THE TEXAS TAX LAWYER

Fall 2009
Vol.ÁH7, No.1
www.texastaxsection.org

STATE BAR OF TEXAS

2009

Created in 1939

TABLE OF CONTENTS

From Our Leader:
The Chair's Message i
Tyree Collier**,** Thompson & Knight LLP

Special Attention and Upcoming Events:

12th Annual International Tax Symposium
November 6, 2009 - The Center for American & International Law, Plano, Texas ii

Nomination Form For 2010 Outstanding Texas Tax Lawyer iii

Articles:

International Philanthropy, A U.S. Tax Perspective. 1
Andrius R. Kontrimas and Moira C. Gillis, Fulbright & Jaworski LLP

Tax Planning for the Redemption of Stock in S Corporations. 2
Jeffry M. Blair, Hunton & Williams LLP

Family Limited Partnerships: An Estate Planner's Guide To Understanding Basic Tax Allocation Provisions 3
Gene Wolf, Kemp Smith LLP

Update on the Application of the Step Transaction Doctrine to Gifts of Partnership Interests 4
Daniel H. McCarthy, The Blum Firm, P.C.

Successor Liability for Texas Taxes in Private Foreclosure Sales –
A Roadmap of Authorities. 5
Matt Larsen and Jon Wellington, Baker Botts L.L.P.

State Bar of Texas Tax Section’s 2009 Annual Law Student Tax Paper Competition, Winning Submission, Tax Implications for Natural Resource Master Limited Partnerships 6
James K. Rowland, University of Houston Law Center, LL.M., Class of 2009

Recent IRS Guidance Indicates that Auto Dealerships Face Increased Federal Income Taxes and Complexity 7
Stephen A. Beck, Meadows, Collier, Reed, Cousins & Blau LLP

IRS Pointers on Worker Classification 8
Robert W. Wood, Wood & Porter PC

Practitioner's Corner:

Simple Will Commentary and Form 9
Catherine C. Scheid, Law Offices of Catherine C. Scheid

Overview of the United States Tax Court 10
Mary McNulty, Thompson & Knight LLP

Sample Timetable, Taxpayer v. Commissioner. 11
Mary McNulty, Thompson & Knight LLP

Outline For Determination of Partnership and Corporation Taxable Income 12
Ryan T. Gardner, Locke Lord Bissell & Liddell LLP

Registration of Foreign Series LLC 13
Ryan T. Gardner, Locke Lord Bissell & Liddell LLP

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

CHAIR'S MESSAGE

Greetings and welcome to another year (fiscal, that is) of practicing tax law in Texas. I am looking forward to a great year working with my fellow officers Patrick O'Daniel (Chair-Elect), Mary McNulty (Secretary), and Tina Green (Treasurer), as well as with all of our Council members, Committee Chairs and Vice Chairs, and the many other members who volunteer, without whom our Section could not function.

Our Section is already off to a fine start. For the third straight year, the Section's Annual Meeting in June included tax-focused CLE programs and a popular "Legends" discussion featuring several of our more "experienced" members. This year's program began with a Legends Breakfast, where Bill Elliott was a superb moderator for our panel of Bill Bowers, Bob Davis, and David Glickman, who regaled us with stories of their experiences in Washington in the Reagan and Bush administrations. Later in the morning, we spent "60 Minutes Flat" discussing a variety of interesting issues involved in forming a professional services firm.

The Section's Officers and Council Members met after the Annual Meeting in June to review our goals and to plan for the new year. We have set an ambitious agenda for the year, building on the successful programs put in place over the last several years. Our goals are (1) to provide world-class education to our members, (2) to enhance the profile of the Section and all Texas tax lawyers, (3) to improve the substance and administration of state and federal tax laws, (4) to reach out to law students and encourage them to consider the practice of tax law, and (5) to serve those who cannot afford to pay for the services of tax lawyers. We will accomplish these goals primarily through our free-to-members 24/7 CLE webcast library, our in-person CLE programs, our Government Submissions (COGS) program, our Pro Bono activities, and our law student outreach efforts and tax paper competition.

We now have 42 CLE programs available free of charge to our members through the Section's 24/7 webcast library, which includes 40 hours of allowable CLE credit, 3 of which count towards the ethics requirement. We are adding new programs on a monthly basis and plan to add at least 30 new programs to the library this fiscal year. I am pleased that Ron Adzgery has agreed to lead our CLE Committee this year, since former CLE Committee chair Tina Green has stepped up to the Treasurer position this year.

Our Section will also continue to provide members with excellent in-person CLE programs. These include the Advanced Tax Law Course that was held in Houston on August 27 and 28, the 12th Annual International Tax Symposium that is being held in Plano on November 6, the annual Property Tax Committee meeting and seminar to be held in Austin in April of 2010, the State and Local Tax Committee's annual meeting with the Comptroller's Office and other events, and of course our nationally respected Texas Federal Tax Institute, which will be held in San Antonio on June 10 and 11, 2010.

We're also expecting another active year with our COGS program, which provides comments to governmental authorities on federal and state tax laws. These commenting projects have greatly enhanced the profile of our Section and all Texas tax lawyers over the last few years, and have also helped to improve the substance and administration of state and federal tax

laws. We have asked each of our substantive committees to produce at least one comment project during the year. We are fortunate that Dan Baucum has again agreed to serve as chair of the COGS committee, and that Stephanie Schroepfer has again agreed to serve as vice chair.

I know we will also have another great year from our award-winning pro bono committee, which Elizabeth Copeland has graciously agreed to chair again this year. Through the pro bono committee's Tax Court Pro Bono Program and its VITA program, the Section serves people who cannot afford to pay for the services of a tax lawyer. Through the Tax Court Pro Bono Program, Section members advise pro se tax payers who appear at calendar calls of the United States Tax Court held in Texas cities. The program is being expanded this year to include calendar calls in all of the Texas cities where the United States Tax Court sits. Through the VITA program, Section members help lower-income taxpayers in the preparation of their federal income tax returns, with a focus on helping qualified taxpayers take the earned income tax credit.

We are expanding our law school outreach program to include at least one additional school this year, and are seeking to expand the number of entries in our law student tax paper competition, which had a successful initial year last year. Speaking of which, I want to congratulate James Keene Rowland for his winning entry, Tax Implications for Natural Resource Master Limited Partnerships, which you can read right here in this October 2009 issue of the Texas Tax Lawyer. Mr. Rowland (University of Houston L.L.M., 2009) received a check for $1,000 and a plaque that was presented to him at the September meeting of the Dallas Bar Association Tax Section.

I also want to again congratulate Stanley Blend, who in June became the sixth individual to receive the Outstanding Texas Tax Lawyer Award from the Section, the highest honor bestowed by the Section. This year's nomination form is on our website and is included in this October 2009 issue of the Texas Tax Lawyer. Nominations must be made by January 15, 2010. Please take a few minutes and consider nominating a worthy individual for this award.

On the subject of nominations, I have appointed the Section's nominating committee for 2009-2010. The nominating committee consists of Dan Micciche (fax 214-969-4343), Kevin Thomason (fax 214-999-9261), Gene Wolf (fax 915-543-6441), and me as an ex officio member. Nominations for Chair-Elect, Secretary, Treasurer, or an Elected Council Member position can be submitted to any member of the nominating committee or to any Officer of the Section at any time on or before March 1, 2010.

I also want to thank my predecessor, Dan Micciche, for his outstanding service as last year's chair of the Section and for all of the hard work he has done for the Section over many years. Dan chaired the State and Local Tax Committee several years ago and did a superb job of expanding its activities and profile. It is no coincidence that the Section's activities and profile as a whole have gone through a great expansion during Dan's years as an Officer of the Section. My job for this year has certainly been made much easier because of Dan's tireless efforts, most notably his work in creating the free-to-members format for our 24/7 CLE webcast library.

And that brings me to my final point, which is that an active Section like ours, that provides so many services to its members and to the community, cannot function without the assistance of its members. The Section's work depends on our many members volunteering their time, from recording CLE webcasts, to working on government commenting projects, to writing articles for the Texas Tax Lawyer, to visiting law schools to talk about the practice of tax law, to attending a VITA clinic for low-income taxpayers, and on and on. If you are not already

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

Thanks, and I look forward to working with all of you and to a great year.

Tyree Collier, Chair

State Bar of Texas

12th ANNUAL INTERNATIONAL TAX SYMPOSIUM NOVEMBER 6, 2009

The Center for American & International Law ▪ 5201 Democracy Drive ▪ Plano, TX

AGENDA

8:00 – 8:30 a.m.	**Registration and Continental Breakfast**
8:30 – 8:35 a.m.	**Welcome/Opening Remarks - Chair, State Bar of Texas Tax Section, International Tax Committee** • Andrius R. Kontrimas, Fulbright, Houston, TX
8:35 – 10:00 a.m.	**International Tax Update** • David L. Forst, Fenwick & West LLP, Palo Alto, CA
10:00 – 10:15 a.m.	**Break**
10:15 – 11:45 a.m.	**Planning for Enhanced IRS Enforcement Initiatives** • Nancy T. Bowen, Fulbright, Houston, TX • William S. Lee, Fulbright, Houston, TX • Jasper (Jack) G. Taylor III, Fulbright, Houston, TX • Andrius R. Kontrimas, Fulbright, Houston, TX
11:45 – 12:45 pm	**Lunch**
12:45 – 1:45 p.m.	**Legislative Developments and Planning Responses** • Melinda Phelan, Baker McKenzie, Houston, TX • Helen Hubbard, Baker McKenzie, Houston, TX
1:45 – 2:00 p.m.	**Break**
2:00 – 3:00 p.m.	**Deducting Losses – Potential Issues** • Victoria Sherlock, KPMG, Houston, TX
3:00 p.m.	**Concluding Remarks/Adjourn**

State Bar of Texas

12th ANNUAL INTERNATIONAL TAX SYMPOSIUM NOVEMBER 6, 2009

The Center for American & International Law ▪ 5201 Democracy Drive ▪ Plano,

REGISTRATION FORM

Name	
Firm/Company	
Address	
Telephone	
E-mail Address	
Materials Delivery	Please specify whether you would prefer to receive the materials in an electronic or printed format. □ **electronic** □ **printed notebook**

Please complete this form and mail it along with your
$200 check made payable to "Tax Section State Bar of Texas" to

Victoria Beard
Fulbright & Jaworski LLP
1301 McKinney, Suite 5100
Houston, TX 77010

Be sure to reference the name of the attendee

Questions? Please contact:
Andrius R. Kontrimas @ 713-651-5482

State Bar of Texas

12th ANNUAL INTERNATIONAL TAX SYMPOSIUM NOVEMBER 6, 2009

The Center for American & International Law ▪ 5201 Democracy Drive ▪ Plano, TX

Dear Tax Colleague:

I am pleased to announce that the **12th Annual International Tax Symposium**, co-sponsored by the State Bar of Teas, Section of Taxation, International Tax Committee and the Dallas Bar Association, Tax Section will be held on Friday, November 6, 2009 at The Center for American and International Law at Legacy Park in Plano, Texas.

Featured speakers and their topics are:

International Tax Update
David L. Forst, Fenwick & West LLP, Palo Alto, CA

Planning for Enhanced IRS Enforcement Initiatives
Nancy T. Bowen, Fulbright, Houston, TX
William S. Lee, Fulbright, Houston, TX
Jasper (Jack) G. Taylor III, Fulbright, Houston, TX
Andrius R. Kontrimas, Fulbright, Houston, TX

Legislative Developments and Planning Responses
Melinda Phelan, Baker McKenzie, Houston, TX
Helen Hubbard, Baker McKenzie, Houston, TX

Deducting Losses – Potential Issues
Victoria Sherlock, KPMG, Houston, TX

As you can see, we have a wonderful line-up of speakers this year for an extremely reasonable cost of $200. If you have participated in this Symposium in the past, you know that it is very well attended by tax professionals from around the Dallas area. For the Symposium, we have applied for five hours of participatory CLE and CPE credit.

Please mail the attached registration form by October 23, 2009. A detailed agenda and directions to the site will be sent to the registrants. If you have any questions, please feel free to contact me at the number or e-mail address shown below. I look forward to seeing you this year.

Andrius R. Kontrimas
Fulbright & Jaworski LLP
1301 McKinney, Suite 5100
Houston, Texas 77010
Telephone: (713) 651-5482
akontrimas@fulbright.com

CALL FOR NOMINATIONS FOR OUTSTANDING TEXAS TAX LAWYER AWARD

The Council of the Section of Taxation is soliciting nominees for the Outstanding Texas Tax Lawyer Award. Please describe the nominee's qualifications using the form below. Nominees must: be a member in good standing of the State Bar of Texas or an inactive member thereof (or have been so at time of death); have been licensed to practice law in Texas or another jurisdiction for at least ten years; and have devoted at least 75 percent of his or her law practice to taxation law.[1] In selecting a winner, the Council will consider a nominee's reputation for expertise and professionalism within the community of tax professionals specifically and the broader legal community; authorship of scholarly works relating to taxation law; significant participation in the State Bar of Texas, American Bar Association, local bar association, or legal fraternities or organizations; significant contributions to the general welfare of the community; significant pro bono activities; reputation for ethics; mentorship of other tax professionals; experience on the bench relating to taxation law; experience in academia relating to taxation law; and other significant contributions or experience relating to taxation law.

Nominations can be filled out online and submitted to Tyree Collier, either by email (tyree.collier@tklaw.com) or hardcopy (fax number (214) 999-1655) no later than January 15, 2010. The award will be presented at the 2010 Texas Federal Tax Institute in San Antonio on June 10 or 11, 2010.

NOMINATION FOR OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Mailing Address: ____

____

Description of Nominee's Contributions/Experience Relating to Taxation Law:

____

____

____

____

____

____

____

______________Cffkkqpcn"r ci gu"o c{ "dg"cwcej gf "kh"f guktgf 0aaaaaa______________

[1] "Law practice" means work performed primarily for the purpose of rendering legal advice or providing representation, and also includes: service as a judge of any court of record; corporate or government service if the work performed was legal in nature and primarily for the purpose of providing legal advice to, or legal representation of, the corporation or government agency or individuals connected therewith; and the activity of teaching at an accredited law school. "Taxation law" means: "Tax Law" as defined by the Texas Board of Legal Specialization's standards for attorney certification in Tax Law; tax controversy; employee benefits and executive compensation practice; criminal defense or prosecution relating to taxation; taxation practice in the public and private sectors, including the nonprofit sector; and teaching taxation law or related subjects at an accredited law school. The award may be granted posthumously.

International Philanthropy a U.S. Tax Perspective

by Andrius R. Kontrimas[1]
Fulbright & Jaworski L.L.P.

Table of Contents

Initial Observations 1

Introduction 2

I. Outbound Contributions 2

A. Charitable Purpose 2

B. When can a U.S. taxpayer deduct contributions that are ultimately received by a foreign charity? 3

C. "Friends Of" Organizations 3

D. U.S. Gift and Estate Tax Deductibility 5

E. Charitable Contributions by U.S. Corporations to Foreign Organizations 7

F. Grants by U.S. Private Foundations 8

1. Excise Tax 8

An initial tax of 15 percent is imposed on the undistributed income of a private foundation and an additional tax of 100 percent of the amount remaining undistributed is imposed at the end of the taxable period. Undistributed income is the amount by which the distributable amount, computed based on a 5 percent minimum investment return, exceeds the qualifying distributions of the private foundation 8

2. Qualifying Distributions 8

3. Expenditure Responsibility 8

4. Qualifying Foreign Charities 10

5. Rev. Proc. 92-94 Safe Harbor 10

6. 2001 IRS General Information Letter 11

7. Grants to Foreign Governments 12

8. Significant Asset Dispositions 12

II. Inbound Issues for Foreign Charitable Organizations 14

A. U.S. Fundraising 14

B. When Does the United States Recognize a Foreign Charitable Organization as Tax Exempt in the United States? 15

1. Section 508 Notice 15

2. Properly Filing Notice under Section 508(a) 15

3. Section 4948(b) Override 16

4. What does Substantial Foreign Support Mean? 16

5. Legislative History/Notice of Proposed Rulemaking of Section 4948(b) 20
6. Section 4948(c)(2) - Prohibited Transactions 21
7. Excess Business Holdings Under Section 4943 21
C. Annual U.S. Filing Requirements 23
D. U.S. Taxation of Foreign Charitable Organizations 24
1. Excise Tax on Investment Income 24
2. Effectively Connected Income 24
3. Unrelated Business Taxable Income 25
4. Withholding Obligations 26
5. Withholding Certificates for Exempt Foreign Charitable Organizations. 26
III. Bilateral Income Tax Treaties: A Case-Study of the Fifth Protocol to the U.S.-Canada Income Tax Treaty 27
A. Brief Overview of the Canadian Tax Credit for Charitable Bequests 27
B. Cross-Border Charitable Bequests Under the Treaty 28
1. If a Canadian resident were to donate Canadian-situs property to a U.S. exempt organization upon his death, this donation would be considered a disposition under Canadian federal income tax laws and thus would trigger Canadian federal income tax on any inherent capital gains in the property 28
2. If a Canadian resident donated U.S.-situs property to a Canadian exempt organization upon his death, in addition to the Canadian tax on the inherent capital gain on the property, as reduced by any Election made, the property would also be included in the taxable estate of the decedent and subject to the U.S. estate tax 29
3. If a U.S. resident donated U.S.-situs property to a Canadian exempt organization upon his death, then the property will be includable in the taxable estate of the decedent 29
4. If a U.S. decedent donated Canadian-situs property to a Canadian exempt organization upon his death, the donation would be considered a disposition under Canadian federal income tax laws and thus trigger Canadian federal income tax on an inherent capital gains in the property. Furthermore, the U.S. estate tax applies to the entire worldwide estate of the U.S. decedent, and so would apply to the Canadian-situs property 29
The above examples are intended to be a simple and limited demonstration of the rules 29

There were two significant ambiguities in the provisions of the Treaty applicable to cross-border bequests, and as noted in the Joint Committee on Taxation Explanation of the Protocol (the "Joint Committee Report"), and the Protocol's changes to the Treaty provisions were generally intended to address these ambiguities regarding the application of Canadian tax rules and regarding the availability of tax credits or deductions when the United States and Canada impose tax on the same items of income or property 30

C. Changes Made by the Protocol 30

1. The Protocol supplies two rules in place of Article XXIX B of the Treaty that apply when property of a U.S. resident passes at that individual's death to a Canadian exempt organization or when property of a Canadian resident passes at that individual's death to a U.S. exempt organization... 30

2. Where the property of an individual who is a resident of a Contracting State passes by reason of the individual's death to an organization that is referred to in paragraph Article XXI (Exempt Organizations) and that is a resident of the other Contracting State, ... 30

D. Exempt Organizations under the Treaty and the Protocol. 31

IV. Concluding Remarks... 32

Initial Observations

Charitable giving has been taking place for centuries and knows no borders. Until relatively recently, however, there have been few organized multinational efforts to support international charitable objectives. Perhaps the first well published international organized relief effort began with the musician Bob Geldhof of the Boomtown Rats band when in 1984 he organized an Ethiopian famine relief effort. A group of British and Irish artists, collectively referring to themselves as "Band Aid", all recorded the song "Do They Know It's Christmas." The song became an immediate hit and helped create an international cause célèbre. Americans, not to be outdone, followed this initiative a few weeks later with Lionel Ritchie and the late Michael Jackson writing "We Are the World" which was sung by numerous famous musicians on the night of the American Music Awards. In 1985 Bob Geldhof organized the concert called Live Aid which was broadcast simultaneously in England and the US for 16 hours via satellite as a symbol of international unity. It was the concert of the decade and raised millions of dollars for famine relief in Africa. Riding this wave of success were other efforts such as Willie Nelson's Farm Aid to support other charitable objectives.

Only since the 1990s, however, has instant global media coverage existed. It is this phenomenon which quickly and graphically depicts natural and other disasters to a global audience. For example, the terrorist attacks of September 11, 2001 in the United States were communicated and known by most of the world within a matter of minutes. Within a few hours, charitable contributions from throughout the globe were made, organized and deployed. Less than four months later, more than $1.5 billion had been contributed to known charitable relief organizations such as the Red Cross as well as other funds established for specific purposes such as college expenses for the children of the victims. Substantial funds were contributed to September 11th relief efforts not only from U.S. sources but from foreign contributors.

This trend has continues, as demonstrated by the immediate national and international response to the victims of the 2004 Indian Ocean Tsunami that hit Phuket as well as the victims of Hurricane Katrina and the September 11th attacks. The Internal Revenue Service ("IRS") web site[2] contains a list of hundreds of organizations that have been formed to help these disaster victims. This list is contained on the IRS Charities and Non-profits page and indicates that the IRS has granted tax exempt status to each of these organizations and that contributions to them are tax deductible.[3] The IRS Charities page also contains a special IRS Publication called "Disaster Relief: Providing assistance through charitable organizations."[4] Among other things, the publication contains guidance about how charitable organizations can help victims, information about gifts and charitable contribution rules, and advice about creating a new charitable organization.

