature could have added a TTC § 171.0003(c) stating that "income from a limited liability company and distributive shares of partnership income shall qualify as income described in Subsection 171.0003(a)(2) only to the extent the income of the limited liability company or partnership qualifies as income described in Subsection 171.0003(a)(2)." We believe that the Legislature would have used this level of specificity if the Comptroller's interpretation were the intended result. As discussed in Section III.C. below, the characterization of distributive income from a partnership as "rent" based on the character of the income at the partnership level is a controversial interpretive leap. If the Legislature had intended a consequence of such significance, we believe that it would have more clearly stated so.

The Legislature has displayed great specificity in another instance in which it intended otherwise passive income to be treated as active income. The Legislature specifically included in the definition of "passive income" federal gross income from "royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests."[38] However, the Legislature further specified in the TTC that this type of income should not be treated as passive income where it was "received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement."[39] Because the Legislature has explicitly defined a situation in which income falling within a general passive income category should be treated as active income, absent a similarly explicit statutory provision, it seems inappropriate to conclude that the Legislature intended to recharacterize items falling within any category of passive income as active income in other situations.[40]

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[37] For example, partnerships/LLCs and partners/members compute total revenue as separate entities; each entity is analyzed separately to determine if it is a passive entity; partnerships/LLCs and partners/members may elect different treatment of cost of goods sold under TTC § 171.1012(g) (capitalize or expense); and each entity separately determines whether they have Texas nexus.
[38] Tex. Tax Code § 171.0003(a)(3)(D).
[39] Tex. Tax Code § 171.0003(b)(2)
[40] The existence of the tiered partnership rules of TTC § 171.1015 is additional evidence that the Legislature was capable of great specificity in expressing its intent regarding income earned at the partnership level versus income attributable to its owners.

Because rent is treated as "passive" income for federal income tax purposes under IRC § 469, the separate statement in Section 171.0003(b)(1) that "rent" is not passive under Section 171.0003(a)(1) was likely intended simply to clarify that the federal income tax characterization of rent as passive does not apply for franchise tax purposes. The Legislature's desire to make this abundantly clear is understandable given that federal income tax concepts are incorporated throughout the franchise tax provisions. This reading of Section 171.0003(b)(1) seems more plausible in our view than construing it as effectively overriding both Section 171.0003(a)(2) (defining distributive income from a partnership as passive) and Section 171.0003(a-1) (providing that income which falls into one of the passive categories described by TTC § 171.0003(a)(2) cannot be treated as non-passive, active income).

Moreover, viewing Section 171.0003(b)(1) as merely emphasizing that rent should not be regarded as passive income for franchise tax purposes seems consistent with the Comptroller's treatment of other similar provisions in the Texas Tax Code. Through the course of our conversations with the Texas Comptroller's office, we understand that the Comptroller's office currently views some provisions in the franchise tax code sections as merely emphasizing a result already established in other sections. One example is the 10% active income test for passive income purposes. We understand that the Comptroller currently views that provision as merely restating the 90% test and not adding any separate meaning or limitation to the 90% passive income test. Thus, the fact that Section 171.0003(b)(1) simply emphasizes the result of applying Section 171.0003(a)(2) to rental income should not be viewed by the Comptroller as anomalous or in any way unusual in the franchise tax scheme.

D. STATED RATIONALE OF COMPTROLLER FOR THIS POSITION

We understand that the Comptroller's rationale for flow-through treatment of rental income is based on the supposition that because the rental income of a partnership is separately reported to individual partners on federal Schedules K-1 rather than on the partnership's Form 1065,[41] the character of such income as rent should flow-through to the partners. We agree that rental income is separately reported to individual partners on Schedules K-1 rather than on the partnership's Form 1065; however, there is a specific federal income tax reason for this treatment. For federal income tax purposes, IRC § 469 limits a taxpayer's ability to deduct losses from passive activities against non-passive income. Generally, passive income (or loss) reported by a partnership is passive income (or loss) for all partners equally. However, IRC § 469 specifically provides that this general rule does not apply with respect to individual partners who are real estate professionals and who materially participate in the partnership's activity.[42] Thus, this separate Schedule K-1 reporting for rental activities is required simply to accommodate