A similar report was published by a joint working group of the European Foundation Centre and the Council on Foundations called "Disaster Grantmaking: A Practical Guide for Foundations and Corporations"[5] in order to assist contributors with effective grantmaking under such circumstances.

Does U.S. tax policy have any effect on charitable giving? Should it have an effect? 'It is estimated that the value of federal income tax benefits for charitable contributions and organizations is approximately $100 billion per year.[6] Beginning in 2001, several bills were

introduced in Congress which would have expanded these charitable benefits.[7] Notably, there were several efforts to expand the charitable deduction provided for in Section 170 of the Code to include those individual taxpayers that did not itemize. The Congressional Budget Office had estimated that such an expansion, even assuming it was capped at $250 for single taxpayers and $500 for married couples filing jointly, would cost the Treasury over $14 billion and $38 billion, respectively.[8] Although those particular efforts have met with little success, in 2005 a new series of expansion efforts began in response to the 2004 Indian Ocean Tsunami and Hurricane Katrina.[9] Although these provisions were limited to the 2004 and 2005 taxable years, their goal was to increase charitable giving to disaster victims. Recently, President Obama's 2010 budget proposal introduced a phase-out of the charitable deduction for those taxpayers earning over $200,000, or $250,000 in the case of married taxpayers filing jointly.[10] Will these differing policies have a material impact on charitable giving?

What about the estate tax? Would its abolition dramatically reduce charitable giving? Many say yes including Bill Gates Sr., George Soros, a handful of Rockefellers and a number of other very wealthy individuals who signed their names in a newspaper ad supporting the estate tax. On the other hand, how does one explain the museums, concert halls and libraries of any Eastern city that were built by the philanthropist "robber barons" before we had an income tax in the United States? It is unlikely that Bill Gates reportedly contributed more than $20 billion to his foundation for the income tax benefits. Due to the 30 percent deductibility limitation and a 5 year carry forward period,[11] for Bill to "realize" the full income tax benefits of $20 billion in charitable contribution deductions, Bill would have needed approximately $70 billion of income in the 5 year period succeeding his gift which exceeds the value of all his Microsoft stock at the time of his gift.

Introduction

This paper will first present the primary U.S. tax considerations that arise in connection with outbound charitable giving (i.e. gifts from U.S. taxpayers for foreign philanthropic endeavors). Different concerns arise depending upon whether the U.S. contributor is an individual, corporation or tax-exempt entity and the U.S. characterization of the foreign recipient. Secondly, this paper will address the primary U.S. tax consequences pertaining to the income and activities of foreign charitable organizations in the United States. The third and final part of this paper will address how bilateral income tax treaties can alter these rules pertaining to cross-border charitable activities, and will look specifically at the potential discrepancies created by the Fifth Protocol to the U.S.-Canada Income Tax Treaty that was adopted on December 15, 2008.

This paper does not present or analyze the underlying tax policy behind the existing legal regime or attempt to measure the effects of existing policy on either inbound or outbound charitable giving. There is very little publicly available data on this subject and it is worthy of a separate in-depth analysis.

I. Outbound Contributions

A. Charitable Purpose

Section 501(c)(3) provides that for an organization to qualify under this section of the Code it must be "organized and operated exclusively for religious, charitable, scientific, literary or

educational purposes, or to foster national or international sports competition or for the prevention of cruelty to children or animals." The definition of "charitable" is expanded by the Treasury Regulations to include:

> Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments or works; lessening the burden of Government; and promotion of social welfare by organizations designed to accomplish any of the above, or (i) lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.[12]

Charitable activity outside the United States is clearly permissible for Section 501(c)(3) organizations. As early as 1920 the IRS recognized that a non profit association formed to provide memorial buildings in Europe to serve as museums of World War I and as venues for lectures constituted an exclusively educational organization.[13] More recent rulings also provide that domestic organizations that conduct all or part of their exempt purposes outside of the United States nonetheless qualify as organizations described in Section 501(c)(3).[14]

B. When can a U.S. taxpayer deduct contributions that are ultimately received by a foreign charity?

In determining whether contributions to a charitable organization are deductible, it must first be determined that the recipient organization was validly created or organized in the United States, as required by Section 170(c)(2)(A). If the organization does not qualify under Section 170(c)(2)(A) -- that is, it was not created or organized in the United States--a contribution to such non-domestic organization is not deductible under Section 170. *Welti v. Commissioner*, 1 T.C. 905 (1943); *ErSelcuk v. Commissioner*, 30 T.C. 962 (1958). It must further be found that the recipient was organized and operated exclusively for one of the purposes stated in Section 170(c)(2)(B), namely, religious, charitable, scientific, literary, or educational purposes, and that it meets the remaining requirements of Section 170(c)(2). As discussed in greater length in Part III of this paper, there are a limited number of bilateral income tax treaties with the United States that override the general rule and allow deductibility for contributions made to qualifying organizations within a treaty partner's jurisdiction.[15]

C. "Friends Of" Organizations

The concept of a "friends of" organization grew out of the need for supporters of non-U.S. charitable organizations to raise U.S. tax deductible funds. As discussed above, the recipient entity has to be organized in the United States for the donor to receive an income tax deduction. The question presented here is whether the result should differ when funds are contributed to a domestic charity which then transmits those funds to a foreign charity. May the donor request or "earmark" the use of such funds for a particular foreign organization (*e.g.* Cambridge University) and what degree of independent control must be exercised by the initial donee organization?[16]

Rev. Rul. 63-252[17] specifically addresses the question raised above. If the domestic organization is a mere conduit for the distribution of funds to the foreign entity, contributions to that domestic charity will not be deductible. On the other hand, if the contributions received by the domestic organization are not earmarked in any manner, and use of those contributions is subject to the control of the domestic organization, they will be deductible even though the organization uses its funds in foreign countries in carrying out its charitable purposes. The scenario of contributing funds to a domestic charitable organization, which in-turn transmits such funds to a foreign charitable organization, is described in examples four and five of the ruling as follows:

> (4) A domestic organization conducts a variety of charitable activities in a foreign country. Where its purposes can be furthered by granting funds to charitable groups organized in the foreign country, the domestic organization makes such grants for purposes which it has reviewed and approved. The grants are paid from its general funds and although the organization solicits from the public, no special fund is raised by a solicitation on behalf of particular foreign organizations.
>
> (5) A domestic organization, which does charitable work in a foreign country, formed a subsidiary in that country to facilitate its operations there. The foreign organization was formed for purposes of administrative convenience and the domestic organization controls every facet of its operations. In the past the domestic organization solicited contributions for the specific purpose of carrying out its charitable activities in the foreign country and it will continue to do so in the future. However, following the formation of the foreign subsidiary, the domestic organization will transmit funds it receives for its foreign charitable activities directly to that organization.[18]

The IRS then answers the question of deductibility with reference to examples four and five:

> [C]ontributions received by the domestic organization described in the fourth example will not be earmarked in any manner, and use of such contributions will be subject to control by the domestic organization. Consequently, the domestic organization is considered to be the recipient of such contributions for purposes of applying Section 170(c) of the Code. Similarly, the domestic organization described in the fifth example is considered to be the real beneficiary of contributions it receives for transmission to the foreign organization. Since the foreign organization is merely an administrative arm of the domestic organization, the fact that contributions are ultimately paid over to the foreign organization does not require a conclusion that the domestic organization is not the real recipient of those contributions. Accordingly, contributions by individuals to the domestic organizations described in the fourth and fifth examples are considered to be deductible.[19]

In *Bilingual Montessori School of Paris v. Commissioner*, 75 TC 480 (1980) (hereinafter "*Montessori*") both the IRS and the Taxpayer relied on Rev. Rul. 63-252 to argue either for or against deductibility of contributions to a domestic non-profit corporation. In *Montessori*, contributions to a nonprofit Delaware corporation qualified for charitable deduction although the

corporation had no U.S. activities. The IRS argued that the corporation was merely a shell company acting as a conduit of funds to a foreign French Montessori school. However, in holding that contributions to the Delaware corporation were deductible, the court pointed out that since the Delaware corporation was also operating the school, the transfer of funds did not amount to a mere distribution of funds to a foreign organization.

Similarly, in Priv. Ltr. Rul. 9651031 (Dec. 20, 1996),[20] again, relying on Rev. Rul. 63-252, contributions to a domestic foundation, organized by a domestic alumni association of a foreign university, were deductible even though all funds were distributed to the foreign university. In this ruling the IRS concluded that the foundation was not acting as a mere conduit to the university but instead was exercising discretion and control over the use of contributions in order to make grants for projects that furthered its charitable purposes.

D. U.S. Gift and Estate Tax Deductibility

There is not parallel treatment of foreign contributions for income, gift and estate tax deductibility under U.S. law. Gift tax Section 2522(a) provides for a charitable deduction for lifetime gifts by an individual. The recipient must be, *inter alia,*:

> a corporation, or trust, or community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, 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), including the encouragement of art and 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, which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, 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;

or

> a fraternal society, order, or association, operating under the lodge system, but only if such gifts are to be used exclusively for religious, charitable, scientific, literary or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals[.][21]

The accompanying Treasury Regulations indicate that the deduction is not limited to gifts for use within the United States, or to gifts to or for the use of domestic corporations, trusts, community chests, funds, or foundations, or fraternal societies, order, or associations operating under the lodge system.[22] There is no reference in the statute to the nationality of these recipient entities as long as the organization is described in Section 2522(a)(2)-(3).

In contrast, the estate tax charitable deduction applies to bequests, legacies, devises or transfers, *inter alia*:

> to or for the use of <u>any corporation</u> organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art, 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), and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, 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; (emphasis added)

or

> to a <u>trustee or trustees</u>, or a fraternal society, order, or association operating under the lodge system, but only if such contributions or gifts are to be used by such trustee or trustees, or by such fraternal society, order, or association, exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, such trust, fraternal society, order, or association would not be disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and such trustee or trustees, or such fraternal society, order, or association, 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[.][23] (emphasis added)

Although the estate tax deductibility statute uses only the term "*corporation,*" the regulations expand the definition of "qualifying recipients" to "any corporation or association," thereby implying that other forms of organizations which are taxable as corporations are also encompassed within this provision.[24] There is no requirement that the recipient corporation be formed by the time of the decedent's death.[25] Similar to the gift tax regulations, the transfer for estate tax purposes is not limited to transfers to domestic recipient entities.[26]

Also interesting is that IRS rulings in this area conclude that gifts to foreign governments or political subdivisions that are to be used exclusively for charitable purposes qualify for an estate tax charitable deduction under Section 2055, despite the fact they do not appear to be described in the Code or Treasury Regulations.[27] Where, however, the bequest is not specifically limited to exclusively charitable purposes, a deduction under Section 2055 will be denied.[28]

The results in the gift and estate tax arena, which permit deductible contributions to certain recipients organized and operating in foreign jurisdictions, can be contrasted with charitable

contributions deductible against federal *income* tax, where the charitable organization must be organized in the United States for the contribution, and further, in the case of a corporation's gift to a trust or foundation, must be used in the United States.[29]

E. Charitable Contributions by U.S. Corporations to Foreign Organizations

As with gifts made by individual U.S. citizens, the Code limits charitable contribution deductions to gifts made for a charitable purpose to a governmental unit, or to a "corporation, trust, or community chest, fund or foundation"[30] that is created or organized in the United States. If the U.S. corporation makes a grant to a charitable organization created in the United States, the gift is generally deductible under Section 170 even if such funds are used outside of the United States. There are a number of "international" charities incorporated in the United States that have active programs throughout the world such as the Red Cross and Amnesty International USA.

For U.S. corporate gifts to be deductible the recipient organization needs to be a corporation instead of a trust or unincorporated association due to an anomaly in the Code. Section 170(c)(2) states that "[a] contribution or gift by a corporation to a trust, chest, fund or foundation shall be deductible…only if it is to be used within the United States or any of its possessions…." Notably, corporate gifts to corporations are excluded from the above mentioned limitation. Consequently, all of the funds contributed by a U.S. corporation can be used outside of the United States and be deductible to the contributor as long as the recipient charitable organization is organized as a corporation. For this reason, almost all "international" charitable organizations operating in the United States are corporations.

There are alternatives to direct corporate giving for foreign charitable activity. First, the U.S. corporation can make a qualifying contribution to a "friends of" organization in the United States. Another alternative is to attempt to qualify the foreign contribution as an ordinary and necessary public relations or advertising business expense under Section 162(a). Support for deductibility is bolstered to the extent that the U.S. corporation enters into a contract with the recipient entity and receives any services or privileges in return for its support. Corporations are limited to deductions under Section 170(a) to amounts not exceeding ten percent of their taxable income as adjusted by Section 170(b)(2). Additionally, Section 162(b) disallows business expense deductions that would also qualify as charitable contribution deductions under Section 170 were it not for the percentage or dollar limitations set forth in Section 170.

The foreign tax credit consequences of foreign charitable contributions for U.S. multinationals is not entirely clear. After the Tax Reform Act of 1986 Section 864(e)(6) states that "[e]xpenses other than interest which are not directly allocable or apportioned to any specific income producing activity shall be allocated and apportioned as if all members of the affiliated group were a single corporation." In IRS Notice 89-91, 1989-2 C.B. 408, the IRS announced its intent to modify Treas. Reg. § 1.861-14T by publishing future Treasury Regulations which would require charitable contributions to be subject to the allocation rules for foreign tax credit purposes.

Proposed Treasury Regulations were issued in 1991 but never finalized. In 1992 Senate Bill S.2979 was introduced which would have permitted multinationals to deduct all charitable contributions from their U.S. income without allocation and apportionment. The bill, as finally approved by the Senate Finance Committee, provided that multinational corporations could deduct

55 percent of all charitable gifts from U.S. source income and the remaining 45 percent would require allocation between foreign and U.S. source income. All verbiage pertaining to this issue was dropped from the final version of H.R. 11 which was then vetoed by President George H. Bush in 1992.

F. Grants by U.S. Private Foundations

1. Excise Tax. An initial tax of 15 percent is imposed on the undistributed income of a private foundation and an additional tax of 100 percent of the amount remaining undistributed is imposed at the end of the taxable period.[31] Undistributed income is the amount by which the distributable amount, computed based on a 5 percent minimum investment return, exceeds the qualifying distributions of the private foundation. Therefore, in order to avoid the "initial" and "additional" tax, private foundations seek to distribute their 5 percent minimum investment return by way of "qualified distributions." The question present is whether distributions from a domestic private foundation to a foreign charity qualify as "qualified distributions."

2. Qualifying Distributions. "Qualifying distributions" are defined to be any amounts paid to accomplish one or more charitable purposes (as defined by Section 170(c)(2)(B)), other than any contribution to "(i) an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in Section 4946) with respect to the foundation…, or (ii) a private foundation which is not an operating foundation…."[32] Thus, as long as the grant by the foundation is used for charitable purposes, the recipient can be domestic or foreign and the recipient does not necessarily need to be a charitable organization. However, the Code provides that if the recipient organization is not essentially the equivalent of a public charity (as described in Sections 509(a)(1)-(3)) or is an exempt operating foundation, then the grantor private foundation must exercise "expenditure responsibility" with respect to the grant.[33] If expenditure responsibility is not exercised both the foundation and its managers are subject to excise taxes under Chapter 42 of the Code as well as possible termination of exempt status for the private foundation.

3. Expenditure Responsibility. The Code provides that a transferor private foundation must exercise "expenditure responsibility" under Section 4945(h) on any grants to any donor which is not a public charity equivalent or an exempt private operating foundation, in order for the grant not to be a "taxable expenditure."[34] "Expenditure responsibility" means that the grantor private foundation must make a pre-grant inquiry and require post-grant reports as to the grantee's use of the grant funds.[35] The pre-grant inquiry must be thorough enough to give a reasonable person assurance that the grantee will use the grant funds for exempt purposes.[36] The grant itself must be subject to a written commitment, signed by an officer, director, or trustee of the grantee, which includes the grantee's agreement to repay any portion of the grant which is not used for the purposes of the grant, to submit complete annual reports on the manner in which the grant funds are spent and the progress made in accomplishing the purposes of the grant, to maintain records of receipts and expenditures, to make its books and records available to the grantor at reasonable times, and not to use any of the funds to carry on propaganda or otherwise attempt to influence legislation under Section 4945(d)(1), or to influence the outcome of any specific public election or to carry on directly or indirectly any voter registration drive under Section 4945(d)(2), or to make any grant which is to a person or organization not listed in Section 4945(d)(3) or

4945(d)(4), or to undertake any activity for any purpose other than ones specified in Section 170(c)(2)(B) concerning certain charitable purposes.[37]

The grant agreement must specify the purposes of the grant, which can include contributing towards the grantee's capital endowment, but in any event the purposes must be those listed in Section 170(c)(2)(B).[38] If the grant is for capital endowment purposes, then the annual reports – instead of having to be made by the grantee for the life of the grant – may be made for the tax year in which the grant was made and for the grantee's immediately succeeding two tax years.[39] However, the reports can be discontinued thereafter only if it is reasonably apparent to the grantor, before the end of the grantee's second succeeding tax year, that neither the principal nor the income from the grant funds has been used for any purpose that would otherwise constitute a taxable expenditure under Section 4945. [40] These reports, in addition to containing the information required by the regulations for non-endowment grants, shall describe the use of the principal and the income (if any) from the grant funds.

With respect to the grantor's information reporting requirements, Treas. Reg. § 53.4945-5(d)(1) provides that, to satisfy the report making requirements of Section 4945(h)(3), a granting foundation must provide the required information on its annual information return for each taxable year with respect to each grant made during the taxable year which is subject to the expenditure responsibility requirements of Section 4945(h). Such information must also be provided on such return with respect to each grant subject to such requirements upon which any amount or any report is outstanding at any time during the taxable year. However, with respect to any grant made for endowment or other capital purposes, the grantor must provide the required information only for any taxable year for which the grantor must require a report from the grantee under Treas. Reg. § 53.4945-5(d)(2). The information reporting requirements with respect to any grant may be satisfied by submission with the foundation's information return of a report received from the grantee if the information required by Treas. Reg. § 53.4945-5(d)(2) is contained in such report.

Treas. Reg. § 53.4945-5(d)(2) provides that the report required by Treas. Reg. § 53-4945-5(d)(1) shall include the following information: (i) the name and address of the grantee; (ii) The date and amount of the grant; (iii) the purpose of the grant; (iv) the amounts expended by the grantee (based upon the most recent report received from the grantee); (v) whether the grantee has diverted any portion of the funds (or the income therefrom in the case of an endowment grant) from the purpose of the grant (to the knowledge of the grantor); (vi) the dates of any reports received from the grantee; and (vii) the date and results of any verification of the grantee's reports.

Expenditure responsibility under Sections 4945(d)(4) and (h) automatically ceases during any period in which the transferor private foundation has no net assets.[41] This cessation, however, does not apply with respect to any information reporting requirements imposed by Section 4945 for the tax year in which the transfer is made.[42] Further, this cessation does not apply in certain situations where the assets are transferred to another private foundation which is directly or indirectly controlled by the same persons who control the transferor private foundation.[43] In Priv. Ltr. Rul. 199929047, the IRS treated the transferee foreign charity, Y, as a private foundation for purposes of avoiding the taxable expenditure rules but apparently it did not treat Y as a private foundation for the purpose of expenditure responsibility since it found that those requirements ceased once the domestic private foundation, X, no longer had any assets, even though X was controlled by the same persons who controlled Y.

4. Qualifying Foreign Charities. There are no specific provisions in the Code addressing the transfer of charitable assets by a private foundation to a foreign entity. The Treasury Regulations, however, provide that the U.S. donor is not prevented from making a grant merely because the foreign charity has not applied for and received a determination letter from the IRS establishing its status. Instead, the Treasury Regulations require that the grantor foundation must make a "reasonable judgment" that the grantee is an organization described in Section 501(c)(3).[44] Also, the grantor foundation must make a "good-faith determination" that is based on an affidavit of the donee organization or an opinion of counsel (of the distributing foundation or the donee organization) that the donee is an organization described in Section 509(a)(1), (2), or (3) or 4942(j)(3).[45]

In order to make a determination of public charity equivalency for a foreign charity, most U.S. private foundations have historically relied on the written advice of outside counsel. Obtaining an "equivalency opinion" also protects foundation management from being personally subjected to penalty taxes[46] because reliance on the opinion of outside counsel constitutes "reasonable cause."[47] If several different U.S. private foundations wished to make contributions to the same foreign charity, each would have to hire counsel and receive separate equivalency letters with respect to the same foreign charity.

Although equivalency determinations eliminate the need for the foreign charity to go to the effort of obtaining a determination letter from the IRS (as well as ongoing compliance with U.S. tax law), almost all of the same documentation that is necessary to file a determination letter is necessary for U.S. counsel to be able to render an equivalency opinion. Such documentation includes copies of the organizational documents of the foreign charity as well as bylaws or other internal governing instruments, copies of the relevant statutory provisions pertaining to the entity particularly to determine what occurs with the assets of the grantee in the event of a liquidation or dissolution, detailed descriptions of past and proposed activities of the grantee, and provisions demonstrating that the grantee will prevent private inurement as well as prohibited political lobbying. Financial statements are also typically requested when public support is a necessary element for public charity equivalency.

Foreign charities may be unwilling to provide the level of detailed information necessary for a U.S. private foundation to make a proper equivalency analysis. Foreign charities may also be unwilling to modify their governing instruments or uses of charitable proceeds to comply with U.S. law.

5. Rev. Proc. 92-94 Safe Harbor. Because of the uncertainties surrounding what constituted a "reasonable judgment" or a "good-faith determination," the IRS has promulgated a safe-harbor procedure for certain non-liquidating transfers to foreign charities without IRS determination letters.[48] Compliance with this procedure eliminates the need for the grantor to exercise expenditure responsibility with respect to such contribution.

Rev. Proc. 92-94 applies to certain grants made by a domestic private foundation to foreign organizations that do not have a determination letter from the IRS. These grants must be for purposes set forth in Section 170(b)(2)(B). In addition, the grants must be made to entities that satisfy the substantive provisions of Sections 509(a)(1), (2) or (3) or 4942(j)(3). Finally, the grants must not constitute transfers of assets pursuant to any liquidation, merger, redemption,

recapitalization, or other adjustment, organization, or reorganization described in Section 507(b)(2). Contributions made pursuant to this procedure will be treated as qualifying distributions for the U.S. private foundation making the grant to the foreign charity.

The safe harbor generally requires the completion of an affidavit that must be "currently qualified", meaning that the facts it contains are current. The affidavit must be written in English and an English translation must be provided for any supporting documents that are not written in English. A principal officer of the grantee organization must attest to the truth of the affidavit.

Foreign organizations that qualify as public charity equivalents by definition (e.g., church, educational institution, or medical institution) are only required to update their original affidavit if the facts described therein have changed. Where the foreign organization, however, meets a public support test to determine its public charity equivalence, the affidavit must be updated by requesting the grantee to provide an attested statement containing enough financial information to establish that it continues to the pass the public support test. Finally, any educational institution must specify that it operates pursuant to racially nondiscriminatory policy as to its students to qualify under Rev. Proc. 92-94.

To summarize, there are several advantages of Rev. Proc. 92-94. First, a form of qualifying affidavit has been approved by the IRS. Second, multiple U.S. grantors can rely on a single currently qualified affidavit of a foreign charity. Finally, it is unnecessary to obtain a separate opinion of counsel that the laws, customs and governing instruments of a grantee and its country satisfy the underlying requirements of Section 501(c)(3). To the extent that the U.S. private foundation cannot obtain sufficient information from the foreign grantee, or the foreign grantee does not qualify, the U.S. private foundation should consider exercise expenditure responsibility, if possible, as discussed above, or not make the contribution.

6. 2001 IRS General Information Letter. The Council on Foundations in Washington, D.C., a nonprofit membership association of grantmaking foundations, submitted a letter to the IRS requesting clarification of the procedures under Rev. Proc. 92-94. The IRS responded to this request by issuing a general information letter issued on May 15, 2001 indicating that nothing in the Code or Treasury Regulations requires a private foundation to inquire or evaluate whether it can make a good faith determination that a foreign grantee is the equivalent of a U.S. charity. The IRS clarified that private foundations may treat a foreign organization as a non-charity from the outset, without first having to make a determination as to whether the foreign organization satisfies the equivalency requirements. If, therefore, a private foundation makes a grant for exclusively charitable purposes to a foreign grantee and exercises expenditure responsibility without first attempting to make a good faith determination that the foreign grantee is described in Section 501(c)(3) or after abandoning an inconclusive effort to make such a determination, the grant will be a qualifying distribution under Section 4942 and will not be a taxable expenditure for purposes of Section 4945.

The fact that another private foundation has made a good faith determination with respect to a particular foreign grantee is also not relevant—even if one U.S. foundation has chosen to treat a foreign organization as the equivalent of a U.S. public charity, another private foundation may elect to exercise expenditure responsibility in connection with its grant to the same organization.

Furthermore, although the IRS may have the authority to characterize the same foreign grantee differently, nothing in the statute or regulations compels it to do so.

Therefore, unless an entity has applied for and received an IRS determination letter, the IRS will respect how a grantmaking foundation treats a foreign grantee for purposes of applying Sections 4942 (relating to qualifying distributions) and 4945 (relating to taxable expenditures). Moreover, the IRS will not re-characterize the foreign grantee as described in Section 501(c)(3) so that the so-called "out of corpus" rules of Section 4942(g)(3) could potentially apply so long as the grantee has not applied for and received an IRS determination letter. This means that where a grantor elects to exercise expenditure responsibility, there is generally no requirement that the foreign grantee provide the grantor foundation evidence that an amount equal to the contribution was distributed by the grantee, which amount would be treated as a qualifying distribution out of corpus if the grantee were a private non-operating foundation.

7. Grants to Foreign Governments. The Treasury Regulations provide that a foreign organization will be treated as a public charity (Section 509(a)(1) entity) if "[i]t is a foreign government, or any agency or instrumentality thereof, or an international organization designated as such by Executive order under 22 U.S.C. 288, even if it is not described in Section 501(c)(3)."[49] Any grant, however, to a foreign government must be made exclusively for charitable purposes.[50] Grants made to foreign government for its general support are not considered by the IRS to have been made for a charitable purpose.

8. Significant Asset Dispositions. As discussed above, Rev. Proc. 92-94 does not apply if the transfer of assets to the foreign charity if the grant constitutes a liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization described in Section 507(b)(2). The term "other adjustment, organization, or reorganization" includes a significant disposition of assets.[51] A significant disposition of assets occurs when a private foundation transfers 25 percent or more of the fair market value of its net assets to another private foundation in one year, or where a private foundation transfers 25 percent or more of its net assets to a private foundation in a series of related dispositions over two or more years.[52] Thus, a transferee private foundation will not be treated as a newly created organization if it is the recipient of a significant disposition of assets from another private foundation.[53]

Generally the minimum dividing line between a Section 507(b)(2) transfer and an ordinary charitable transfer is whether 25 percent or more of a transferor private foundation's assets have been given to a transferee. This determination is not so clear cut where the same transferee has received more than one disposition. The IRS will make the determination of whether a series of periodic dispositions is related (and hence exceeds 25 percent) from the facts and circumstances an important factor being whether the same disqualified persons exist for both the transferor and transferee.[54] Once a series of dispositions is found to be related, the IRS will then determine whether the sum of those dispositions equals or exceeds 25 percent based on the fair market value of the transferor's net assets at the beginning of the first taxable year in which it made any of the series of related dispositions.[55]

The Treasury Regulations specifically provide that the transferee of a Section 507(b)(2) transfer will "be treated as possessing those attributes and characteristics of the transferor organization which are described in subparagraphs (2),(3) and (4)" of Treas. Reg. § 1.507-3(a)(1).[56]

These attributes are generally related to aggregate tax benefit, substantial contributors, and the taxes of Chapter 42 of the Code imposed upon the transferor.

First, a transferee organization is deemed to succeed to the aggregate tax benefit of the transferor organization.[57] Notwithstanding this provision, a transferee organization which is not effectively controlled, directly or indirectly, by the same person or persons who effectively control the transferor organization shall not succeed to an aggregate tax benefit in excess of the fair market value of the assets transferred at the time of the transfer. Second, any person that is treated as a substantial contributor with respect to the transferor foundation will be treated as a substantial contributor with respect to the transferee foundation, regardless of whether such person meets the "$5,000-two percent test" with respect to the transferee organization at any time.[58] And, third, if a private foundation incurs liability for one or more of the taxes imposed under Chapter 42 of the Code prior to, or as a result of, making a Section 507(b)(2) transfer, in any case where the transferee liability applies each transferee foundation will be treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such liability.[59]

Thus, while Section 507(b)(2) may suggest, on its face, that all tax characteristics of the transferor in a Section 507(b)(2) transfer should carry over, proportionately, to the transferee, the Treasury Regulations clearly state that the transferee should be treated as possessing only the three attributes discussed above.[60] Furthermore, Treas. Reg. § 1.507-3(a)(9)(i) provides that effective control must exist before the transferee is treated proportionately as the transferor for purposes of Chapter 42 and Sections 507-509.[61]

Specifically, if a private foundation transfers all of its net assets to one or more private foundation which are effectively controlled, directly or indirectly, by the same person or persons which effectively controlled the transferor private foundation, for purposes of Chapter 42 of the Code and Sections 507 to 509, the transferee foundation will be treated as if it were the transferor.[62] Where, however, proportionality is appropriate, the transferee foundation will be treated as if it were the transferor in the proportion which the fair market value of the assets (less encumbrances) transferred to the transferee bears to the fair market value of the transferor's assets (less encumbrances) immediately before the transfer.[63] The examples in the regulations pertaining to this rule provide examples where either all the assets of a foundation are transferred to one foundation, or where all the assets of a foundation are transferred to three separate foundations. The two examples in the Treasury Regulations also indicate that Treas. Reg. § 1.507-3(a)(9)(i) allows a transferee organization to take advantage of any special rules or savings provisions to the same extent that the grantor could have and also imposes any remaining expenditure responsibility obligations with respect to outstanding grants of the grantor on the grantee(s).[64]

The preceding discussion regarding Section 507 does not apply to foreign charitable organizations ("FCOs", each being an "FCO") qualifying under Section 4948(b). Section 4948(b) clearly states that Section 507 "shall not apply to any organization which has received substantially all of its support (other than gross investment income) from sources outside the United States" (i.e., the "85 percent test"). Accordingly, if a FCO is treated as receiving at least 85 percent of its support from foreign sources, then the provisions of Section 507 should not apply. A grant from a U.S. private foundation should constitute U.S. support and would therefore obviously reduce the FCOs foreign support percentage.

There are very few rulings which deal with Section 4948(b) and even fewer that refer to both Sections 4948(b) and 507. Of those that mention both Section 4948(b) and 507, none specifically address this issue, other than to simply state that Section 4948(b) provides that Section 507 (relating to termination taxes on private foundations) shall not apply to organizations which have received substantially all of their support from sources outside the United States.[65]

In Priv. Ltr. Rul. 199929047 (July 26, 1999), X, a domestic private foundation planned on transferring all of its assets to Y, a foreign charitable foundation. Y did not plan to obtain a Section 501(c)(3) determination letter from the IRS and was effectively controlled by the same persons controlling X. Curiously, the transfer of tax attributes to Y and its continuing U.S. compliance was not discussed. If Treas. Reg. § 1.507-3(a)(9)(i) was applicable, then the transferee foreign foundation in Priv. Ltr. Rul. 199929047 should have been treated as the transferor for purposes of Section 507-509 and Chapter 42. It appears that the foreign organization Y clearly wanted to avoid all U.S. ties and that after the expiration of the three-year expenditure responsibility period, the IRS did not intend to require any sort of compliance from the recipient foreign foundation. This should not have been the case, however, because the foreign transferee organization in Priv. Ltr. Rul. 199929047 did not receive substantially all of its support from sources outside the U.S. Accordingly, the foreign transferee did not qualify for the Section 4948(b) exclusionary provisions with respect to Section 507.

II. Inbound Issues for Foreign Charitable Organizations

Many countries of the world have laws governing charitable organizations.[66] A comparative analysis is well beyond the scope of this paper. As a matter of tax or social policies, however, there are a wide variety of approaches to donor deductibility, income exemption for charitable entities and operational requirements and compliance for such entities. This section of the paper addresses the primary U.S. tax issues affecting foreign charitable organizations.

A. U.S. Fundraising

To the extent that the FCO wishes to raise funds in the United States, its efforts will be impaired because U.S. donors will not be entitled to a tax deduction for their contributions. If the FCO wishes to concentrate its fund raising on U.S. private foundations for whom deductibility is irrelevant, it may wish to seek a determination letter from the IRS to recognize it as U.S. tax exempt organization. There is no restriction on a FCO to apply for recognition as either a public charity or a private foundation under Section 501(c)(3). To apply, FCOs need to complete IRS Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code* (the "Form 1023") and submit it to the Baltimore key district office of the IRS. The advantage for an FCO having a determination letter is that it eliminates U.S. income taxation as well as the need for equivalency determinations or affidavits with respect to grants from U.S. private foundations. The disadvantage of filing a determination letter is that the FCO would become compliant to the United States not only with respect to U.S. source grants but all of its activities. For this reason, there are relatively few foreign supported FCOs that obtain U.S. determination letters.

B. When Does the United States Recognize a Foreign Charitable Organization as Tax Exempt in the United States?

1. Section 508 Notice. Section 501(a) exempts from taxation organizations "described" in Section 501(c). Generally, an organization will not be treated as an organization described in Section 501(c)(3) unless it has given notice to the Secretary of the Treasury Department (the "Secretary") in the manner set forth in the Treasury Regulations that is it applying for recognition of such status.[67] Furthermore, an organization described in Section 501(c)(3) which does not notify the Secretary that it is not a private foundation is generally presumed to be a private foundation.[68]

Section 508 contains the filing requirements necessary to be treated as an organization described in Section 501(c)(3), as well as certain other provisions relating to charitable deductions and the governing instruments of private foundations. Section 508(a) provides that an organization will generally not be treated as an organization described in Section 501(c)(3) unless it has given notice to the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition of such status, or (i) for any period before the giving of such notice, if such notice is given after the time prescribed by the Secretary by Treasury Regulations for giving notice. There are, however, certain exceptions to this filing requirement contained in Section 508(c) and Treas. Reg. § 1.508-1(a)(3).

2. Properly Filing Notice under Section 508(a). An organization seeking exemption under Section 501(c)(3) is generally required to file notice within 15 months from the end of the of the month in which the organization was organized. "Such notice is filed by submitting a properly completed and executed Form 1023 to the district director.[69] Although the information required by Form 1023 must be submitted to satisfy the notice requirement, the failure to supply all such information is not alone sufficient to deny exemption from the date of organization to the date such complete information is submitted by the organization. If the information submitted within the required time is incomplete, and the organization supplies the necessary additional information at the request of the Commissioner of the IRS (the "Commissioner") within the additional time period allowed by him, the original notice will be considered timely.[70] If incomplete information is submitted, it does not mean that an organization will be considered exempt by the IRS by virtue of having filed, but instead means that exemption will generally not be denied from the date of organization if complete information is eventually submitted.[71] An organization is considered "organized" on the date it becomes an organization described in Section 501(c)(3), determined without regard to Section 508(a).

Accordingly, although Form 1023 is the required method for filing for exemption, it appears, based on Treas. Reg. § 1.508-1(a)(2)(ii), that an incomplete submission of the information required by Form 1023 (not, necessarily, submitted by means of the form itself) might suspend the clock and shift the burden to the Commissioner to request additional information within whatever time guidelines the Commissioner establishes. This interpretation is undermined, however, by IRS rulings such as Gen. Couns. Mem. 38997 (June 10, 1983), which states that "Section 508(a) provides that charitable organizations shall not be considered 'described in Section 501(c)(3)' unless a Form 1023 is appropriately filed." Congress' stated purpose in enacting Section 508(a) was to "require new organizations to notify the IRS of their existence and the fact that they are claiming to be exempt under Section 501(c)(3)." H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess.

38 (1969), 1969-3 C.B. 200 at 225. Accordingly, "[t]he 'notice' requirement is satisfied only when an organization submits a properly completed and executed [Form 1023]."[72] Thus, it appears that the filing of Form 1023 is the only means by which notice may properly be given to the IRS under Section 501(a).[73]

Of the rulings located regarding organizations' filing of notice with the IRS pursuant to Section 508(a), only one failed to use Form 1023-- and in that case, the failure to use Form 1023 was a mistake. In Gen. Couns. Mem. 38316 (March 21, 1980), the IRS addressed whether an extension of time under Treas. Reg. § 1.9100-1 would be available to an organization filing notice under Section 508(a). An organization inadvertently filed Form 1028, *Application for Recognition of Exemption*, instead of Form 1023, and the IRS determined that an extension might be available. Every other ruling located which addressed this issue indicated that Form 1023 was used as the means for filing notice.

3. Section 4948(b) Override. Section 4948(b) of the Code generally provides that Sections 507, 508 and Chapter 42 of the Code shall not apply to any foreign organizations which have received substantially all of their support from sources outside the United States. A provision included in the paragraph entitled "Filing of notice" of Treas. Reg. § 1.508-1(a)(2)(vi), provides that a "foreign organization shall, for purposes of Section 508, be treated in the same manner as a domestic organization, except that Section 508 shall not apply to a foreign organization which is described in Section 4948(b)." The Treasury Regulations also provide that any organization excepted from the requirement of filing notice under Section 508(a) will be exempt from taxation under Section 501(c)(3) if it meets the requirements of that section, whether or not it files notice.[74] This paragraph continues by noting that in order to establish its exemption with the IRS and receive a ruling or determination letter recognizing its exempt status, an organization excepted from the notice requirements by reason of subparagraph (3) should file proof of its exemption in the manner prescribed by Treas. Reg. § 1-501(a)-1 (i.e., by submitting Form 1023).[75]

The provision relating to the inapplicability of Section 508 to foreign organizations described in Section 4948(b) is not however contained in Treas. Reg. § 1.507-1(a)(3), entitled "Exceptions from notice," which specifically excepts organizations such as (i) churches, conventions or associations of churches, or integrated auxiliaries of a church; (ii) any organization which is not a private foundation which normally receives not more than $5,000 in gross receipts; (iii) subordinate organizations covered by a group exemption letter; (iv) trusts described in Section 4947(a)(1); and (v) any other class of organization that the Commissioner may exclude from the filing requirements. Instead, the provision regarding foreign organizations is contained in a subparagraph under "Filing of notice."[76] This subparagraph of Treas. Reg. § 1.508-1(a)(2)(vi), specifically states that Section 508 does not apply to a foreign organization which is described in Section 4948(b).

4. What does Substantial Foreign Support Mean? As mentioned earlier, Section 4948(b) provides that Section 507, Section 508, and Chapter 42 of the Code (other than Section 4948) do not apply to any foreign organization which has received substantially all of its support (other than gross investment income) from sources outside the United States. A foreign organization which has received substantially all of its support from sources outside the United States is an organization which, from the date of its creation, has received at least 85 percent of its

support (as defined in Section 509(d), other than Section 509(d)(4))[77] from sources outside the United States.[78] Gifts, grants, contributions, or membership fees directly or indirectly from a U.S. person (as defined in Section 7701(a)(3)) are from sources within the United States.[79]

U.S. persons include citizens or residents of the United States, domestic partnerships, domestic corporations, any estate (other than a foreign estate), and certain trusts. Section 7701(a)(30). Based on this definition, a contribution from foreign persons should not constitute a contribution from sources within the United States. However, the following Private Letter Rulings, which mention Section 4948(b), address a number of related issues that are relevant in the context of a foreign contribution, namely:

(i) the interaction of Section 4948(b) and Section 508, and the eligibility of a foreign charitable organization described in Section 4948(b) for tax exemption under Section 501(a) (Priv. Ltr. Rul. 199911050 9 (Dec. 17, 1998));
(ii) the impact of the location of contributed assets for purposes of determining source of support (Priv. Ltr. Rul. 9842004 (July 7, 1998) and Priv. Ltr. Rul. 9014053 (Jan. 8, 1990)); and
(iii) an initial "start-up" transfer of assets should be included in calculating the amount and source of support (Priv. Ltr. Rul. 7902075 (Oct. 16, 1978)).

These various issues are best understand by reviewing the pertinent facts of each ruling, as set forth below:

a. Priv. Ltr. Rul. 199911050 (Dec. 17, 1998) – In determining whether an intervivos gift by a U.S. donor to a foreign-organized charitable (art-oriented) organization ("Foundation") should qualify for the gift tax charitable deduction under Section 2522, the IRS considered the interaction of Section 4948(b) and Section 508(e)(1), which requires certain provisions be included in the governing instrument of a private foundation in order for such foundation to qualify for exemption from taxation under Section 501(a). Foundation was formed by the donor's siblings in a foreign country. Although, based on the available facts, the provisions of Foundation's governing instrument mirrored those of a domestic private foundation's, the IRS noted that Section 4948(b) and the accompanying regulations provide that Section 508 does not apply to any foreign organization which has received substantially all of its support (other than gross investment income) from sources outside the United States.