[41] IRC § 702(a)(7) and (8).
[42] IRC §469(c)(7) via IRC §469(c)(2).

the narrow passive loss rules found in IRC § 469 with respect to certain partners in limited cases. Separate Schedule K-1 reporting of rent is not intended to establish a broad characterization of rental income for all partners for federal income tax purposes—to the contrary, the rent will be characterized as passive to some partners and non-passive to others. When the purposes for the K-1 and the federal income tax principles at issue are considered, we believe that the Comptroller is ascribing more significance to the manner of reporting on federal Schedules K-1 than is warranted.

Moreover, Schedule K-1 requires the reporting of rental income to individual partners on a *net* basis, whereas the 90% passive income test under TTC § 171.0003(a) requires such testing be done on a *gross* basis for Texas franchise tax purposes. Thus, the Comptroller's reliance on federal K-1 reporting as a basis for its policy seems inconsistent with the statutory requirements of TTC § 171.0003(a).

Finally, line 1 of Schedule K-1 requires reporting "ordinary business income" to partners as a separate line item as well. To be consistent with the Comptroller's reliance on the "separate" reporting of rent on federal Schedules K-1 as a justification for a "look-through" approach, partners would also need to treat Schedule K-1 amounts reported on line 1 as non-passive. This would not seem to be an intended result.

Because the characterization of distributive income as rent is not a simple federal income tax issue, the Legislature would probably have provided specific guidance had they wished the Comptroller's position to be implemented. We believe it is unlikely that the Legislature would have left the necessary interpretive leaps to chance.

E. THE COMPTROLLER'S INTERPRETATION AS TAX POLICY

In addition to appearing contrary to the natural reading of TTC § 171.0003 and contrary to legislative intent, the Comptroller's "look-through" approach may also be difficult to support from a tax policy perspective. We are unable to identify any instances in which the Comptroller's policy is necessary to capture taxable revenues that would otherwise escape the system. Rather, the primary effect of the Comptroller's policy appears to be to impose an unexpected one-time tax on flow-through passive income that the Legislature did not intend to tax. Going forward, taxpayers can easily avoid paying additional margin tax as a result of this policy, but with the undesirable side-effect of otherwise unnecessary structuring of activities and additional entity creation.

First, the policy does not seem necessary to prevent Texas rental income from escaping taxation. Rent that is received *directly* by an operating partnership or LLC can never be treated as passive, and accordingly Texas rental income should be subject to franchise tax at the operating entity level. Any upstream entities—taxable entities that own interests in operating entities receiving rent—will not be taxed on the rent because they will subtract from total revenue their distributive shares of the operating partnership or LLC income (to the extent the net income of the passive entity was generated by the margin of any other taxable entity).[43] Under normal circumstances, therefore, rental income falls squarely within the revised franchise tax policy paradigm: a single layer of tax imposed on the entity that earns the income. Accordingly, the Comptroller's policy would not close a loophole – dropping a rental property into a subsidiary partnership will not allow the rent to escape tax with or without the Comptroller's policy. Rather, the primary result of requiring partners or LLC members to treat flow-through rental amounts as non-passive appears to be a one-time trap for the unwary that taxes other, clearly passive income.

Assume, for example, that two investors form an investment partnership (the "Partnership") to hold two investments: a royalty interest in a Texas gas property, and a limited partnership interest in a syndicated real estate investment partnership. Further assume that the royalties account for 85% of the Partnership's gross income and the net distributive income from the real estate partnership reported on its Schedule K-1 as net rental income generates 15% of the Partnership's gross income. Under the Comptroller's policy, the Partnership now has received 15% of its gross income from non-passive sources (the flow-through rent), and therefore cannot qualify as a passive entity. As a result, the Texas royalty income received by the Partnership becomes fully taxable to the Partnership, while the flow-through rent itself is not taxable because the Partnership will subtract the net distributive income from total revenue.