The IRS noted, however, that no gift would be allowed as a deduction (i) if made in a taxable year in which Foundation is not tax exempt under Section 501(a) because it has engaged in a prohibited transaction or (ii) after the date on which the Secretary publishes notice that Foundation has been notified that it engaged in a prohibited transaction.[80] A prohibited transaction generally means any act or failure to act which would subject a foreign organization, or a disqualified person with respect thereto, to liability for a penalty under Section 6684 or a termination tax under Section 507 if such organization were a domestic organization.[81]

In Priv. Ltr. Rul. 19911050, the IRS declined to rule on whether Foundation's total support from non-U.S. sources was at least 85 percent. However, based on Foundation's representations and presuming Foundation had not been notified that it engaged in a prohibited transaction, the IRS determined that the gift by the U.S. donor to Foundation should qualify for the gift tax charitable

deduction, provided that Foundation maintained its status as an exempt foundation in the foreign country. Accordingly, this ruling supports the position that a foreign charitable organization described in Section 4948(b) may be eligible for tax exemption under Section 501(a) if the "substantially all" test is met.

b. Priv. Ltr. Rul. 9842004 (July 7, 1998) – Priv. Ltr. Rul. 9842004 addressed, among other issues, whether a decedent's bequest in trust should be disallowed under Section 2055(e) because the foreign charitable trust could accumulate undistributed income in a given year for distribution in a later year. The IRS determined that because the trust came within the purview of Section 4948(b) it was therefore exempt from the application of Section 508, which requires the inclusion of certain provisions in the governing instrument.

The donor was a dual citizen of the United States and a foreign country. She instructed her executor to sell her vineyard, located in the foreign country, and transfer the proceeds from the sale to the trust. The IRS noted that because the trust assets were situated in the foreign country, the trust should be treated as a foreign organization which received substantially all of its support (other than gross investment income) from sources outside the United States Accordingly, since Section 4948(b) exempts such foreign organizations, including the trust, from the application of Section 508, the trust instrument was not required to include a provision requiring the annual distribution of income. The fact, therefore, that the trustees could accumulate income would not disqualify the trust as an organization described in Section 508(d).

This ruling suggests that the location of the assets may play a significant role in determining source of support. However, the definition of support for purposes of Section 4948(b) hinges not on the property's location but on the donor's status. In this ruling, the donor's dual citizenship may have presented a difficult issue and the location of the assets abroad may have therefore influenced the finding. Further, Priv. Ltr. Rul. 9014053, discussed below, indicates that the location of contributed assets should not be controlling.

c. Priv. Ltr. Rul. 9014053 (Jan. 8, 1990) – This ruling addressed the question of whether a foreign trust qualifies as a foreign organization for purposes of Section 4948 and the accompanying Treasury Regulations. C was born in, held a passport from, and was registered as a citizen in separate foreign countries, but C did not reside in the United States and only visited the United States on brief occasions. When C's husband died, C inherited two foreign corporations which managed the assets of her late husband. C's assets were held in an intervivos trust. For U.S. income tax purposes, C was not subject to U.S. income tax except with respect to U.S. source income.

While visiting the United Kingdom, C created A, signed A's trust instrument, and assigned assets to A. A was drafted by an attorney in the United States but was submitted to a solicitor in the United Kingdom for signature with the expectation that A would comply with U.S. laws for foreign charitable organizations that are exempt from U.S. income taxation. One half or more of the assets were invested in the United States and would continue the remain there. Approximately 44.6 percent of the trust corpus (i.e., cash and securities) was held in a custody account in a bank located in the United States. Although some of the trust beneficiaries were to be U.S. organizations, it was expected that many grants would be to non-U.S. beneficiaries.

The IRS ruled that A, based on the facts, met the 85 percent test imposed by Section 4948(b) so as to avoid application of Sections 507, 508, and Chapter 42 of the Code(other than Section 4948). The IRS noted that C transferred the property to A and signed A in the United Kingdom to be held in trust for charitable purposes. Thus, C clearly manifested an intent to create A in the United Kingdom. Accordingly, A was found to be a foreign organization for purposes of Section 4948 and the underlying Treasury Regulations. Thus, the actual location of the contributed property, a significant portion of which was in the United States, was not found to be controlling.

d. Priv. Ltr. Rul. 7902075 (Oct. 16, 1978) – A private foundation requested a ruling that its transfer of all its assets to a yet-to-be formed foreign foundation would not result in the imposition of tax under Section 507, 4941, 4942, 4945 and would not constitute support to the foreign foundation. The private foundation indicated that, although it would make an initial grant of all of its assets to the foreign foundation, after that initial transfer the foreign foundation should receive at least 85 percent of its support from sources outside the United States.

Among the issues addressed by the IRS, the IRS determined that the initial transfer would constitute support to the foreign foundation from sources within the United States. Accordingly, if the foreign foundation did not receive from the date of its creation 85 percent of its support from sources outside the United States, Sections 507, 508, and Chapter 42 of the Code would apply to the new foreign foundation. The IRS also noted that the Section 507 tax should not apply to the private foundation's transfer, based on the assumption that the foreign foundation would apply and receive a determination letter that it was an organization described in Section 501(c)(3) and a private foundation described in Section 509(a). This requirement that the foreign foundation obtain a ruling may, however, be attributable to the fact that the foreign foundation's support was not proven to be 85 percent or more from sources outside the United States. The ruling does not address the treatment of this type of transfer where substantially all of the foreign foundation's support is from outside the United States or where the private foundation making the transfer of its assets is a foreign private foundation.

e. Priv. Ltr. Rul. 8652035 (Sept. 29, 1986) – In Priv. Ltr. Rul. 8652035, an estate sought a ruling regarding the deductibility of certain bequests made to two foreign museums under a decedent's will. One of the prerequisites to deductibility under Section 2055(e)(1) provides that no charitable deduction shall be allowed for a transfer to or for the use of an organization described in Section 508(d) or 4948(c)(4) subject to the conditions specified in such sections. Section 4948(b) provides in pertinent part, however, that Section 508 will not apply to any foreign organization which has received substantially all of its support from sources outside the United States. Section 4948(c)(4) and the Treasury Regulations thereunder disallow as a deduction any bequest made under Section 2055, if such bequest is made to a foreign organization described in Section 4948(b) after the date on which the Commissioner publishes notice that he has notified such organization that it has engaged in a prohibited transaction, and if made in a taxable year of such organization (after December 31, 1969) for which it would not be exempt from taxation under Section 501(a) because it had engaged in such prohibited transaction.

The IRS ruled that an estate tax charitable deduction should be available for contributions to the two museums, in part, because the Commissioner had not notified either museum that it engaged in a prohibited transaction. The IRS also noted that one of the museums received almost all of its financial support from certain German sources. The other museum was owned and

operated by a city in Austria. The IRS did not, however, specifically address whether the 85 percent substantially all support test was met in order to determine the Austrian museum's qualification as a foreign charitable organization under Section 4948(b).

f. Gen. Couns. Mem. 39842 (April 15, 1991) – In determining whether the minimum distribution requirements of Section 4942 apply to foreign private foundations, the IRS reviewed the legislative history Section 4948, contained in Senate Report 91-552, 91st Cong. 1st Sess 59, reprinted in 1969-3 C.B. at 462, to confirm that Congress did not intend to impose the distribution requirements on foreign organizations described in Section 4948(b).

g. Priv. Ltr. Rul. 9141050 (July 16, 1991) – The IRS concluded that a "foreign organization described in Section 4948 is not subject to the notice requirements of Section 508." The foreign organization in Priv. Ltr. Rul. 9141050 had, however, obtained a determination letter from the IRS. The organization provided educational programs in Germany and wanted to discontinue its tax exempt status because it derived no benefit therefrom (i.e., no tax deductible contributions, no U.S. activities, and no U.S. income), but was nevertheless required to file Form 990-PF, *Return of a Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation* ("Form 990-PF"). The IRS ruled, however, that where a foreign organization has voluntarily provided notice to the IRS in order to have its tax exempt status recognized, it cannot voluntarily terminate its tax exempt status. The importance of this ruling is that it specifically recognizes that foreign charitable organizations which receive substantially all of their support from outside the United States are not subject to the notice requirements of Section 508. The notice provisions are, in such a situation, merely voluntary.

5. Legislative History/Notice of Proposed Rulemaking of Section 4948(b). The legislative history of Section 4948(b) and the accompanying Treasury Regulations do not provide any specific guidance regarding how to determine what constitutes the source of support. The Senate indicated that an organization meeting the definition of a private foundation should, if formed outside the United States, nevertheless be treated as a private foundation despite the place of its organization. However, because some of the rules could not easily be applied in practice to foreign organizations, the Senate Finance Committee recognized that certain requirements should not be applied to foreign private foundations if no significant part of their normal support (other than investment income) comes from U.S. sources. Accordingly, the Committee Report ("Report") states that the rules regarding change of status, governing instruments, self-dealing, minimum distributions, excess business holdings, jeopardy investments, and limitations on activities should not apply to foreign private foundations.[82]

The Report goes on, however, to state that a foreign private foundation may lose its exempt status under the Code if it engages in any of the acts that would have justified a doubling of the taxes imposed upon the organization had it been a domestic organization engaging in the same act (i.e., repeated or willful and flagrant violations). The general rule regarding prohibited transactions is contained in Section 4948(c)(1) and provides that a foreign organization described in Section 4948(b) (i.e., an organization which receives substantially all its support from sources outside the United States) will not be exempt from taxation under Section 501(a) if it has engaged in a prohibited transaction after December 31, 1969. Note also that this statement supports the position that, prior to engaging in a prohibited transaction, a foreign organization may be treated as exempt under Section 501(a)-- for only if such organizations were previously treated as exempt could

exemption be lost. Nevertheless, the rules regarding prohibited transactions should be examined to determine when a foreign organization may be in danger of losing its exempt status.

6. Section 4948(c)(2) - Prohibited Transactions. A prohibited transaction is defined as any act or failure to act (other than with respect to Section 4942(e), relating to minimum investment return) which would subject a foreign private foundation described in Section 4948(b), or a disqualified person (as defined in Section 4946) with respect thereto, to liability for a penalty under Section 6684 (relating to assessable penalties with respect to liability for tax under Chapter 42 of the Code) or a tax under Section 507 (relating to termination of private foundation status) if such foreign private foundation were a domestic private foundation.[83]

In order for an act or failure to act to be treated as a prohibited transaction by reason of the application of Section 6684(a),[84] there must have been a prior act or failure to act which (i) would have resulted in liability for tax under Chapter 42 of the Code (other than Section 4940 or 4948(a)) if the foreign private foundation had been a domestic private foundation, and (ii) had been the subject of a warning from the Commissioner that a second act or failure to act would result in a prohibited transaction. The second act or failure to act need not be related to the prior act or failure to act with respect to which a warning from the Commissioner was given.[85] Accordingly, exempt status may be lost because of a repeated act or failure to act that would have subjected a domestic private foundation to a tax for a prohibited activity if the IRS has already warned the foreign organization that a second act or failure to act will be treated as a prohibited activity.

A foreign organization described in Section 4948(b) will be denied exemption from taxation under Section 501(a) by reason of the prohibited transaction rule for all taxable years beginning with the taxable year during which it is notified by the Secretary that it has engaged in a prohibited transaction.[86] Any foreign organization described in Section 4948(b) which is denied exemption from taxation under Section 501(a) by reason of the prohibited transaction rule may, however, file a claim for exemption from taxation under Section 501(a) in the second taxable year following the year in which the Secretary given notice.[87] Thus, an organization denied exemption under Section 4948(c) will not be exempt from taxation under Section 501(a) for the taxable year in which notice of loss of exemption is given and at least one immediately subsequent taxable year.[88]

In short, Section 7.27.27.4.1. of the Internal Revenue Manual summarizes the prohibited transaction rule by stating that "foreign private foundations described in Section 4948(b) and their disqualified persons[89] are held to the same requirements as other private foundations except for the minimum investment return requirements and certain special variances in respect to grants. However, for such foundations the sanction for failure to observe requirements is a potential denial of exemption under Section 501(a) as opposed to a tax on nonconforming activity. Also, the applicable sanction, denial of exemption, is operative only where the failure to observe requirements would result in a penalty tax under Section 6684 or a termination tax under Section 507 if the organization were a private foundation other than Section 4948(b)." This loss of exempt status should not, however, relate back prior to the time of the organization's first violation.[90]

7. Excess Business Holdings Under Section 4943. The "excess business holdings rule" is contained in Section 4943 of Chapter 42 of the Code and is therefore covered by the prohibited transaction rule. "Excess business holdings" are the amount of stock or other interest in a business enterprise that a private foundation would need to transfer to a person other

than disqualified person in order for the foundation's holding to remain permitted holdings. Permitted holdings are generally limited to 20 percent of a corporation's voting stock held by the foundation and all disqualified persons with respect to the foundation.[91] If persons who are not disqualified persons with respect to the private foundation have effective control of the corporation, the percent of interest allowed increases to 35 percent.[92]

The application of provisions of Chapter 42 of the Code to foreign-supported organizations is somewhat deceptive. This is because Section 4948(b) of the Code provides that Chapter 42 of the Code (including Section 4943) does not apply to any foreign organization which has received substantially all of its support (other than gross investment income) from sources outside the United States. Nevertheless, the prohibited transaction rule requires compliance with the rules of Chapter 42 of the Code and on the second failure to comply with such rules, an organization's tax exempt status will be revoked.

This contradiction is evidenced in Priv. Ltr. Rul. 9844033 (Aug. 4, 1998), which specifically states that Code "Section 4948 of the Code provides that Chapter 42 of the Code (including Section 4943) shall not apply to any foreign organization which has received substantially all of its support (other than gross investment income) from sources outside the United States." Nevertheless, the ruling also recognized that a foreign organization's exemption under Section 501(a) may be revoked if the organization engages in a prohibited transaction. The IRS ultimately ruled that holding companies formed by a tax-exempt foreign private foundation that were used to invest in domestic and foreign funds did not constitute business enterprises. The taxpayer ("Taxpayer") was a charitable trust that was recognized by the IRS as exempt under Section 501(c)(3) and treated as a foreign private foundation. The Taxpayer planned to create and hold an interest in domestic and foreign holding companies, which would in turn hold interests in other investment vehicles (i.e., limited partnership interests in investment partnerships, foreign investment entities treated as partnerships) (the "Funds").

Because many of the better performing Funds in which Taxpayer was interested were oversubscribed, Fund managers would exclude less favored investors or reduce the amount of money that such investors were allowed to invest. Due to Taxpayer's atypical withholding requirements, the Taxpayer was concerned that in attempting to prevent over-withholding, it might jeopardize its ability to invest in certain Funds. Accordingly, the creation of the holding companies would allow the Taxpayer to properly apply withholding tax laws without jeopardizing its opportunity to invest.

Although the ruling does not clarify that Taxpayer was an organization described in Section 4948(b), the IRS cited generally to Section 4948 for the proposition that Chapter 42 does not apply to organizations that have received substantially all of their support (other than gross investment income) for sources outside the United States, but that such organization's exemption under Section 501(a) may be revoked if the organization engages in a prohibited transaction. The IRS also referred to Section 4948(c)(2) relating to prohibited transactions, Section 6684 relating to penalties that may be imposed on taxes relating to Chapter 42 of the Code, and the provisions of Section 4943. The IRS concluded that for purposes of Section 4943, the holding companies would not constitute business enterprises and that the determination of whether the Taxpayer holds excess business holdings would instead be determined by reference to the proportionate shares of any interest in a business enterprise held by each Fund in which a holding company held an interest.

Thus, although the Taxpayer's business interests in this ruling were found not to constitute excess business holdings, Priv. Ltr. Rul. 9844033 indicates that foreign organizations (i.e., in particular, those described in Section 4948(b)) should be concerned with whether or not a violation of Section 4943 may be found.

C. Annual U.S. Filing Requirements

Organizations exempt under Section 501(a) are generally required to file an annual return with the IRS. Section 6033(a)(1). This filing requirement does not apply to:

(i) churches, their integrated auxiliaries, and conventions or associations of churches;
(ii) certain organizations (other than private foundations, as defined in Section 509(a)) with less than $5,000 in gross receipts; or
(iii) the exclusively religious activities of any religious order.[93]

The IRS also has the authority to grant discretionary exemptions from filing requirements where the IRS determines that the filing is not necessary to the efficient administration of the Code and Treasury Regulations.[94]

The discretionary exemptions granted by the IRS exempts foreign organizations, other than private foundations, from the filing requirement if the foreign organization normally does not receive more than $25,000 in gross receipts annually from U.S. sources and has "no significant activity" in the United States.[95] The source of a foreign organization's gifts, grants, contributions or membership fees is determined under Treas. Reg. § 53.4948-1(b). The source of all other gross receipts are determined under the general sourcing rules contained in Sections 861-865. Furthermore, the term significant activity includes lobbying and political activity and the operation of a trade or business, but does not include investment activity.

The instructions to Form 990-PF provide that Form 990-PF must be filed by exempt private foundations, but does not address any filing exceptions with respect to foreign charitable organizations. In fact, a foreign organization which claims to have received at least 85 percent of its support from the date of its creation from sources outside the United States must also attach a computation to its Form 990-PF. The instructions do note, however, that foreign organizations meeting the 85 percent test are not required to complete Parts XI and XIII (relating to distributable amounts and undistributed income) of the Form 990-PF. Moreover, the notice and publication requirements and the requirement to furnish copies of annual returns to state officials do not apply to foreign foundations receiving at least 85 percent of their support from sources outside of the United States.

Accordingly, a newly created foreign organization that qualifies as a private foundation exempt under Section 501(a) will generally be required to file Form 990-PF. If, however, the newly created foreign organization is not a private foundation, has less than $25,000 of U.S. sourced gross receipts, and no significant activity in the United States, then the organization should not be required to file Form 990-PF.

D. U.S. Taxation of Foreign Charitable Organizations

Foreign charitable organizations fall into three general categories for purposes of determining how they will be taxed with respect to their U.S. income: (i) foreign charitable organizations that have received a determination letter from the IRS, (ii) foreign supported charitable organizations (within the meaning of Section 4948(b)), and (iii) all others.

A U.S.-supported foreign charity that has not obtained a determination letter from the IRS is not subject to the 4 percent excise tax under Section 4948(a), but is instead treated as a nonresident alien.[96] The Treasury Regulations and Gen. Couns. Mem. 33840 indicate that the Section 4948(a) tax is limited to exempt foreign private foundations.[97] Support for this interpretation is founded in the legislative history of Section 4948, contained in Senate Report 91-552, 91st Cong. 1st Sess 59, reprinted in 1969-3 C.B. at 462, which explains that a foreign organization's loss of Section 501(a) exemption means "[i]n effect, such an organization would be treated as a taxable nonresident alien."

An organization that is granted an exemption under Section 501(c)(3) is exempt from most types of income taxes in the United States.[98] The Treasury Regulations promulgated under this section make clear that "Section 501(a) provides an exemption from income taxes for organizations which are described in Section 501(c) .... However, the exemption does not extend to unrelated business taxable income of such an organization." Treas. Reg. § 1.501(a)-1(a). Furthermore, neither the Code nor Treasury Regulations promulgated thereunder distinguish between domestic and foreign organizations. Therefore, all U.S. income taxes except for unrelated business taxable income ("UBTI") imposed under Section 511 are inapplicable to Section 501(c)(3) organizations whether foreign or domestic. Therefore, unless the provisions of UBTI or a non-U.S. income tax section specifically provide otherwise, none of the income tax provisions of the Code should be applicable to a Section 501(c)(3) entity.

1. Excise Tax on Investment Income. Section 4948 imposes a 4 percent excise, as opposed to income, tax on exempt foreign private foundations. Specifically, it imposes the tax on the "gross investment income" derived by a foreign organization from sources within the United States (as determined under Section 861 and the regulations promulgated thereunder).[99] The Treasury Regulations provide that the term "gross investment income" has the same meaning under Section 4948 as it does under Section 4940 which imposes a similar excise tax on domestic organizations.[100] In either instance, such gross investment income is, in general, the gross amount of income from interest, dividends, rents and royalties.[101] It does not include any such income to the extent included in the computation of UBTI.[102] Therefore, this excise tax is not cumulative with UBTI and does not incorporate any other tax into its terms.

2. Effectively Connected Income. A foreign entity is subject to U.S. income tax on its U.S. effectively connected income ("ECI"), which is defined as its income that is effectively connected with a trade or business conducted by the foreign entity in the United States.[103] A foreign entity that is a partner in a U.S. partnership that is engaged in a U.S. trade or business shall be deemed to be engaged in a U.S. trade or business.[104] Allocable partnership income will be ECI to the foreign partner. Should the U.S. partnership have ECI, then under Section 1446 it must withhold at the highest rate of tax with regard to distributions made to its foreign partners.[105] Consequently, if an exempt foreign charitable organization owns U.S. partnership interests, its

allocable income from such partnerships could be classified as ECI (depending upon the activity of the partnership) and subject to withholding under Section 1446. Because of its Section 501(c)(3) exemption, however, the exempt foreign charitable organization should not owe any income tax under the above-cited sections.

Generally, under U.S. domestic law, foreign corporations that are directly engaged in a trade or business in the United States are subject not only to corporate income tax regarding their ECI under Section 882 but also to a system of branch taxation under Section 884. The "branch profits tax" is meant to roughly approximate the Section 881 withholding tax payable with respect to dividends received by a foreign corporation from its United States subsidiary. Therefore, if a foreign corporation is directly engaged in a trade or business in the United States, it will be effectively taxed twice on its gross income just as a domestic corporation and its shareholders would be taxed. However, the IRS has never stated that the branch profits tax as an income tax applies to a Section 501(c)(3) foreign tax-exempt entity.

3. Unrelated Business Taxable Income. As mentioned above, the general exemption from income taxes granted to Section 501(c)(3) organizations does not apply to UBTI as determined under Sections 511 through 515. These sections impose a tax on an otherwise exempt organization's UBTI. In order to generate UBTI, the organization must engage in an "unrelated trade or business" ("UTB"). Assuming that an exempt foreign charitable organization is engaged in an UTB through the ownership of U.S. partnership interests and other investments, the issue then becomes whether, as a result of the imposition of UBTI on the foreign organization, it will also be liable for the branch profits tax and corporate taxes imposed on ECI or some other tax.

First, there are no provisions contained within Sections 511 through 515 which specifically allow the branch profits tax to apply to a foreign Section 501(c)(3) entity. Furthermore, as discussed below, the regulations specifically define UBTI for foreign organizations and the branch profits tax is again not mentioned.[106] Also the Treasury Regulations under Section 511 do specifically provide that where applicable an exempt organization will be subject to the alternative minimum tax for tax preferences under Section 56.[107]

These factors would tend to indicate that UBTI does not encompass the branch profits tax. However, the Treasury Regulations also provide that "all provisions of law and of the regulations applicable to the taxes imposed by subtitle A are applicable to the taxes imposed by subtitle A are applicable to the assessment and collection of the taxes imposed by Section 511."[108] Since the branch profits tax imposed under Section 884 is a tax "imposed by subtitle A" one could argue that is applicable to the computation of UBTI. This reasoning is purely speculative since apparently neither the IRS nor any commentator has advanced this argument or described the relationship between UBTI and the branch profits tax.

In any event, when applied to foreign charities, UBTI itself resembles the ECI tax scheme and in some respects taxes a broader range of income than that which is included in the definition of ECI. Generally speaking, foreign corporations must pay corporate income tax on their ECI. UBTI taxes a charity's income derived from a UTB and is assessed at the regular corporate rate under Section 11. Section 511(a)(1).[109] The foreign charity's UBTI consists of the sum of the foreign charity's income derived from: (1) sources within the United States but which is not effectively connected with the conduct of a trade or business within the United States; and (2) ECI

from a U.S. trade or business (whether or not such income is derived from sources within the United States).[110] In other words, the only UTB amounts not subject to UBTI are amounts that are not ECI from a U.S. trade or business and are not sourced in the United States. This Treasury Regulation references Sections 861 through 865 for determining whether income realized by a foreign charity is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States.[111]

4. Withholding Obligations. As explained above, absent any wrongful acts, only two kinds of U.S. taxes might apply to exempt foreign charitable organizations: UBTI and the excise tax under Section 4948 on gross investment income. Confirming this conclusion is Section 1443 which imposes withholding obligations as to foreign exempt organizations only for UBTI which is essentially net ECI and the Section 4948 excise tax. As for UBTI, under Section 1443(a), withholding at the 30-percent rate in Section 1441 applies as to that portion of a foreign tax-exempt entity's income subject to UBTI which is net ECI.[112] However, withholding under Section 1443(a) won't apply to UBTI that is ECI if the foreign tax-exempt entity claims a withholding exemption for such income.[113]

Section 1443(b) provides for withholding at a 4 percent rate for a foreign private foundation's gross investment income from U.S. sources that is subject to the Section 4948 excise tax.[114] As with the imposition of the tax itself, this withholding provision is inapplicable if the gross investment income is subject to UBTI and that tax's withholding requirements under Section 1443(a).[115]

5. Withholding Certificates for Exempt Foreign Charitable Organizations. Exempt foreign charitable organizations should file IRS Form W-8EXP, *Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding* ("Form W-8EXP"), with U.S. payors to establish their tax exemption and reduced rate of withholding pursuant to Section 1443(b). Under Treas. Reg. § 1.1441-9(b)(2), if a foreign organization "cannot certify that it has been issued a favorable determination letter that is still in effect, its withholding certificate is nevertheless valid…if the organization attaches to the withholding certificate an opinion that is acceptable to the withholding agent from counsel concluding that the organization is described in Section 501(c)." Treas. Reg. § 1.1441-9(b)(2) continues by stating that if "the determination letter or opinion of counsel to which the withholding certificate refers concludes that the organization is described in Section 501(c)(3), and the certificate further certifies that the organization is not a private foundation described in Section 509, an affidavit of the organization setting forth sufficient facts concerning the operations and support of the organization for the IRS to determine that such organization would be likely to qualify as an organization described in Section 509(a)(1), (2), (3), or (4) must be attached to the withholding certificate."

It is important to keep in mind that, in order for a foreign organization to be treated a Section 501(c)(3) organization, it must either have requested exemption from the IRS or be described in Section 4948(b) (*i.e.*, substantially all its support comes from outside the United States). Accordingly, the only way counsel could legitimately provide an opinion stating that a foreign organization is a Section 501(c)(3) organization is if the foreign organization is in fact substantially supported from sources outside the United States. Otherwise, the organization would have to file with the IRS in order to be considered a Section 501(c)(3) organization. This

interpretation is supported by T.D. 8734 (October 6, 1997) which states that, with respect to the final withholding regulations regarding foreign tax-exempt entities:

> foreign organizations that are required to obtain an IRS determination letter in order to qualify as a tax-exempt organization under Section 501(c)(3) (i.e., those organizations that obtain a substantial portion of their support from U.S. sources) must obtain such a determination letter and attach it to their Form W-8. Other foreign organizations that may qualify for tax-exempt status under Section 501(c)(3) without an IRS determination letter (*i.e.*, organizations that receive substantially all of their support from sources outside the U.S.; see Section 4948(b)) may establish their exempt status on the basis of an opinion of counsel.

A foreign charitable organization described in Section 501(c) may choose to claim a reduced rate of withholding under other provisions of the Section 1441 Treasury Regulations.[116] For example, the foreign charitable organization may choose to claim benefit under an income tax treaty and therefore would need to comply solely with the provisions of Treas. Reg. § 1.1441-6.

III. Bilateral Income Tax Treaties: A Case-Study of the Fifth Protocol to the U.S.-Canada Income Tax Treaty.

This paper has addressed the intricacies of the U.S. tax law applicable to contributions made by U.S. persons to foreign charitable organizations, as well as foreign charitable organizations operating within the United States, and now, as a final point of analysis, this paper will turn to the realm of bilateral income tax treaties which may override those general rules just discussed. Currently there are only three such U.S. income tax treaties – the U.S.-Israel Income Tax Treaty, the U.S.-Mexico Income Tax Treaty, and the U.S.-Canada Income Tax Treaty (the "Treaty"). An interesting glimpse as to the effects of those bilateral income tax treaties on International philanthropy might be gleaned from the U.S.-Canada Income Tax Treaty, and its recent amendment by the Fifth Protocol that entered into force on December 15, 2008 (the "Protocol"). The Protocol was intended to resolve certain discrepancies in the existing U.S.-Canada Income Tax Treaty with respect to cross-border charitable bequests, however, it has potentially created the exact opposite effect.

A. Brief Overview of the Canadian Tax Credit for Charitable Bequests

Although charitable deductions against the U.S. estate tax was previously discussed, a brief overview of the Canadian counterpart is necessary for an understanding of the Treaty and Protocol, noting that an analysis of Canadian law is far beyond the scope of this paper.

As an initial matter, Canada does not have a federal estate tax. Rather, a decedent is deemed to have disposed of certain property immediately before death. Consequently, a tax is generally imposed on the inherent gains in certain property subject to Canadian federal income tax.[117] Section 118.1 of the Income Tax Act (Canada) (the "Act"), provides that a tax credit against Canadian federal income tax otherwise payable is available to individual taxpayers for donations to certain qualified organizations.[118] The tax credit is limited to 75 percent of the net income of an

individual taxpayer for a given tax year, and any excess credits may be carried forward for five years.[119] To qualify for such a tax credit, a donation must be proven by filing receipts that contain prescribed information and must have been made to (1) a registered charity; (2) a registered Canadian amateur athletic association; (3) a tax-exempt Canadian housing corporation; (4) a Canadian municipality; (5) the United Nations or an agency thereof; (6) a prescribed foreign university; (7) a foreign charitable organization to which the Canadian government has made a gift during the year of the preceding twelve months; or (8) Her Majesty in right of Canada or a province.[120]

Generally, a donation of property other than cash is considered a deemed disposition of the donated property at fair market value. Donations of appreciated property are subject to an elective provision (an "Election"), which in certain circumstances, permits a taxpayer to choose an amount, not greater than the fair market value of the gift and not less than the adjusted cost base of the property, as constituting both the amount of the donation and proceeds of the disposition. For example, assume a taxpayer owns land with a adjusted cost basis of CAN$50 and a fair market value of CAN$100. Assuming the property circumstances have been met, the taxpayer could make an Election to "value" the donation in an amount between CAN$50 and CAN$100. An Election to value the property at CAN$100, it would trigger a capital gain of CAN$50, but the potential tax credit for the donation would be capped at the maximum of CAN$100.

B. Cross-Border Charitable Bequests Under the Treaty

Prior to the enactment of the Protocol, charitable bequests between the United States and Canada were governed by Paragraph 1 of Article XXIX B of the Treaty which states:

> Where the property of an individual who is a resident of a Contracting State passes by reason of the individual's death to [a tax exempt] organization . . . the tax consequences in a Contracting State arising out of the passing of the property shall apply as if the organization were a resident of that State.

Accordingly, where the property of a Canadian resident or a U.S. resident passed by reason of death to a U.S. or Canadian exempt organization, the U.S. tax consequences arising out of the passing of the property would apply as if the organization were a resident of the United States, and the Canadian tax consequences apply as if the organization were a resident of Canada. The following examples are intended to highlight the application of this provision of the Treaty prior to the enactment of the Protocol.

1. If a Canadian resident were to donate Canadian-situs property to a U.S. exempt organization upon his death, this donation would be considered a disposition under Canadian federal income tax laws and thus would trigger Canadian federal income tax on any inherent capital gains in the property. Note than an Election might be available to reduce the Canadian capital gains tax (but see discussion below regarding ambiguities within the Treaty). Furthermore, Article XXIX B of the Treaty requires that Canada treat the U.S. exempt organization as if it were a resident of Canada and should allow the estate of the decedent a tax credit against his Canadian federal income tax liability. As mentioned above, the amount of the tax credit would be determined in accordance with the limitations established by Canadian tax law. The result would be similar if the donation was to a Canadian exempt organization.

2. If a Canadian resident donated U.S.-situs property to a Canadian exempt organization upon his death, in addition to the Canadian tax on the inherent capital gain on the property, as reduced by any Election made, the property would also be included in the taxable estate of the decedent and subject to the U.S. estate tax. However the estate of a Canadian resident is generally eligible for a special unified tax credit against the U.S. estate tax imposed on its U.S. situs property. Paragraph 6 of Article XXIX B of the Treaty generally reduces the possible double taxation allowing a "deduction" against the Canadian capital gains tax for any U.S. federal, state estate or inheritance tax paid with respect to the property.[121] Furthermore, the United States would treat the Canadian exempt organization as a U.S. exempt organization under the Treaty, and as such, the value of the donated property would be deducted from the taxable estate despite the restriction under Section 2106(a)(2)(ii) limiting such a deduction for donations to U.S. exempt organizations.

3. If a U.S. resident donated U.S.-situs property to a Canadian exempt organization upon his death, then the property will be includable in the taxable estate of the decedent. However as in the example immediately above, the United States would treat the Canadian exempt organization as a U.S. exempt organization and therefore the value of the donated property would be deducted from the taxable estate despite the restriction under Section 2106(a)(2)(ii) limiting such a deduction for donations to U.S. exempt organizations.

4. If a U.S. decedent donated Canadian-situs property to a Canadian exempt organization upon his death, the donation would be considered a disposition under Canadian federal income tax laws and thus trigger Canadian federal income tax on an inherent capital gains in the property. Furthermore, the U.S. estate tax applies to the entire worldwide estate of the U.S. decedent, and so would apply to the Canadian-situs property. However, a U.S. decedent's estate is entitled to a foreign tax credit for foreign estate, inheritance, legacy, or succession taxes under Section 2014. Paragraph 7 of Article XXIX B of the Treaty expands this foreign tax credit to include the Canadian federal income tax imposed on such property upon death. And again, the United States would treat the Canadian exempt organization as a U.S. exempt organization and so the value of the of the donated property would be deducted from the taxable estate.

The above examples are intended to be a simple and limited demonstration of the rules. There are other provisions of the Treaty that would impact these calculations, specifically preventing a "double credit" or "double deduction" in cases where both the United States and Canada have imposed a tax. For example, Subparagraph 7(c) of Article XXIX B of the Treaty generally denies relief from the U.S. estate tax to the extent that a credit or deduction has been claimed for the same amount in determining any other tax imposed by the United States. This provision would operate to deny relief, for example, to the extent that relief from U.S. federal income tax is claimed under Article XXIV of the Treaty in respect of the same amount of Canadian federal income tax. It should be noted though that there is no requirement that relief from U.S. federal income tax be claimed first (or exclusively) under Article XXIV of the Treaty. Also, Paragraph 6 of Article XXIX B of the Treaty prevents the claiming of double relief from Canadian federal income taxation under both Article XXIX B and Article XXIV of the Treaty, by providing that the credit provided by Article XXIX B applies only after the application of the credit provided by Article XXIV.

There were two significant ambiguities in the provisions of the Treaty applicable to cross-border bequests, and as noted in the Joint Committee on Taxation Explanation of the Protocol[122] (the "Joint Committee Report"), and the Protocol's changes to the Treaty provisions were generally intended to address these ambiguities regarding the application of Canadian tax rules and regarding the availability of tax credits or deductions when the United States and Canada impose tax on the same items of income or property.

C. Changes Made by the Protocol

1. The Protocol supplies two rules in place of Article XXIX B of the Treaty that apply when property of a U.S. resident passes at that individual's death to a Canadian exempt organization or when property of a Canadian resident passes at that individual's death to a U.S. exempt organization. Specifically, Article 26 of the Protocol amends Paragraph 1 of Article XXIX B of the Treaty to read in pertinent part:

2. Where the property of an individual who is a resident of a Contracting State passes by reason of the individual's death to an organization that is referred to in paragraph Article XXI (Exempt Organizations) and that is a resident of the other Contracting State,

> (a) If the individual is a resident of the United States and the organization is a resident of Canada, the tax consequences in the United States arising out of the passing of the property shall apply as if the organization were a resident of the United States; and
>
> (b) If the individual is a resident of Canada and the organization is a resident of the United States, the tax consequences in Canada arising out of the passing of the property shall apply as if the individual had disposed of the property for proceeds equal to an amount elected on behalf of the individual for this purpose (in a manner specified by the competent authority of Canada), which amount shall be no less than the individual's cost of the property as determined for purposes of Canadian tax and no greater than the fair market value of the property.

Under Subparagraph (a), if property passes from a U.S. resident to a Canadian exempt organization upon death, the estate will generally be entitled to deduct the value of the property from the tax estate as it could have under the Treaty prior to the Protocol.

Subparagraph (b) of the Protocol was intended to resolve questions that had been raised about the application of the Treaty if property passed from a Canadian resident to a U.S. exempt organization that is not a "registered charity". It specifies that an Election is available to such a bequest, and as the Election is only available under Canadian law for donations to registered charities, the Protocol indirectly states that a tax exempt organization under the laws of the United States and as described in Paragraph I of Article XXI of the Treaty, qualifies as a "registered charity" for these purposes. Subparagraph (b) is also intended to resolve issues relating to the double taxation of donated property. If the Election is made to treat the Canadian resident as having disposed of the property for an amount equal to his adjusted cost basis, then there will be no

inherent capital gains subject to Canadian federal income tax (note this does not change the seventy percent net income limitation of Paragraph six of Article XXI of the Treaty).

Both the Joint Committee Report and the Treasury Technical Explanation of the Protocol[123] (the "Technical Explanation") note that although the revisions made by the Protocol resolve certain ambiguities in the language of the Treaty, the revisions also create potentially larger uncertainty. The Protocol does not address the situation in which a resident of one jurisdiction bequeaths property situated in the other jurisdiction to an exempt organization in the decedent's, country of resident. Under the revised Article XXIX B, there is no example describing the tax consequences if a U.S.-situs property of Canadian resident passes to a Canadian charity upon death, and concluding that the value will be excluded from the taxable estate. However, although this precise example is not provided in the Technical Explanation, arguably it is not an exclusive list of examples. The opening line in the revised Article XXIX B states: "[w]here property of an individual who is a resident of a Contracting State passes by reason of the individual's death to an organization that is referred to in paragraph I of Article XXI (Exempt Organizations) *and* that is a resident of the other Contracting State . . . [emphasis added]." It would be reasonable to conclude that the examples were only meant only to clarify particular situations rather than disallowing the tax benefits for all scenarios except those listed. Both the Joint Committee Report and the Technical Explanation note that the situs of the property is not addressed by the Protocol and predict that this will be an area of concern. Importantly, neither notes that the result, or even that the intended result of the Protocol language would be to disallow previously available tax benefits for all other cross-border bequests. The purpose of the amendment was to address the ambiguities mentioned above, to clarify the availability of a tax credit against Canadian federal income taxes when the donation is to a U.S. exempt organization and to reduce the potential for double taxation by specifically including the availability of the Election.

As such, although the revised language does not address the tax consequences if U.S.-situs property of a Canadian decedent passes to a Canadian exempt organization, it is reasonable to assume that if such a drastic variation from the Treaty was intended, it would have been mentioned in either the Joint Committee Report or the Technical Explanation. It would be reasonable to assume that the new rules of the revised Article XXIX B are intended to clarify certain situations and are not meant as a exclusive list of cross border bequests eligible for tax benefits.

D. Exempt Organizations under the Treaty and the Protocol.

As a final note, the paragraphs above refer to an "U.S. exempt organization", but rather than refer directly to the language of the Code, the Protocol provides its own definition. Potentially adding yet another layer of complexity to the complex subject.

Under the Treaty prior to its amendment by the Protocol, eligibility of tax benefits required that if a bequest is to a U.S. exempt organization, that the organization must be exempt from U.S. federal tax under Section 501(c)(3) and that it is not a private foundation as described in Section 509(a)(2). Yet, as previously noted, the first line of the revised Article XXIX B states that: "[w]here the property of an individual who is a resident of a Contacting State passes by reason of the individual's death to an organization that is referred to in paragraph 1 of Article XXI Exempt Organizations . . . ." The revised Paragraph I of Article XXI states in turn "income derived by a religious, scientific, literary, education or charitable organization shall be exempt from tax in a

Contracting State if it is resident in the other Contracting State, but only to the extent that such income is exempt from tax in that other State." In this way, the Protocol has created its own definition of an "exempt organization" separate and apart from the Code. "U.S. exempt organizations" under the Protocol include religious, scientific, literary, education or charitable organizations exempt from either U.S. or Canadian federal income tax. Practically speaking, although there is nothing specifically stating that an organization must be exempt under Section 501(c)(3) and not be a private foundation within the meaning of Section 509(a), such organizations are the most likely to fulfill the requirements of the revised Article XXIX B and Article XXI of the Protocol. This departure from the definitions of the Code, could prove interesting and create future loopholes and inconsistencies.

IV. Concluding Remarks

International philanthropy involving the U.S., either with U.S. persons donating to foreign causes or foreign charitable organizations establishing themselves in the United States, invokes a whole host of potential U.S. tax considerations. Although there are some general well-defined rules, there are a number of "gray areas" in which there is frequently little, and sometimes conflicting, guidance. However, it is also an area that will have increasing significance as international philanthropy continues to become more prominent and expansive.