The investors may be surprised to learn not only that their passive royalty income is taxable, but also that this result could have been easily avoided. If the investors had created separate partnerships to hold the royalty interest and the real estate partnership interest, then (i) the royalty partnership would have been a nontaxable passive entity, and (ii) the partnership holding the interest in the real estate investment partnership would have been a taxable entity, but would have had no tax liability because it would have been allowed to subtract net distributive income from total revenue. Investors potentially subject to the Comptroller's currently stated policy on flow-through income can thus avoid the policy merely by causing any interests in partnerships or LLCs that generate flow-through nonpassive income to be held in an investment partnership other than one holding other types of passive income-generating assets.

From a tax policy perspective, the Comptrollers' flow-through approach to rent seems troubling because the policy does not appear to be supported by any direct (or indirect) statutory language, lacks direct or indirect support in the legislative history, can be avoided easily by tax structuring, and appears to result mainly in either unexpected taxation of unequivocally passive income or the otherwise unnecessary creation of multiple entities. The Comptroller's flow-through approach also seems to be treating as somehow improper a taxpayer reporting provision that is in no way abusive.

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[43] Tex. Tax Code §171.1011(e).

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F. COMPTROLLER'S POLICY MAY RAISE CONSTITUTIONAL CONCERNS

Finally, the Comptroller's flow-through policy may raise constitutional concerns. Article VIII, section 1(a) of the Texas Constitution requires taxation to be equal and uniform. Under this provision, the Comptroller is prohibited from adopting an interpretation of a statute that makes arbitrary or unreasonable classifications among taxpayers without a rational basis related to a legitimate government purpose.[44] Notwithstanding the combined reporting obligations that exist in some situations, the revised franchise tax is essentially computed and applied in almost all respects on a separate entity basis. For certain taxpayers, however, the Comptroller has opted to apply flow-through characterization to distributions from a partnership attributable to rent (presumably even if the distributing partnership was fully taxed on those rental receipts) for purposes of applying the passive entity income test under TTC § 171.0003. Moreover, the Comptroller has not opted to apply the flow-through characterization to dividends attributable to rent received by a corporation. Nor has the Comptroller opted to apply the flow-through characterization to many other categories of non-passive income that a partnership might receive. The Comptroller's policy could thus be viewed as drawing classification distinctions between rent received by a partnership and rent received by a corporation, as well as between rent and other types of non-passive income received by a partnership. Due to the absence of a clear and legitimate governmental purpose for drawing these classification distinctions, the flow-through characterization of rent from a partnership but not from other entities raises concerns under the Texas constitutional requirement of equal and uniform taxation.

IV. CONCLUSION

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

Very truly yours,

Donna R. Rutter
Chair, State Tax Committee
Texas Society of Certified Public Accountants

Daniel J. Micciche
Chair, Section of Taxation
State Bar of Texas

cc:

[44] *See, e.g., Bullock v Sage Energy Co.*, 728 S.W.2d 465 (Tex. App.—Austin 1987, writ ref'd n.r.e.).

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July	
17	10:00 a.m. – 3:00 p.m. 2008 New Chair and Treasurer Orientation Marriott Waterway 1601 Lake Robbins Drive Spring, TX (800) 204-2222, ext. 1419
August	
15	Deadline for submitting articles for the October 2008 issue of the *Texas Tax Lawyer*
27	Tax Law Bootcamp - Dallas
28-29	26th Annual Advanced Tax Law Course - Dallas
September	
5	10:30 a.m. – 12:30 p.m. Tax Section Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Ste. 4100 Dallas, Texas 75218 (214) 969-2800
11-13	ABA Section of Taxation 2008 Joint Fall CLE Meeting - San Francisco, CA
October	
1	Tax Law Bootcamp – Houston (Video)
November	
2- 3	26th Annual Advanced Tax Law Course - Houston (Video)
14	10:30 a.m. – 12:30 p.m. Council Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Ste. 4100 Dallas, Texas 75218 (214) 969-2800
December	
12	Deadline for submitting articles for the February 2009 issue of the *Texas Tax Lawyer*