---

[1] Andrius Kontrimas is a partner at Fulbright & Jaworski L.L.P. Special thanks to Moira C. Gillis an associate with Fulbright & Jaworski L.L.P. for her detailed review and update of this paper as well as for her contribution of the third section addressing the Canadian Treaty Protocol.
[2] *See* http://www.irs.gov (last accessed Sept. 7, 2009).
[3] *See* http://www.irs.gov/charities/article/0,,id=96136,00.html (last accessed Aug, 21, 2009)
[4] IRS Publication 3833, *available at* http://www.irs.gov/pub/irs-pdf/p3833.pdf (last accessed Aug. 21, 2009).
[5] *See* http://www.efc.be/ftp/public/IC/DisasterGrantmaking.pdf (last accessed Aug. 20, 2009).
[6] Jane G. Gravell, Congressional Research Service Report for Congress, *Tax Issues Relating to Charitable Contributions and Organizations* (August 5, 2008).
[7] *See for example*, H.R.7, 107th Cong. (2001) (containing eight new federal income tax benefits for charitable donations); H.R. 777, 107th Cong. (2002) (allowing taxpayers who do not itemize a deduction for a portion of their charitable contributions).
[8] Congressional Budget Office, *Budget Options*, p. 273 (Feb. 2007).
[9] *See for exampl*e, The Tsunami Relief Act of 2005, P.L. 109-1 (Jan 7, 2005); The Gulf Opportunity Zone Act, P.L. 109-135 (De. 22, 2005).
[10] The President's Budget, Table S-11, *available at* http://www.whitehouse.gov/omb/budget/fy2010/assets/summary.pdf (last accessed Sept. 7, 2009).
[11] Section 170(d)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). All section references herein are to the Code unless otherwise noted.
[12] Treas. Reg. § 1. 501(c)(3)-1(d)(2).
[13] 1920-3 C.B. 188, 1920 WL 4812 (US).
[14] Rev. Rul. 71-460, 1971-2 C.B. 231; Rev. Rul. 68-117, 1968-1 C.B. 251; Rev. Rul. 68-165, 1968-1 C.B. 253; and Rev. Rul. 80-286, 1980-2 C.B. 179.
[15] *See* Art. XXI(5) U.S. – Canada Income Tax Treaty; Art. 22(2) U.S.-Mexico Income Tax Treaty; and Art. 15A U.S.-Israel Income Treaty.
[16] Treas. Reg. § 53.4945-5(a)(6).
[17] 1963-2 C.B. 101.
[18] *Id*.

[19] *Id.*; *see also* Rev. Rul. 66-79, 1966-1 CB 48 (finding a deduction allowed for contributions to domestic organization which specifically solicited funds for the foreign charity and transmitted such funds to foreign charity).
[20] Although Private Letter Rulings may not be used or cited as precedent pursuant to Section 6610(k)(3) they do indicate the position of the National Office of the IRS.
[21] Section 2522(a)(2)-(3).
[22] Treas. Reg. § 25.2522(a)-1(a).
[23] Section 2055(a)(2)-(3).
[24] Treas. Reg. § 20.2055-1(a)(2); Section 7701(a)(3).
[25] *Estate of Smith v. Comm'r.*, T.C. Memo 1961-242 (1961).
[26] Treas. Reg. § 20.2055-1(a); s*ee also* Priv. Let. Rul. 8318043 (Jan. 31, 1983) (recognizing that an educational organization created by the legislative act of a foreign government was an organization described in Section 2055(a)(2)).
[27] *See e.g.,* Rev. Rul. 74-523, 1974-2 C.B. 304; *Kaplun v. U.S.*, 436 F.2d 799 (2nd Cir. 1970) (holding that an estate tax charitable deduction is permitted for the value of a coin collection bequeathed to the State of Israel for exhibition in a museum); and *Nat'l Savings and Trust Co., v. U.S.*, 436 F.2d 458 (Ct. Cl. 1971) (allowing an estate tax deduction allowed for bequest to a German city on the condition it be used for the construction or improvement of a home for the aged).
[28] Rev. Rul. 74-523, 1974-2 C.B. 304.
[29] Section 170(c).
[30] Section 170(b)(2).
[31] Section 4942(a)-(b).
[32] Section 4942(g)(1)(A).
[33] Section 4945(d)(4).
[34] Section 4945(d)(4).
[35] *Id*.
[36] Treas. Reg. § 53.4945-5(b)(2).
[37] Treas. Reg. § 53.4945-5(b).
[38] Treas. Reg. § 53.4945-5(b).
[39] Treas. Reg. § 53.4945-5(c)(2).
[40] *Id*.
[41] Treas. Reg. § 1.507-3(a)(7).
[42] *Id*.
[43] *Ibid*.; Treas. Reg. § 1.507-3(a)(9).
[44] *See* Treas. Reg. § 53.4945-6(c)(2)(ii).
[45] Treas. Reg. § 53.4942-3(a)(6)(i).
[46] Section 4945(a)(2); Treas. Reg § 53.4945-1(a)(2).
[47] Treas. Reg. § 53. 4945-1(a)(2)(vi).
[48] *See* Rev. Proc. 92-94, 1992-2 C. B. 507.
[49] Treas. Reg. § 53.4945-5(a)(4)(iii)
[50] *Id*.
[51] Treas. Reg. § 1.507-3(c)(1).
[52] Treas. Reg. § 1.507-3(c)(2).
[53] Treas. Reg. § 1.507-3(a)(1).
[54] *See* Treas. Reg. § 1.507-3(c)(2); Priv. Ltr. Rul. 7834022 (July 12, 1978).
[55] Treas. Reg. § 1.507-3(c)(2).
[56] Treas. Reg. § 1.507-3(a)(1)
[57] Treas. Reg. § 1.507-3(a)(2).
[58] Treas. Reg. § 1.507-3(a)(3).
[59] Treas. Reg. § 1.507-3(a)(4).
[60] Treas. Reg. § 1.507-3(a)(1).
[61] Priv. Ltr. Rul. 9834035 (May 28, 1998).
[62] Treas. Reg. § 1.507-3(a)(9)(i).
[63] Treas. Reg. § 1.507-3(a)(9)(i).
[64] Treas. Reg. § 1.507-3(a)(9)(iii).

[65] Priv. Ltr. Rul. 9014053 (Jan. 8, 1990); Gen. Couns. Mem. 39842 (April 1, 1991); Priv. Ltr. Rul. 7902086 (Oct. 16, 1978).
[66] For a comprehensive treatise on this topic, *see* CAROL SHELBOURNE GEORGE, INTERNATIONAL CHARITABLE GIVING: LAW AND TAXATION (1994).
[67] Section 508(a).
[68] Section 508(b).
[69] Treas. Reg. § 1.508-1(a)(2)(i).
[70] Treas. Reg. § 1.508-1(a)(2)(ii).
[71] Treas. Reg. § 1.508-1(a)(2)(ii).
[72] Gen. Couns. Mem. 38316 (Mar. 21, 1980).
[73] Treas. Reg. § 1.508-1(a)(2)(i).
[74] Treas. Reg. § 1.508-1(a)(4).
[75] Treas. Reg. § 1.508-1(a)(4).
[76] Treas. Reg. § 1.508-1(a)(2)(vi).
[77] Section 509(d) defines "support" to include (but not be limited to): (i) gifts grants, contributions, or membership fees; (ii) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity which is not an unrelated trade or business; (iii) net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business; (iv) gross investment income; (iv) tax revenues levied for the benefits of an organization and either paid to or expended on behalf of such organization; and (vi) the value of services or facilities furnished by certain governmental units to an organization without charge. For purposes of determining support under Treas. Reg. § 53.4948-1(b), however, gross investment income is not included.
[78] Treas. Reg. § 53.4948-1(b).
[79] Treas. Reg. § 53.4948-1(b).
[80] Section 4948(c)(4).
[81] Section 4948(c)(2).
[82] S. Rep. No. 91-562, 91st Cong. 1st Sess. 59.
[83] Treas. Reg. § 53.4948-1(c)(2).
[84] Section 6684 also notes that liability may arise where the act (or failure to act) giving rise to the penalty "is not due to reasonable cause".
[85] Treas. Reg. § 53.4948-1(c)(2)(iii).
[86] Section 4948(c)(3)(A).
[87] Section 4948(c)(3)(B).
[88] Treas. Reg. § 53.4948-1(c)(3)(ii)(b).
[89] This language raises a concern as to whether a disqualified person of a foreign private foundation described in Section 4948(b) could be held liable for engaging in a prohibited transaction with a foreign charitable organization. Based on the Treasury Regulations, a disqualified person's act (or failure to act) may rise to the level of a prohibited transaction, but the consequences are not the imposition of taxation, but are instead the refusal of exemption under Section 501(a). Treas. Reg. § 53.4948-1(c).
[90] H. Rep. No. 91-413, 91st Cong. 1st Sess. 225.
[91] Section 4943(c)(2)(A).
[92] Section 4943(c)(2)(B).
[93] Section 6033(a)(2).
[94] Section 6033(a)(2)(B).
[95] Rev. Proc. 94-17, 1994-1 C.B. 579.
[96] Gen. Couns. Mem. 38840 (April 22, 1982).
[97] Treas. Reg. § 53.4948-1(a)(1).
[98] Section 501(a)
[99] Treas. Reg. § 53.4948-1(a)(1). Under Treas. Reg. § 53.4948-1(a), a foreign organization is defined as an organization which is not described in Section 170(c)(2)(A). Section 170(c)(2)(A) applies to a corporation, trust, community chest, fund, or foundation, "created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States."
[100] *Id.*
[101] Section 4940(c)(2).
[102] *Id.*
[103] Section 871(b).

[104] Section 875(1); Treas. Reg. § 1.875-1.
[105] Section 1446(a)-(b).
[106] Treas. Reg. § 1.512(a)-1(g)(1).
[107] Treas. Reg. § 1.511-4.
[108] Treas. Reg. § 1.511-3(a).
[109] Section 6655(g) provides that all tax-exempt organizations, regardless of legal form, must make quarterly estimated payments of tax on unrelated business income and net investment income (per Section 4940) under the same rules as those for corporate estimated tax payments. Section 6655(g) and the regulations promulgated thereunder does not mention the excise tax on a foreign private foundation's gross investment income imposed under Section 4948.
[110] Treas. Reg. § 1.512(a)-1(g)(1).
[111] *Id*.
[112] Treas. Reg. § 1.1443-1(a)(2). Withholding under Section 1443(a) does not apply to a foreign tax-exempt organization's interest income that is not includible in UBTI. *See* Rev. Rul. 72-244, 1972-1 C.B. 282 (withholding under Section 1443 does not apply to foreign tax-exempt organization's bond interest income that is excludible from UBTI; contains suggested notation for tax-exempt organization to place on Form 1001). To secure the withholding exemption for such income, the tax-exempt entity should file Form W-8 EXP with the appropriate information.
[113] A foreign tax-exempt entity may receive such an exemption by filing with the withholding agent a statement that the income is ECI and will be included in the entity's gross income for the taxable year. Treas. Reg. §§ 1.1443-1(a)(2), 1.1441-4(a)(2). Section 1446 requires a partnership to withhold with respect to a foreign partner's share of ECI. It is unclear if Section 1446 supersedes Section 1443, or vice-versa. However, given that the Treasury Regulations under Section 1443 apply to "any income ... which is includible under Section 512," one could argue that the above described procedure should apply to Section 1446 as well. Any such conclusion is speculative, however, since no regulations have been promulgated under Section 1446.
[114] Treas. Reg. § 1.1443-1(b)(1)(i).
[115] Rev. Rul. 72-244, 1972-1 C.B. 282. Note that under either Section 1443(a) or (b), the withholding agent must complete and file IRS Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, for any foreign private foundation that is subject to withholding and submit the balance due (if any) of the withholding tax.
[116] Treas. Reg. § 1.1441-9.
[117] Layman, Richard P., *New U.S.-Canada Protocol Provides Estate Tax Relief*, 6 J. OF INT'L TAXATION, No. 5 (May 1995).
[118] Note that unlike individual taxpayers, under Section 110.1 of the Act, corporate taxpayers are entitled to a deduction for donations in computing their Canadian federal taxable income, rather than a credit against taxes otherwise payable.
[119] Portfolio 955-4th, T.M., *Business Operations of Canada, Part VII Income Taxation, available at* http://taxandaccounting.bna.com/btac (last accessed on Nov. 04, 2008).
[120] *Id.*
[121] *See generally Henkel, U.S.-Canadian Protocol in* ESTATE PLANNING AND WEALTH PRESERVATION; STRATEGIES AND SOLUTIONS, Ch. 52, (1997).
[122] *Joint Committee on Taxation Provides Explanation of Proposed Canada-U.S. Treaty Protocol* (July 8, 2008).
[123] *Department of the Treasury Technical Explanation of the Protocol Done At Chelsea on September 21, 2007 Amending the Convention between the United States of America and Canada with respect to Taxes on Income and on Capital Done on September 26, 1980 as Amended by the Protocols Done on June 14, 1983, March 28, 1994, March 17, 1995 and July 29, 1997* (July 10, 2008).

Tax Planning for the Redemption of Stock in S Corporations

by Jeffry M. Blair
Hunton & Williams LLP

Tax Planning for the Redemption of Stock in S Corporations

by Jeffry M. Blair[1]
Hunton & Williams LLP

There are many reasons why a corporation would choose to redeem some of its outstanding shares of stock. Such reasons include: permitting a majority shareholder of a closely held business to withdraw from the corporation; changing the corporate structure to rely more on debt than equity financing, buying out certain minority or dissatisfied shareholders, reducing the number of outstanding shareholders in preparation of an election to be treated as an S corporation, or providing a funding source to pay the estate taxes of a majority owner.

Whatever the reason, the tax consequences of the redemption should be taken into account. In addition, although the tax consequences of the redemption of stock in an S corporation are similar to the tax consequences of the redemption of stock in a C corporation, there are some key differences that should be considered.

Does the Redemption Qualify as a Sale or Exchange?

In many redemptions, a corporation is acquiring the stock of some but not all of its shareholders. Since the transaction looks like a sale of the shareholder's stock to the issuing corporation, it is easy to assume that the transaction would always be treated as a sale or exchange for federal income tax purposes. This assumption is often incorrect. In cases where the redeemed shareholder is deemed to not have sufficiently reduced his ownership in the corporation redeeming its stock, the transaction could be treated as if that shareholder had received a dividend instead of having sold its stock. Furthermore, where the transaction is treated as the distribution of a dividend and the corporation is an S corporation, a partial redemption may be able to qualify (in whole or in part) as a tax-free return of the redeemed shareholder's tax basis. Therefore, the first tax issue that should be addressed with respect to a proposed redemption is whether the transaction will be treated as a sale or exchange or as a distribution by the redeeming corporation with respect to its stock for federal income tax purposes.

In general, if a shareholder receives cash from a corporation in exchange for some or all of his stock in that corporation, the transaction will generally be treated as a redemption of the stock by the corporation and will be governed by Section 302 of the Internal Revenue Code.[2] The rules of Code Section 302 apply to both C and S corporations.[3] Under Code Section 302, a shareholder who exchanges his shares of stock in a corporation for cash will be treated as having sold his shares if the exchange meets one of the following three tests:

(i) the exchange results in a "*complete termination*" of his equity interest in the redeeming corporation;

(ii) the exchange is "*substantially disproportionate*" with respect to the shareholder; or

(iii) the cash received is "*not essentially equivalent to a dividend*" with respect to the shareholder.[4]

Alternatively, if none of the above three tests are satisfied, then the shareholder's receipt of cash in redemption of his shares of stock in the redeeming corporation will generally be treated as a distribution by the redeeming corporation to that shareholder with respect to his shares of stock in the redeeming corporation. As explained in greater detail below, this distribution could result in the cash received being treated for as the receipt of a dividend by the redeemed shareholder for federal income tax purposes.

In analyzing whether one of these three tests is satisfied, in addition to the shares the shareholder actually owns, he may be deemed to own additional shares under the constructive ownership rules of Code Section 318.[5] Generally, the constructive ownership rules under Code Section 318 treat a shareholder as owning:

(a) shares of stock owned by certain relatives,

(b) shares of stock owned by related corporations, partnerships, estates or trusts, and

(c) shares of stock the shareholder has an option to acquire.[6]

The constructive ownership rules are relatively complex and factually intensive. Thus, redeeming corporations and shareholders should consult with their tax advisors with respect to the applicability of these rules to their particular facts and circumstances.

Complete Termination Test

The complete termination test will be satisfied if a shareholder is treated for federal income tax purposes as having completely terminated his interest in the redeeming corporation. A redeemed shareholder will be treated as having completely terminated his interest in the redeeming corporation if, immediately after the redemption, the shareholder does not actually own and is not treated as owning under the constructive ownership rules any shares in the redeeming corporation.[7] If this test would be satisfied but for the fact that the redeemed shareholder is considered to own stock that is owned by his spouse, children, grandchildren, or parents, the redeemed shareholder may be able to waive the attribution of these family owned shares provided certain conditions are met and certain agreements are made with the Internal Revenue Service.[8] However, meeting these requirements may not always be possible. For example, one of the requirements to waive family attribution is that the redeemed shareholder may not own any interest in the redeeming corporation (other than an interest as a creditor) for the ten year period immediately following the redemption.[9] This requirement could make it difficult to qualify a redemption under this test where older family members are turning over a company to their children but want to continue to have a vote in the operations of the business.

Substantially Disproportionate Test

A redemption will also be treated as a sale or exchange for federal income tax purposes if the redemption meets the "substantially disproportionate" test. In general, this is a mechanical test aimed at determining whether the redeemed shareholder has had a substantial reduction in

his voting power in the redeeming corporation. A redeemed shareholder is considered to have a substantial reduction in his voting power if such shareholder's percentage ownership in the voting stock of the redeeming corporation, including both actual and constructive ownership, immediately after the redemption is both:

(i) less than eighty percent (< 80%) of such shareholder's percentage ownership of the voting stock of the redeeming corporation (including both actual and constructive ownership) immediately before the redemption; and

(ii) less than fifty percent (< 50%) of the total combined voting powers of all classes of stock entitled to vote.[10]

Although, the test appears to be fairly straight forward, you still need to careful in its application. In making the calculations, the test becomes somewhat complicated because the ownership includes both the redeemed shareholder's direct and constructive ownership of the stock of the redeeming corporation.[11] The constructive ownership rules will make it impossible for some relatives of majority shareholders from being able to meet this test. In addition, care must be taken when the redeeming corporation has multiple classes of stock because the test focuses on the voting power of the redeemed shareholder. For example, if the redeeming corporation has voting common stock and non-voting preferred stock and the only stock being redeemed is non-voting preferred stock, then the redemption will not be able to meet the substantially disproportionate test because there will be no decrease in the redeemed shareholder's voting stock.

Not Essentially Equivalent to a Dividend Test

In addition to the complete termination and substantially disproportionate tests, a third test permits a shareholder to receive sale or exchange treatment if the redemption is "not essentially equivalent to a dividend."[12] The Supreme Court has defined this test as requiring a "meaningful reduction" in the redeemed shareholder's percentage ownership of the redeeming corporation's stock.[13] This test requires a redeemed shareholder to compare his share interest in the redeeming corporation, including any actual and constructive ownership, immediately after the redemption to his share interest in such corporation, including any actual and constructive ownership, immediately before the redemption. Whether a redemption will result in a meaningful reduction in the redeemed shareholder's percentage ownership of the redeeming corporation depends on the facts and circumstances of the redeemed shareholder. The Internal Revenue Service has held in a published Revenue Ruling that a minority stockholder in a widely-held public corporation (i.e., a holder whose relative stock interest in the company was minimal in relation to the respective shares outstanding and who exercises no "control" over corporate affairs) had a meaningful reduction in the holder's share interest after a redemption transaction where the holder's actual and constructive percentage ownership in the corporation was reduced from 0.00011118 percent to 0.0001081 percent (an approximate 3.31 percent reduction in relative interest).[14] Since this test is very fact specific, the prudent approach will be to make sure that the proposed redemption falls within prior holdings of the Internal Revenue Service or applicable court decisions prior to relying on this test for sale or exchange treatment.

What are the Tax Consequences of a Sale or Exchange?

If the redeemed shareholder meets any one of the above three tests of Code Section 302, then the redeemed shareholder will be treated as having sold his or her stock in exchange for the cash received.[15] Such redeemed shareholder will generally recognize gain or loss in an amount equal to the difference between the cash received and the redeemed shareholder's tax basis in the redeeming corporation stock exchanged therefor.[16] Such gain will be a capital gain if the redeeming shareholder held his or her shares in the redeeming corporation as a capital asset within the meaning of Code Section 1221 (generally requiring that such stock is held for investment purposes) on the effective date of the redemption.[17] In addition, such capital gain will be a long-term capital gain if the redeemed shareholder held such redeemed shares in the redeeming corporation for a period of more than one year as of the effective date of the redemption.[18] If the shareholder is a non-corporate taxpayer, such net long-term capital gains are currently taxed at a maximum federal income tax rate of 15%.[19]

If the redemption triggers a loss, the loss will generally be a capital loss and may be subject to certain limitations. In general, capital losses incurred by taxpayers other than a corporation may only be recognized in a given tax year to the extent of the sum of the individual's capital gains plus $3,000, with any excess carried over to future tax years subject to these same annual limitations.[20] In the case of a corporation, losses from the sale or exchange of capital assets are allowed only to the extent of the corporation's capital gains and any excess capital loss is generally carried back three and forward five taxable years.[21]

What are the Tax Consequences of a Distribution (i.e. Redemptions Not Treated as a Sale or Exchange)?

If a redemption does not satisfy any of the three tests described above, then the amounts distributed by a redeeming corporation to a redeemed shareholder in exchange for his shares will be treated as a distribution by such corporation to the shareholder with respect to that shareholder's stock in the corporation. In this context, the rules for a C corporation and an S corporation differ.

In the case of a C corporation, the distribution will be treated as a dividend to the extent of the C corporation's undistributed earnings and profits.[22] If the amount of the distribution exceeds the corporation's undistributed earnings and profits, then such excess amount will be treated as a non-taxable return to the extent of the shareholder's tax basis in the stock and then as capital gain.[23] This gain would be treated as long-term capital gain if the shareholder held the stock for more than one year as of the effective date of the redemption.[24]

The rules for S corporations are a bit more complex and will depend on several factors including whether:

(i) the S corporation was formerly a C corporation and has undistributed C corporation earnings and profits;
(ii) the tax basis of the shareholder's stock being redeemed; and
(iii) where applicable, the amount of the S corporation's accumulated adjustments account (hereinafter, "AAA").

If the redeeming corporation is an S corporation that was originally a C corporation and has undistributed C corporation earnings and profits, the shareholder's tax consequences will depend upon the shareholder's tax basis in his S corporation stock immediately before the distribution, the balance of the S corporation's AAA and the amount of the S corporation's undistributed C corporation earnings and profits. In general, an S corporation's AAA account represents the earnings of the S corporation that have been previously taxed to the S corporation shareholders for all years that the corporation has been an S corporation reduced by the amount of any prior distributions treated as distributions of AAA and certain other reductions. Thus, in essence, the balance of AAA represents previously taxed S corporation net income that has not been distributed to that S corporation's shareholders and can, under the correct circumstances, be distributed to the S corporation shareholders without incurring another level of tax. If an S corporation makes a distribution to its shareholders during a tax year, other than a distribution treated as a dividend of the S corporation's undistributed C corporation earnings and profits, then the S corporation reduces its AAA by the amount of the distribution. If the S corporation makes multiple distributions in a tax year that exceed the amount of the S corporation's AAA, determined as of the end of the S corporation's tax year, then the AAA is allocated proportionately between such distributions. Therefore, unless the S corporation has excess AAA above the amount of the S corporation's distributions for a tax year, the exact amount of AAA allocated to a distribution will not be known until the end of that tax year. The amount of AAA allocable to a distribution is important because, as described below, where the AAA allocable to the distribution exceeds a redeemed shareholder's tax basis in his stock the result is a capital gain distribution which simultaneously reduces the S corporation's AAA.

In general, assuming the redemption does not qualify for sale or exchange treatment but the AAA allocable to such distribution *does not exceed the shareholder's tax basis in his stock*, the distribution will be treated as follows:

(i) first, as a non-taxable distribution of the S corporation's AAA to the extent the distribution does not exceed the redeemed shareholder's tax basis in his stock and the S corporation's AAA that is allocated to the distribution;
(ii) then, the excess is treated as a taxable dividend to the extent of the S corporation's undistributed C corporation earnings and profits;
(iii) then, any remaining amount is treated as a nontaxable reduction in the remaining tax basis in the shareholder's stock; and
(iv) finally, amounts in excess of tax basis result in a capital gain distribution.[25]

Alternatively, if the exact same distribution occurs but the allocable share of the S corporation's AAA to such redemption *exceeds the shareholder's tax basis in his stock*, the distribution would be treated as follows:

(i) first, as a non-taxable distribution of the S corporation's AAA to the extent the distribution does not exceed the redeemed shareholder's tax basis in his stock;
(ii) then, as a taxable capital gain to the extent of the excess allocable AAA (i.e. AAA allocable to the distribution that is excess of the shareholder's tax basis in his stock);

(iii) then, the excess is treated as a taxable dividend to the extent of the S corporation's undistributed C corporation earnings and profits; and

(iv) finally, amounts in excess of the S corporation's undistributed C corporation earnings and profits results in a capital gain distribution.[26]

In both of the above cases, distributions that are not treated as dividends will reduce both the S corporation's AAA and the shareholder's tax basis in their S corporation stock (but not below zero).

Although these two distributions look fairly similar, they have different impacts on the S corporation and the redeemed shareholder. In the first distribution, the redeemed shareholder is treated as receiving all of his tax basis in his stock to the extent of the S corporation has sufficient AAA prior to being treated as having received a taxable dividend or a capital gain distribution. In the second distribution, the redeemed shareholder recognizes capital gain to the extent that the AAA allocated to the distribution exceeds the shareholder's tax basis in his stock. The second distribution is not very tax efficient because the S corporation's AAA, which is a corporate level asset, is being reduced simultaneously with the redeemed shareholder recognizing capital gain on such distribution. Therefore, a redeeming corporation should make sure it will have sufficient AAA to help prevent the loss of AAA with a simultaneous recognition of capital gain by the redeemed shareholder.

In a redemptions treated as a distribution, amounts treated as distributions of undistributed C corporation earnings and profits by the S corporation are treated similar to dividends by a C corporation. These distributions should generally be treated as qualified dividend income under Code Section 1(h) if the redeemed shareholder held stock in the redeeming S corporation for at least 60 days during the 121 day period beginning 60 days prior to the effective date of the redemption.[27] Qualified dividend income is currently taxed at a maximum federal income tax rate of 15%.[28] Amounts treated as capital gain will be treated as long-term capital gain if the redeemed shareholder held his redeemed stock for more than one year as of the effective date of the redemption. As stated above, net long-term capital gains for non-corporate taxpayers are currently taxed at a maximum federal income tax rate of 15%.[29]

The rules for S corporations that have always been an S corporations and S corporations that were prior C corporations but do not have undistributed C corporation earnings and profits are a bit simpler. In such a case, distributions in redemption of a shareholders S corporation shares are treated first as a nontaxable return of the shareholder's tax basis in their S corporation stock, then as a capital gain distribution.[30] If the stock is held by the shareholder for more than one year as of the effective date of the redemption, the gain should be treated as long-term capital gain, and for non-corporate taxpayers, currently taxed at a maximum federal income tax rate of 15%.[31]

Shareholder's Other Considerations

When the shareholder of an S corporation has his stock redeemed, there are a few things that should be taken into account with respect to the shareholder's tax basis in his stock. In general, a shareholder's tax basis in his S corporation's stock is adjusted at the close of the S

corporation's taxable year.[32] However, if a shareholder disposes of his stock during the S corporation's taxable year, then the stock basis adjustments with respect to the stock are effective immediately prior to the disposition.[33] Therefore, in calculating the tax consequences of a redemption to an S corporation shareholder, the tax basis of the stock being redeemed should be adjusted to reflect the income, loss, distributions and other items that have taken place prior to the effective date of the redemption.

Getting a reasonable estimate of the expected basis adjustment prior to the redemption may not always be an easy process. An S corporation generally allocates its income and loss pro rata to its shareholders on a per share per day basis.[34] However, if any shareholder completely terminates his interest in the S corporation or if the S corporation redeems at least 20% of the S corporation's outstanding stock, then the S corporation may elect to "close its books" as of the end of the day of the disposition.[35] This closing of the books creates two tax years, with the first ending at the close of the day on which there is a qualifying disposition of S corporation stock and the second running from the following day through the S corporation's normal year-end.[36] In the case of a shareholder completely terminating his interest in the S corporation, all shareholders of the S corporation must agree to the election.[37] In some cases, this may make it difficult or unfeasible for an S corporation to elect to "close its books" when the shareholder redeemed owns less than 20% of the S corporation's outstanding stock. Since a "closing of the books" election may not always be available, the ability to accurately estimate the amount of the partial year adjustment should be considered in determining the timing of redemptions.

Another shareholder consideration when planning for a redemption of his stock is to determine whether it is beneficial for him to designate which shares are to be redeemed. In general, the stock basis of each S corporation share is determined on a share-by-share basis.[38] Therefore, if some but not all of a shareholder's shares of S corporation stock are being redeemed and that shareholder has different tax basis in his shares he may want to specifically identify the higher tax basis shares as the shares being redeemed.[39] These rules permit a redeemed shareholder to specify the shares with a higher tax basis, and thus, reduce the amount of current gain recognized.

Still another aspect to be considered in redemptions is the possibility of "disappearing tax basis." In general, when a redemption transaction is treated as a distribution rather than as a sale or exchange, if there is any tax basis in the redeemed stock that is not reduced to zero as a result of the rules described above, that excess basis is transferred to the redeemed shareholder's remaining shares.[40] Thus, if the redeemed shareholder's interest in the S corporation completely terminates, but due to the shareholder's constructive ownership under Code Section 318 of other persons or entity's shares, such shareholder may not be entitled to sale or exchange treatment and could have tax basis remaining in shares in which he does not own. If that occurs, it is unclear what happens to the remaining tax basis.

Current Treasury Regulations seem to indicate that this "remaining" tax basis would not disappear but would be transferred to the stock of the related person that the redeemed shareholder is treated as constructively owning.[41] However, these rules have been used by some abusive tax shelters and the Internal Revenue Service has announced that it will disallow the basis shift in tax avoidance transactions.[42] In addition, the Internal Revenue Service has issued

Proposed Treasury Regulations that would not transfer the redeemed shareholder's remaining tax basis to the stock of the related person but instead would treat that basis as a capital loss of the redeemed shareholder.[43] Under these Proposed Treasury Regulations, a redeemed shareholder that is not a corporation would generally be permitted to include the loss as of the date that he no longer actually or constructively owned stock in the redeeming corporation.[44] Although these rules are generally less important in S corporation redemptions, due to the S corporation rules reducing tax basis in transactions treated as distributions, they still must be a consideration in transactions where the redeemed shareholder has tax basis in excess of the amount paid for his stock.

The amount of a redeeming S corporation's AAA is important because it tracks the ability of the S corporation to make tax-free distributions to the S corporation shareholders. In addition, as stated above, AAA is a corporate level asset. Therefore, if only some shareholders are redeemed, the AAA may be allocated disproportionately to those shareholders. In certain cases, this can increase the chances that a redemption will be treated as a tax free return of the redeemed shareholder's tax basis. For example, suppose an S corporation is redeeming a 30% shareholder that is the father of the 70% shareholder. Unless the redeemed shareholder waives family attribution, a redemption of some of the father's stock will be treated as a tax-free distribution to the shareholder provided the shareholder has tax basis and allocable AAA in the amount paid to the father in the redemption.

In addition, the impact on AAA may also be a consideration in determining whether a transaction should be structured to qualify as a sale or exchange or as a transaction treated as a distribution with respect to the redeemed shareholder's stock.[45] If the redemption is treated as a sale or exchange, then the AAA is reduced by the pro rata number of S corporation shares redeemed[46]. For example, if an S corporation has $1,000,000 of AAA and it redeems 20% of its outstanding shares, if the redemption is treated as a sale or exchange, then AAA would be reduced by $200,000. Alternatively, if the redemption is treated as a distribution, then the AAA will be reduced based on the distribution rules described above. This can produce widely different results in the amount of the reduction of AAA and, with the importance of AAA, should be considered in determining the best structure for a proposed redemption.

Conclusion:

Although a redemption by a corporation of its outstanding stock from some of its shareholders seems like a fairly straight forward stock sale, as described above, the redemption rules will often cause the transaction to be treated as a distribution by the corporation to the shareholder and not a sale or exchange. This change in treatment can create significantly different tax results both in the amount of taxable gain recognized and, in the case of S corporations, in the impact to the redeeming corporation's AAA. Furthermore, the likelihood of these rules applying to cause a redemption to be treated as a distribution is generally greater in closely held corporations, making these rules very important considerations to redeeming S corporations. Moreover, although the differences in tax consequences are presently reduced by the fact that currently the maximum tax rate on net long-term capital gains and qualified dividend income are both 15%, this will probably not be the case for tax years beginning after December 31, 2010. If earlier tax rate reductions are not made permanent, then federal income

tax rates for tax years beginning after December 31, 2010 will go back to the rates that existed back in 2003. This would cause the maximum federal income tax rate on net long-term capital gains to increase to 20% and for the maximum tax rate on C corporation dividends to increase to 39.6%. This would mean a possible difference in tax rates of 19.6%. Therefore, both now and in the near future, when structuring a redemption of S corporation stock it is important to remember the six P principle ---- i.e. Proper Prior Planning Prevents Poor Performance.

---

1 Jeffry Blair is a partner with Hunton & Williams LLP. He practices in the firm's Dallas office.

2 All Section references are to the Internal Revenue Code of 1986, as amended (the "Code") unless otherwise indicated.

3 *See* § 1371(a) (indicating that except as otherwise provided and except to the extent inconsistent with subchapter S, subchapter C shall apply to an S corporation and its shareholders).

4 § 302(b)(1)-(3). If the redeeming corporation liquidates a portion of its business and makes a distribution of the proceeds of that business to its shareholders in partial liquidation of the redeeming corporation, the partial redemption transaction may also qualify for sale or exchange treatment to the partially redeemed shareholders. Partial liquidations and the rules thereunder are covered under § 302(b)(4) and beyond the scope of this article. For recent articles on partial liquidations *see* Braithwaite, "S Corporations and Partial Liquidations -- Two Favorable Tax Regimes; When Two Rights Make a Wrong," 6 Bus. Entities 4 (May/June 2004); Haas, "Favorable Treatment for Distributions after Corporate Dispositions: Use of Partial Liquidations," 98 J. Tax'n 142 (Mar. 2003).

5 § 302(c)(1).

6 *See* § 318(a).

7 § 302(b)(3).

8 *See* § 302(c)(2). These conditions include: (i) immediately after the redemption, the redeemed shareholder must have no interest in the redeemed corporation, including an interest as an officer, director, or employee, other than an interest as a creditor; (ii) the redeemed shareholder must not acquire any interest in the corporation (other than stock acquired by bequest or inheritance) within 10 years from the date of the redemption; and (iii) the redeemed shareholder must agree to notify the Internal Revenue Service of any acquisition of such interest and to retain records of the transaction. § 302(c)(2)(A)(i)-(iii).

9 § 302(c)(2)(ii).

10 § 302(b)(2).

11 § 302(c).

12 § 302(b)(3).

13 *U.S. v. Davis*, 397 U.S. 301 (1970), *reh'g denied*, 397 U.S. 1071 (1970).

14 *See* Rev. Rul. 76-385, 1976-2 C.B. 92.

15 § 302(a).

16 § 1001(a).

17 § 1221(a).

18 § 1222(3).

19 § 1(h). Net long-term capital gains for a taxpayer is defined as the excess of long-term capital gains for the taxable year for that taxpayer over the long-term capital losses for that taxable year for that taxpayer. § 1222(7). For tax years beginning after December 31, 2010, the maximum federal income tax rate on net long-term capital gains will increase back to 20% for most long-term capital gains.

20 §§ 1211(b), 1212(b).

21 §§ 1211(a), 1212(a)(1).

22 §§ 301(c), 302(a), and 316.

23 § 301(c)(2)-(3).

24 §§ 1222(3).

25 § 1368(b)(2), (c)(1).

26 *Id.*

27 § 1(h)(11)(B).

28 § 1(h)(1)(C). For tax years beginning after December 31, 2010, the maximum federal income tax rate on dividends of undistributed earnings and profits from a former C corporation will be 39.6%.

[29] § 1(h). Net long-term capital gains for a taxpayer is defined as the excess of long-term capital gains for the taxable year for that taxpayer over the long-term capital losses for that taxable year for that taxpayer. § 1222(7). For tax years beginning after December 31, 2010, the maximum federal income tax rate on net long-term capital gains will increase back to 20% for most long-term capital gains.

[30] § 1368(b).

[31] § 1(h). Net long-term capital gains for a taxpayer is defined as the excess of long-term capital gains for the taxable year for that taxpayer over the long-term capital losses for that taxable year for that taxpayer. § 1222(7). For tax years beginning after December 31, 2010, the maximum federal income tax rate on net long-term capital gains will increase to 20% for most long-term capital gains.

[32] Treas. Reg. § 1.1367-1(d)(1).

[33] *Id.*

[34] § 1377(a)(1).

[35] *See* § 1377(a)(2); Treas. Reg. §§ 1.1368-1(g), 1.1367-1(d)(3).

[36] § 1377(a)(2); Treas. Reg. § 1.1377-1(b).

[37] § 1377(a)(2).

[38] § 1367(a).

[39] *See* Treas. Reg. § 1.1012-1(c) for rules dealing with the requirements for specifically identifying which shares of stock are sold or transferred by a taxpayer.

[40] Treas. Reg. § 1.302-2(c), example 1.

[41] Treas. Reg. § 1.302-2(c), example 2. Proposed Treasury Regulations that were initially issued with respect to this issue were recently withdrawn and other Proposed Treasury Regulations were more recently issued. *See* Ann. 2006-30, 2006-19 IRB 879; Prop. Treas. Reg. § 1.302-5(f).

[42] Notice 2001-45, 2001-33 IRB 129.

[43] Prop. Treas. Reg. § 1.302-5(f)(a)(3).

[44] Prop. Treas. Reg. § 1.302-5(f)(b)(4).

[45] § 1368(e)(1)(B).

[46] § 1368(e)(1)(B).

Family Limited Partnerships:
An Estate Planners Guide to Understanding Basic Tax Allocation Provisions

by Gene Wolf
Kemp Smith LLP

Family Limited Partnerships: An Estate Planner's Guide to Understanding Basic Tax Allocation Provisions

by Gene Wolf[1]
Kemp Smith LLP

I. INTRODUCTION

Most non-tax lawyers openly acknowledge that they do not understand the allocation provisions contained in their form partnership agreements. But becoming a master of the realm of partnership allocations is even a great challenge to lawyers specializing in the subject. Here is how one preeminent partnership tax lawyer, Terry Cuff, describes the partnership allocation rules contained in the Code[2] and its related Treasury regulations:

> The tax rules governing partnership allocations are complex, pointillist, and stochastic. The rules are complex in the sense that the text of Treasury Regulations is long, difficult to understand, and bewildering to read. Few partnership tax specialists are masters of the rules of substantial economic effect. The rules are pointillist in the sense that regulations, cases, and administrative authority are a set of dots; they address a number of limited situations. Many situations are not directly addressed by Treasury Regulations. You must generalize from the pointillist dots to see the full picture. The rules are stochastic in the sense that many of the rules cannot be applied with mathematical precision. Draftsmen can apply tax rules only in terms of probabilities of a particular answer being correct. There is considerable uncertainty built into the partnership tax rules. New partnership tax rules often address problems in terms of probability.[3]

Nevertheless, because of the extensive use of family limited partnerships[4] in the estate planning arena, it is important that estate planning lawyers have a general understanding of partnership allocation provisions. If they do not, they are performing a disservice to their clients and themselves. If an estate planning lawyer improperly drafts or intentionally omits key allocation provisions from a partnership agreement,[5] that lawyer has granted the IRS an open invitation to change previously reported allocations of income, gain, loss and deduction among partners. Such a change is both frustrating to the client and embarrassing for the drafting lawyer. With these concerns in mind, the objective of this paper is to enable the estate planning lawyer to gain a conceptual understanding of the typical partnership tax allocation provisions that should be included in a partnership agreement.

II. PARTNERSHIP ALLOCATIONS

Section 704 of the Code and its related Treasury regulations govern the allocation of partnership income, gain, loss, deduction or credit (or items thereof) among partners. By design, the Code gives partners freedom to agree to allocations, but each allocation must pass muster under one of the following three sets of rules:[6]

- *SEE Rules*. The first set of rules permits allocations that have substantial economic effect ("SEE"). An allocation will have SEE only if the governing partnership agreement is properly drafted in accordance with the byzantine rules set forth in section 1.704-1(b)(2) of the regulations.

- *PIP Rules*. The second set of rules permits allocations that are in accordance with a partner's interest in the partnership ("PIP"). PIP is the default for all allocations. An allocation will be

governed by PIP if (i) there is no partnership agreement, (ii) there is a partnership agreement, but it fails to provide for allocations, (iii) there is a partnership agreement that contains allocations, but those allocations, for whatever reason, do not have SEE[7] or fail to satisfy the Special Rules (discussed next), or (iv) the partnership agreement is drafted to intentionally satisfy PIP rather than SEE. The PIP provisions are set forth in section 1.704-1(b)(3) of the regulations. Guidance provided by the PIP provisions is at best meager.