January	
8 - 10	ABA Section of Taxation 2009 Midyear Meeting – New Orleans, LA
16	10:30 a.m. – 12:30 p.m. Tax Section Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Ste. 4100 Dallas, Texas 75218 (214) 969-2800
February	
March	
13	Deadline for submitting articles for the May 2009 issue of the *Texas Tax Lawyer*
April	
10	10:30 a.m. – 12:30 p.m. Council Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Ste. 4100 Dallas, Texas 75218 (214) 969-2800
May	
7 - 9	ABA Section of Taxation 2009 May Meeting – Washington, DC
June	
11 - 12	25th Annual Texas Federal Tax Institute – San Antonio
25-26	State Bar of Texas Annual Meeting – Dallas
26	Members' Meeting of the Section of Taxation of the State Bar of Texas – Dallas

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LEADERSHIP ROSTER

Officers

Daniel J. Micciche (Chair)
Akin Gump Strauss Hauer & Feld LLP
1700 Pacific Avenue, Suite 4100
Dallas, Texas 75201
214-969-2797
214-969-4343 (fax)
dmicciche@akingump.com

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

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

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

Council Members

Dan G. Baucum
COGS Chair
Shackelford, Melton & McKinley, LLP
3333 Lee Parkway, Tenth Floor
Dallas, Texas 75219
214-780-1400
214-780-1401 (fax)
dbaucum@shacklaw.net

Tina R. Green
CLE Chair
Patton Roberts, PLLC
400 Century Plaza
2900 St. Michael Drive
Texarkana, TX 75503
903-334-7000
903-334-7007 (fax)
tgreen@pattonroberts.com

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

H. James Howard
Term expires 2009
Locke Lord Bissell & Liddell LLP
600 Travis Street, Suite 3400
Houston, Texas 77002-3095
713-226-1424
713-223-3717 (fax)
jhoward@lockelord.com

Bob Charles Griffo
Term expires 2009
Andrews Kurth LLP
1717 Main Street, Suite 3700
Dallas, Texas 75201
214-659-4651
214-659-4860 (fax)
bgriffo@akllp.com

Ronald W. Adzgery
Term expires 2009
Fulbright & Jaworski LLP
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-7704
713-651-5246 (fax)
radzgery@fulbright.com

Geoffrey R. Polma
Term expires 2010
Locke Lord Bissell & Liddell LLP
2200 Ross Avenue, Suite 2200
Dallas, Texas 75201-6776
214-740-8644
214-740-8800 (fax)
gpolma@lockelord.com

Stephanie M. Schroepfer
Term expires 2010
Fulbright & Jaworski LLP
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-5591
713-651-5246 (fax)
sschroepfer@fulbright.com

Lawrence Ray Jones, Jr.
Term expires 2010
Townsend & Jones LLP
8100 Lomo Alto, Suite 238
Dallas, Texas 75225-6545
214-696-2661
214-764-3320 (fax)
larry@tjtaxlaw.com

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

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

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

Ex Officio Council Members

Kevin Thomason
Immediate Past Chair
Thompson & Knight LLP
One Arts Plaza
1722 Routh Street, Suite 1500
Dallas, Texas 75201-2533
214-969-2561
214-969-9261 (fax)
kevin.thomason@tklaw.com

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

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

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

Abbey B. Garber
IRS Representative
Internal Revenue Service
Mc 2000 Mwsat
18820 Fortson Avenue
Dallas, Texas 75252-2553
972-308-7913
abbey.b.garber@irscounsel.treas.gov

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TAX SECTION LEADERSHIP ROSTER

COMMITTEE	CHAIR	VICE CHAIR
1. Continuing Legal Education	Tina R. Green Patton Roberts, PLLC 400 Century Plaza 2900 St. Michael Drive Texarkana, TX 75503 903-334-7000 903-334-7007 (fax) tgreen@pattonroberts.com	Ronald W. Adzgery Fulbright & Jaworski LLP 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-7704 713-651-5246 (fax) radzgery@fulbright.com Robert Maddox Kemp Smith P.C. 221 North Kansas, Suite 1700 El Paso, Texas 79901 915-533-4424 915-546-5360 (fax) bmad@kempsmith.com
2. Corporate Tax	Robert W. Phillpott, Jr. Fulbright & Jaworski LLP 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5151 713-651-5246 (fax) rphillpott@fulbright.com	Tom D. McNutt Bracewell & Giuliani LLP 111 Congress Avenue, Suite 2300 Austin, Texas 78701-4061 512-542-2138 512-479-3935 (fax) tom.mcnutt@bgllp.com Jeffrey M. Blair Hunton & Williams LLP 1445 Ross Avenue Suite 3700 Dallas, Texas 75202-2799 214-468-3306 214-468-3599 (fax) jblair@hunton.com

RETURN TO TABLE OF CONTENTS

3. Employee Benefits

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

Benny R. Valek
904 Signal Ridge Place
Rockwall, Texas 75032
972-878-1700
972-875-7979 (fax)
bvalek@bvaleklaw.com

4. Energy and Natural Resources Tax

Roger D. Aksamit
Thompson & Knight LLP
333 Clay Street, Suite 3300
Houston, Texas 77002
713-951-5885
832-397-8057 (fax)
Roger.Aksamit@tklaw.com

Brian Dethrow
Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202-3797
214-953-5794
214-953-5794 (fax)
bdethrow@jw.com

5. Estate and Gift Tax

James V. Roberts
Glast, Phillips & Murray, P.C.
2200 One Galleria Tower
13355 Noel Road, LB 48
Dallas, Texas 75240
214-528-2822
214-528-3110 (fax)
jim@jamesvroberts.com

Jason Roy Flaherty
Bennett Flaherty LLP
3307 Northland Drive, Suite 470
Austin, Texas 78731
512-407-8888
512-407-8588 (fax)
jflaherty@bfaustin.com

Daniel H. McCarthy
The Blum Firm, P.C.
420 Throckmorton Street, Suite 650
Fort Worth, Texas 76102-3723
817-334-0066
817-334-0078 (fax)
dmccarthy@theblumfirm.com

6. General Tax Issues

Gene Wolf
Kemp Smith LLC
221 North Kansas, Suite 1700
El Paso, Texas 79901-1441
915-543-6441
915-204-8936 (fax)
gwolf@kempsmith.com

Julie C. Sassenrath
Winstead PC
5400 Renaissance Tower
1201 Elm Street
Dallas, Texas 75270
214-745.5887
214-745.5390 (fax)
jsassenrath@winstead.com

Ryan Thomas Gardner
Haynes and Boone, LLP
1 Houston Center
1221 McKinney, Suite 2100
Houston, Texas 77010
713-547-2122
713-236-5622 (fax)
ryan.gardner@haynesboone.com

7 International Tax

Katrina H. Welch
Texas Instruments
7839 Churchill Way, M/S 3998
Dallas, Texas 75251
972-917-6923
972-917-6006 (fax)
katrina@ti.com

Andrius R. Kontrimas
Fulbright & Jaworski L.L.P.
Fulbright Tower
1301 McKinney
Houston, Texas 77010-3095
713-651-5482
713-651-5246 (fax)
akontrimas@fulbright.com

Mark Horowitz
Gardere Wynne Sewell LLP
1000 Louisiana, Suite 3400
Houston, Texas 77002
713-276-5467
713-276-6467 (fax)
mhorowitz@gardere.com

RETURN TO TABLE OF CONTENTS

8. Partnership and Real Estate

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

Jeffrey D. Wallace
Locke Lord Bissell & Liddell LLP
2200 Ross Avenue, Suite 2200
Dallas, Texas 75201
214-740-8784
214-740-8800 (fax)
jwallace@lockelord.com

J.F. "Jack" Howell III
Sprouse Shrader Smith P.C.
701 S. Taylor, Suite 500
Amarillo, Texas 79101
806-468-3345
806-373-3454 (fax)
jack.howell@sprouselaw.com

9. Property Tax

Amy Reilly Sallusti
Geary Porter & Donovan P.C.
16475 Dallas Parkway, Suite 400
Addison, Texas 75001-6837
972-931-9901
972-931-9208 (fax)
asallusti@gpd.com

Matthew Tepper
McCreary, Veselka, Bragg & Allen, P.C.
700 Jeffrey Way, Suite 100
Round Rock, Texas 78665
512-323-3200
512-323-3205 (fax)
mtepper@mvbalaw.com

10. Solo and Small Firm

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

Everett R. "Rhett" Buck
3730 Kirby Drive, Suite 1200
Houston, Texas 77098
713-868-9448
713-868-6157 (fax)
erhettbuck@aol.com

11. State and Local Tax

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

David D. White
AT&T Corporate Tax Department
175 E. Houston Street
San Antonio, Texas 78205
210-351-3918
210-351-3960 (fax)
dw5939@att.com

Matthew L. Larsen
Baker Botts LLP
2001 Ross Avenue
Dallas, Texas 75201-2980
214-953-6673
214-661-4673 (fax)
matthew.larsen@bakerbotts.com

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

12. Tax Controversy

M. Todd Welty
Sonnenschein Nath & Rosenthal LLP
1717 Main Street, Suite 3400
Dallas, Texas 75201-4612
214-259-0953
214-259-0910 (fax)
twelty@sonnenschein.com
G. Thomas Rhodus

G. Thomas Rhodus
Looper, Reed & McGraw
1601 Elm Street, Suite 4100
Dallas, Texas 75201
214-954-4135
214-953-1332 (fax)
trhodus@lrmlaw.com

RETURN TO TABLE OF CONTENTS

13. Tax-Exempt Finance

Tina Livingston
Allen Boone Humphries Robinson LLP
3200 Southwest Freeway, Suite 2600
Houston, Texas 77027
713-860-6455
713-860-6655 (fax)
tlivingston@abhr.com

W. Mark Scott
Vinson & Elkins LLP
The Willard Office Building
1455 Pennsylvania Avenue NW
Suite 600
Washington, DC 20004-1008
202-639-6797
202-639-6604 (fax)
mscott@velaw.com

14. Tax-Exempt Organizations

Bruce E. Bernstien
Bruce E. Bernstien & Assoc. P.C.
10440 N. Central Expwy., Suite 1130
Lock Box 402
Dallas, Texas 75231
214-706-0837
214-706-0848 (fax)
bbernstien@plusassociates.com

Laura Ann Gabrysch
Fulbright & Jaworski L.L.P.
300 Convent Street, Suite 2200
San Antonio, Texas 78205-3792
210-270-7123
210-270-7205 (fax)
lgabrysch@fulbright.com

Ronald S. Webster
Fizer, Beck, Webster, Bentley
& Scroggins
1330 Post Oak Boulevard, Suite 2900
Houston, Texas 77056
713-840-7710
713-963-8469 (fax)
rwebster@fizerbeck.com

Albert Lin
Brown McCarroll L.L.P.
111 Congress Avenue, Suite 1400
Austin, Texas 78701-4093
512-472-5456
512-479-1101 (fax)
alin@mail

G. Philip Morehead
G. Philip Morehead, P.C.
500 Chestnut Street, Suite 1400
Abilene, Texas 79602-1457
325-676-7575
325-676-7878 (fax)
phil@moreheadlaw.com
rwebster@fizerbeck.com

15. Governmental Submissions

Dan G. Baucum
Shackelford, Melton & McKinley, LLP
3333 Lee Parkway, Tenth Floor
Dallas, Texas 75219
214-780-1400
214-780-1401 (fax)
dbaucum@shacklaw.net

Stephanie M. Schroepfer
Fulbright & Jaworski LLP
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-5591
713-651-5246 (fax)
sschroepfer@fulbright.com

16. Newsletter Editor

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

Jorge Villegas
Kemp Smith LLC
221 North Kansas, Suite 1700
El Paso, Texas 79901-1441
915-533-4424
915-546-5360 (fax)
jvillegas@kempsmith.com

17. Pro Bono

Elizabeth Copeland
Oppenheimer Blend Harrison &
Tate, Inc.
711 Navarro, Suite 600
San Antonio, Texas 78205-1796
210-299-2347
210-224-7540 (fax)
ecopeland@obht.com

Katherine E. David
Oppenheimer Blend Harrison
& Tate, Inc.
711 Navarro, Suite 600
San Antonio, Texas 78205-1796
210-299-2355
210-224-7540 (fax)
kdavid@obht.com

COMMITTEE SELECTION FORM
Section of Taxation
State Bar of Texas

NAME: ______________________________ DATE: ______________

FIRM: ____

ADDRESS: ____

CITY STATE ZIP CODE

TELEPHONE NO: (______)__________________ E-MAIL: ____________________

BAR CARD NO.: ____________________

COMMITTEE SELECTION (PLEASE CHECK BOX)

	COMMITTEE	CHAIR
❑	**Continuing Legal Education**	Tina R. Green Patton, Roberts, McWilliams & Capshaw, LLP 400 Century Plaza 2900 St. Michael Drive Texarkana, Texas 75503 903-334-7000 903-334-7007 (fax) tgreen@pattonroberts.com
❑	**Corporate Tax**	Robert W. Phillpott, Jr. Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5151 713-651-246 (fax) rphillpott@fulbright.com
❑	**Energy and Natural Resources Tax**	Roger D. Aksamit Thompson & Knight LLP 333 Clay Street, Suite 3300 Houston, Texas 77002 713-951-5885 832-397-8057 (fax) Roger.Aksamit@tklaw.com
❑	**Estate & Inheritance Tax**	James V. Roberts Glast, Phillips & Murray, P.C. 2200 One Galleria Towser 13355 Noel Road, LB 48 Dallas, Texas 75240 214-528-2822 214-528-3110 (fax) jim@jamesvroberts.com
❑	**International Tax**	Katrina H. Welch Texas Instruments 7839 Churchill Way, M/S 3998 Dallas, Texas 75251 972-917-6923 972-917-6006 (fax) Katrina@ti.com
❑	**Partnership/Real Estate**	James Michael Threet Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 214-969-2795 214-969-4343 (fax) mthreet@akingump.com
❑	**Property Tax**	Amy Reilly Sallusti Geary, Porter & Donovan P.C. 16475 Dallas Parkway, Suite 500 Addison, Texas 75001-6837 972-931-9901 972-931-9108 (fax) asullusti@pgd.com

RETURN TO TABLE OF CONTENTS

	COMMITTEE	CHAIR
❏	**Small Firm/Solo**	Christi Mondrik Mondrik & Associates 515 Congress Avenue, Suite 1850 Austin, Texas 78701 512-542-9300 512-542-9301 (fax) ccmondrik@mondriklaw.com
❏	**State & Local Tax**	David E. Colmenero Meadows, Collier, Reed, Cousins & Blau, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202-3725 214-744-3700 214-747-3732 (fax) dcolmenero@meadowscollier.com
❏	**Tax Controversy**	M. Todd Welty Sonnenschein Nath & Rosenthal LLP 1717 Main Street, Suite 3400 Dallas, Texas 75201-4612 214-259-0953 214-259-0910 (fax) twelty@sonnenschein.com
❏	**Tax-Exempt Finance**	Tina Livingston Allen Boone Humphries Robinson LLP 3200 Southwest Freeway, Suite 2600 Houston, Texas 77027 713-860-6455 713-860-6655 (fax) tlivingston@abhr.com
❏	**Tax-Exempt Organizations**	Bruce E. Bernstien Bruce E. Bernstien & Assoc. P.C. 10440 N. Central Expwy., Suite 1130 Lock Box 402 Dallas, Texas 75231 214-706-0837 214-706-0848 (fax) bbernstien@plusassociates.com
❏	**Pro Bono**	Elizabeth Copeland Oppenheimer Blend Harrison & Tate, Inc. 711 Navarro, Suite 600 San Antonio, Texas 78205-1796 210-224-2000 210-224-7540 (fax) ecopeland@obht.com
❏	**Publication Editor**	Alyson Outenreath Thompson & Knight LLP 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214-969-1741 214-880-3276 (fax) alyson.outenreath@tklaw.com
❏	**Website/E-Communications**	Tyree Collier Thompson & Knight LLP 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214-969-1409 214-999-1565 (fax) tyree.collier@tklaw.com
❏	**Government Submissions**	Dan G. Baucum Shackelford, Melton & McKinley, LLP 3333 Lee Parkway, Tenth Floor Dallas, Texas 75219 214-780-1400 214-780-1401 (fax) dbaucum@shacklaw.com

Please complete form and forward to the Committee Chair(s).

RETURN TO TABLE OF CONTENTS