- *Special Rules*. The final set of rules apply to items specifically identified in sections 1.704-1(b)(4) and 1.704-2 of the regulations. Those items are either items that are subject to special rules under other Code provisions or items that can never be allocated with economic effect (such as nonrecourse deductions). In either case, the allocation of these items is "deemed" to be in accordance with PIP so long as the allocation complies with the detailed rules contained in section 1.704-1(b)(4) or 1.704-2 of the regulations. Any allocation not made in accordance with the governing regulations will be reallocated in accordance with PIP.

The premise of the three sets of rules is to ensure that allocations of income, gain, loss or deduction (or items thereof) match the manner in which the partners have agreed to share the economic benefits or burdens arising from their joint venture.

In addition to analyzing allocations under the three sets of rules set forth under Code section 704, each partnership allocation must be analyzed under general tax principles and doctrines, such as economic substance, basis limitations, at-risk, passive activity, transfer pricing and assignment of income, just to name a few.[8] Analysis under these broader tax principles and doctrines is beyond the scope of this paper.

The balance of this paper is devoted to reviewing the requirements under the SEE rules, the PIP rules and the Special Rules. At the conclusion of this paper, special rules attributable to family partners are briefly discussed.

A. Substantial Economic Effect ("SEE")

Most allocation provisions contained in a typical form partnership agreement are intended to produce allocations that have SEE. Those allocation provisions may read similar to the provisions set forth in ***Exhibit A*** or may be shortened to read in the manner set forth in ***Exhibit B***.

In order to determine whether an allocation has SEE,[9] that allocation must be analyzed under a two prong test.[10] The first prong considers the "economic effect" of the allocation. The second prong considers the "substantiality" of the allocation. Both tests are applied at the end of each allocation period.[11]

1. Economic Effect

The economic effect test is objective. Its purpose is to ensure that allocations correlate with the underlying economic arrangement of the partners.[12] In order to determine whether an allocation has economic effect, the allocation must satisfy one of three alternative tests: the Basic Test, the Alternative Test or the Economic Effect Equivalence Test.

a. The Basic Test

Under the Basic Test, an allocation will have economic effect if, throughout the full term of the partnership, the partnership agreement[13] satisfies the following three requirements:[14]

- *Capital Account Requirement*. The partnership agreement must require that the partners' capital accounts be maintained in accordance with the detailed rules of section 1.704-1(b)(2)(iv) of the regulations.

- *Liquidation Requirement*. The partnership agreement must require that upon liquidation of the partnership or any partner's interest in the partnership, liquidating distributions be made in accordance with the partners' positive capital account balances.

- *Deficit Restoration Obligation*. The partnership agreement must unconditionally obligate any partner who has a deficit balance in his capital account following the liquidation of his interest to restore the entire amount of that deficit.[15]

Because of the deficit restoration obligation under the Basic Test, the Basic Test is only suitable for general partnerships. This is so because, in order for the deficit restoration obligation to be satisfied by a limited partnership or limited liability company, the limited liability protection afforded to its limited partners or members must be relinquished. Relinquishing limited liability protection is rarely an acceptable risk. Recognizing that mandating the abrogation of limited liability protection to comply with SEE is not feasible, the IRS developed an alternative test (known as the Alternative Test) to the Basic Test. Consequently, allocation provisions contained in limited partnership agreements and operating agreements that are drafted to have SEE will be drafted to satisfy the Alternative Test for economic effect.

b. Alternative Test

Under the Alternative Test, an allocation to a partner will have economic effect if, throughout the full term of the partnership, the partnership agreement[16] satisfies the following four requirements:[17]

- *Capital Account Requirement*. The partnership agreement must require that the partners' capital accounts be maintained in accordance with the detailed rules of section 1.704-1(b)(2)(iv) of the regulations.

- *Liquidation Requirement*. The partnership agreement must require that, upon liquidation of the partnership or any partner's interest in the partnership, liquidating distributions be made in accordance with the partners' positive capital account balances.

- *Deficit Balance Limitation*. The partnership agreement must protect against allocations to a partner from causing or increasing a deficit balance in that partner's capital account in excess of any limited dollar amount that such partner is obligated to restore.[18] In determining whether an allocation satisfies this prong of the Alternative Test, the allocation must be made in light of reasonably expected allocations of depletion allowance, loss and deduction and net distributions.[19]

- *Qualified Income Offset*. The partnership agreement must contain a qualified income offset ("QIO") provision. A QIO protects against unexpected events causing or increasing a partner's deficit capital account balance.

By comparing the prongs of the Basic Test with the prongs of the Alternative Test, it becomes clear that the only difference between the Basic Test and the Alternative test is that the third prong of the Basic Test—the Deficit Restoration Obligation—is replaced under the Alternative Test with a Deficit Balance Limitation and a QIO, neither of which requires the relinquishment of limited liability to be effective.

c. Economic Effect Equivalence Test

Under the Economic Effect Equivalence Test, an allocation will be deemed to have economic effect if at the end of each allocation period a hypothetical liquidation of the partnership would produce the same economic results to the partners as would occur if the Basic Test had been satisfied.[20] As a practical matter its application is narrow, being limited to general partnerships that do not comply with the Basic Test. Consequently, it should have no relevancy in the context of family limited partnerships.

2. Substantiality

Once it is determined that an allocation has economic effect, that allocation must be tested to determine if it has substantiality. The role of substantiality is to prevent partners from making allocations that reduce their overall tax burden without impacting their economic arrangement. In order for an allocation to have substantiality, it must satisfy both a Pre-Tax Test and an After-Tax Test.[21]

a. Pre-Tax Test

Under the Pre-Tax Test, an allocation will not be substantial unless there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners, independent of tax consequences.[22] The regulations set forth three rules for analyzing allocations under the Pre-Tax Test: the General Rule, the Shifting Tax Consequences Rule and the Transitory Allocations Rule.

i. General Rule

The General Rule is simply a restatement of the description of the Pre-Tax Test given immediately above. It serves as a smell test for allocations that are able to circumvent the relatively more objective criteria of the Shifting Tax Consequences Rule and the Transitory Allocations Rule. An allocation will not pass the General Rule if its absence or presence in the partnership agreement has no impact on partners' capital accounts.

ii. Shifting Tax Consequences Rule

The Shifting Tax Consequences Rule is more objective than the General Rule. It looks at an allocation's effect over the course of one allocation period (i.e., one year). Under the Shifting Tax Consequences Rule, an allocation will not be substantial if, at the time the allocation becomes part of the partnership agreement, there is a strong likelihood[23] that:[24]

- During an allocation period, the net increases and decreases to the partners' respective capital accounts will not differ substantially from the net increases and decreases that would be recorded in their respective capital accounts if the allocation was not contained in the partnership agreement, and

- The aggregate actual tax liability of all partners (taking into account tax consequences that result from the interaction of the allocation with partner tax attributes that are unrelated to the partnership) will be less than it would have been if the allocation was not contained in the partnership agreement.

For example, assume Sarah and Tom are equal partners in ST partnership. Sarah is in the 35 percent tax bracket for ordinary income and the 15 percent tax bracket for capital gain income. Tom, on the other hand, is in the 15 percent tax bracket for ordinary income and the 5 percent tax bracket for capital gain income. ST generates the following income:

Type	Amount
Interest Income	$200
Capital Gains	$200

The partnership agreement allocates income as follows:

Type	Sarah	Tom
Interest Income	-	$200
Capital Gains	$200	-
Total	$200	$200

Absent the special allocation, income would have been allocated as follows:

Type	Sarah	Tom
Interest Income	$100	$100
Capital Gains	$100	$100
Total	$200	$200

By virtue of the special allocation, Sarah's tax attributable to ST totals $30 ($200 (capital gains) x 15%). Tom's tax attributable to ST totals $30 ($200 (interest income) x 15%). Absent the special allocation, Sarah's tax attributable to ST would have been $50 (($100 (interest income) x 35%) + (($100 (capital gains) x 15%)). Tom's tax attributable to ST would have been $20 (($100 (interest income) x 15%) + (($100 (capital gains) x 5%)).

Turning to the analysis under the Shifting Tax Consequences Rule, the following is discovered:

- First, Sarah and Tom's capital accounts do not differ substantially (in fact, they do not differ at all) from what they would have been if the special allocation was not contained in the partnership agreement.

- Second, the aggregate actual tax liability of Sarah and Tom is less (in fact, it is $10 less (($50 + $20) – ($30 + $30))) than it would have been if the allocation was not contained in the partnership agreement.

Therefore, the special allocation fails to have substantiality under the Shifting Tax Consequences Rule, and the income must be reallocated under PIP.

iii. Transitory Allocations Rule

(A) General Rule

Like the Shifting Tax Consequences Rule, the Transitory Allocations Rule is more objective than the General Rule. The Transitory Allocations Rule, however, looks at an allocation's effect over the course of multiple allocation periods. Under the Transitory Allocations Rule an allocation is not substantial if there is a possibility that one or more allocations (the "original allocations") will be largely offset by one or more other allocations (the "offsetting allocations"), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood[25] that[26]

- During all allocation periods to which such allocation relates, the net increases and decreases to the partners' respective capital accounts will not differ substantially from the net increases and

decreases that would be recorded in their respective capital accounts if the original allocation and offsetting allocations were not contained in the partnership agreement, and

- The aggregate actual tax liability of all partners (taking into account tax consequences that result from the interaction of the allocation with partner tax attributes that are unrelated to the partnership) will be less than it would have been if the allocation was not contained in the partnership agreement.

For instance, assume Debra and Charlie are equal partners in DC partnership. Debra and Charlie are both ordinarily in the 35 percent tax bracket for ordinary income and the 15 percent tax bracket for capital gain income. Charlie, however, has a $1,000 net operating loss (NOL) that expires in five years. It is anticipated that DC will generate $200 of net ordinary income over each of the next five years. In the fifth year, DC anticipates selling its primary asset and recognizing an estimated capital gain of $1,500. The partnership agreement allocates all ordinary income through Year 5 to Charlie and all capital gain income to Debra. Over the five years, the anticipated capital account adjustments (in light of the special allocations and assuming no distributions) would appear as follows:

Year	Debra	Charlie
Year 1	-	$200
Year 2	-	$200
Year 3	-	$200
Year 4	-	$200
Year 5	$1,500	$200
Total	$1,500	$1,000

Absent the special allocation, all income would have been allocated equally to Debra and Charlie and the anticipated capital account adjustments (assuming no distributions) would have appeared as follows:

Year	Debra	Charlie
Year 1	$100	$100
Year 2	$100	$100
Year 3	$100	$100
Year 4	$100	$100
Year 5	$850	$850
Total	$1,250	$1,250

By virtue of the special allocation, Debra and Charlie would have the following tax liability:

Year	Debra	Charlie[27]
Year 1	$0	$0
Year 2	$0	$0
Year 3	$0	$0
Year 4	$0	$0
Year 5	$225[28]	$0
Total	$225	$0

Absent the special allocation, Debra and Charlie would have had the following tax liability:

Year	Debra	Charlie
Year 1	$35[29]	$0[30]
Year 2	$35	$0

Year	Debra	Charlie
Year 3	$35	$0
Year 4	$35	$0
Year 5	$147.5[31]	$37.5[32]
Total	$287.5	$37.5

Turning to the analysis under the Transitory Allocations Rule, the following is discovered:

- First, Debra and Charlie's capital accounts differ substantially from what they would have been if the special allocation was not contained in the partnership agreement. That is, Debra's capital account is $250 greater and Charlie's capital account is $250 less. Those differences should be considered substantial.

- Second, the aggregate actual tax liability of Debra and Charlie is $100 (($287.5 + $37.5) – ($225 + $0)) less than it would have been if the allocation was not contained in the partnership agreement.

Because the special allocation appears to cause the capital accounts to differ substantially from what they would have been had they not been part of the partnership agreement, the special allocation should have substantiality under the Transitory Allocations Rule.[33]

(B) Applicable Presumptions

There are two helpful presumptions applicable to the Transitory Allocations Rule: the Five Year Presumption and the Book Equals Basis Presumption. The two presumptions help many common allocations not run afoul of the Transitory Allocations Rule.

(1) Five-Year Presumption

Under the Five-Year Presumption, it is presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if, at the time the allocations become part of the partnership agreement, there is a strong likelihood[34] that the offsetting allocation will not, in large part, be made within five years after the original allocation is made (determined on a first-in, first-out basis).[35] Consequently, if an allocation is not reversed (or is not likely to be reversed) within five years, a potential offsetting allocation will not cause the original allocation to fail the Transitory Allocations Rule.

(2) Book Equals Basis Presumption

Under the Book Equals Basis Presumption, the book value[36] of partnership property is presumed to be the fair market value of that property.[37] Accordingly, any adjustments to the book value of that property will be presumed to be matched by corresponding changes in that property's fair market value.[38]

This presumption is best understood by considering an example. Assume a partnership purchases a $1,000 item of equipment that is depreciable on a straight-line basis over five years at $200 per year. Assume further that one partner will be allocated all of the depreciation on the equipment and any gain or loss on its sale. Assume further that at the end of Year 2 the equipment has a fair market value of $900 and an adjusted tax basis/book value of the equipment is $600 ($1,000-($200+$200)). Absent the Book Equals Basis Presumption, it would be presumed that if the partnership sold the equipment at the end of Year 2 the original allocation (i.e., the $400 of deprecation) would be offset by the $300 ($900-$600) of gain from the sale of the equipment and, thus, the allocation would lack substantiality under the

Transitory Allocation Rule. Under the Book Equals Basis Presumption, however, it will be presumed that if the partnership sold the equipment at the end of Year 2, it would receive only $600. Thus, the original allocation (i.e., the $400 of depreciation) would not be offset by a subsequent allocation of gain. Consequently, a chargeback of depreciation previously taken by a partner will not cause that allocation to lack substantiality under the Transitory Allocations Rule.[39]

b. After-Tax Test

The second test for determining substantiality is the After-Tax Test. Under the After-Tax Test, an allocation will not be substantial if, at the time the allocation becomes part of the partnership agreement:[40]

- the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation was not contained in the partnership agreement, and

- there is a strong likelihood[41] that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation was not contained in the partnership agreement.

In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership must be taken into account.[42] Additionally, in making a determination under the After-Tax Test, it appears that both the Five-Year Presumption and the Book Equals Basis Presumption described in Section II.A.2.a.iii above apply.[43]

In an effort to demonstrate the After-Tax Test, the following net present value after-tax cash flow calculations were generated from the example in Section II.A.2.a.iii(A) above:[44]

5% Discount Rate	Debra	Charlie
Special Allocation	999.00	865.90
No Special Allocation	780.91	991.21
Difference	$218.08	($125.31)

10% Discount Rate	Debra	Charlie
Special Allocation	791.67	758.16
No Special Allocation	642.24	821.49
Difference	$149.44	($63.33)

15% Discount Rate	Debra	Charlie
Special Allocation	$633.90	670.43
No Special Allocation	$534.84	689.45
Difference	$99.06	($19.02)

Recall that this allocation did not lack substantiality under the Transitory Allocation Rule.[45] It is difficult to divine, however, whether this allocation lacks substantiality under the After-Tax Test. Using a 5 percent discount rate, the allocation seems to have substantiality under the After-Tax Test because Debra's capital account is enhanced significantly at a substantial cost to Charlie. However, at a 15

percent discount rate, the answer becomes less clear because Debra's capital account is enhanced at a rather insubstantial cost to Charlie.

B. Partner's Interest in the Partnership ("PIP")

Turning now to the second of the three sets of allocation rules covered in this paper—the PIP rules[46]—it first must be noted that PIP is deceptively simple and vexingly subjective. The goal of PIP is to reflect the economic arrangement of the partners, whether item-by-item or on an overall basis, regardless of whether the partners have expressly agreed to that arrangement.[47] PIP is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners,[48] including:[49]

- The partners' relative contributions to the partnership;
- The interests of the partners in economic profits and losses (if different than that in taxable income or loss);
- The interests of the partners in cash flow and other non-liquidating distributions; and
- The rights of the partners to distributions of capital upon liquidation.

A number of partnership tax lawyers intentionally draft their allocations in accordance with PIP (referring to them as "target allocations" or "forced allocations") rather than SEE. They argue that the primary goal of the tax lawyer in drafting a partnership agreement is to reflect their client's "economic deal" rather than worry about tax allocations. They continue by noting that their experience has shown that in certain partnership arrangements liquidating on the basis of positive capital account balances—a requirement of SEE—sometimes results in partners not getting their bargained for economic deal. Consequently, they conclude that PIP allocations, in some instances, are preferential to SEE allocations because PIP allocations are driven by the economic deal. An example of a target allocation provision is set forth in ***Exhibit C***.

Nevertheless, because of the complexity and subjectivity of PIP and a recent inclination of the courts to consider capital accounts in the context of family limited partnerships,[50] extreme caution should be exercised before utilizing PIP allocations for a family limited partnership.

C. Special Rules

1. General

As stated previously, the Special Rules—the third and final set of allocation rules discussed in this paper—govern those items identified in sections 1.704-1(b)(4) and 1.704-2 of the regulations. The allocation of those items must comply with the detailed rules contained in section 1.704-1(b)(4) or 1.704-2 of the regulations. Otherwise, those items will be reallocated under PIP. The items subject to the Special Rules include:

- Allocations that reflect book-tax differences.[51] Understanding book-tax differences (sometimes referred to as "704(c) gain") is critical to understanding partnership allocations. Nevertheless, a discussion of 704(c) gain is beyond the scope of this paper.
- Allocations of tax credits and tax credit recapture.[52]

- Allocations of percentage depletion on depletable property in excess of the adjusted tax basis of that property.[53]

- Allocations and distributions attributable to nonrecourse liabilities.[54] The rules governing these allocations and distributions are examined in more detail in Section II.C.2 below.

- Allocations of adjusted tax basis of oil or gas property ordinarily controlled by Code section 613A(c)(7)(D) and the regulations thereunder.[55]

- Allocations resulting from an amendment of a partnership agreement.[56]

- Allocations of recapture income under Code sections 47 (relating to rehabilitation credits), 1245 (relating to depreciable property), 1250 (relating to depreciable realty) and 1254 (relating to depreciable oil, gas, geothermal, or other mineral properties).[57]

- Allocations of creditable foreign taxes.[58]

The balance of this paper is devoted to reviewing the requirements set forth in the regulations relating to allocations and distributions attributable to nonrecourse liabilities under the Special Rules.

2. Allocations Attributable to Nonrecourse Liabilities

a. Nonrecourse Liabilities

Section 1.704-2 of the regulations governs allocations attributable to nonrecourse liabilities. The two primary types of nonrecourse liabilities[59] are partnership nonrecourse liabilities[60] and partner nonrecourse liabilities.[61]

In order to understand the premise behind allocations attributable to nonrecourse liabilities, it is helpful to consider the Supreme Court's holding in *Commissioner v. Tufts*.[62]

In *Tufts*, a partnership borrowed $1,851,500 in nonrecourse debt to build an apartment complex. The partners took $439,972 in depreciation and ordinary loss deductions in two years. With other adjustments, the adjusted tax basis of the building totaled $1,455,740. The partnership sold the building to a third party. The only consideration for the sale was the assumption of the nonrecourse mortgage. At the time of the sale, building had a fair market value of $1,400,000, but the outstanding amount due on the mortgage still totaled approximately $1,851,500. On the sale, the partners claimed a $55,740 loss ($1,455,740-$1,400,000), arguing that they should be allowed to recognize the loss on the difference between the fair market value and their adjusted basis in the building. The IRS, on the other hand, argued that the partners actually owed tax on $395,760 gain ($1,851,500-$1,455,740), claiming that the partners realized the full amount of the nonrecourse obligation when the third party assumed the mortgage. The Supreme Court ruled in favor of the IRS, holding that "to permit the taxpayer to limit his realization to the fair market value of the property would be to recognize a tax loss for which he has suffered no corresponding economic loss."[63] By recognizing the gain on the assumption of the nonrecourse debt, the taxpayer was, in essence, being "charged back" for his previously allowed deductions since it was the lender who bore the economic risk of loss relating to those deductions. It is this charge back concept that is at the heart of the nonrecourse liability rules.

b. Partnership Nonrecourse Liability

i. General

A nonrecourse liability is a partnership nonrecourse liability to the extent that no partner or related person bears the economic risk of loss[64] for that liability.[65] Allocations of "nonrecourse deductions"—losses, deductions or "section 705(a)(2)(B) expenditures," which are nondeductible expenditures not chargeable to capital accounts, such as nondeductible premiums on life insurance contracts, interest and other expenses relating to the production of tax-exempt income and nondeductible personal interest—attributable to, and distributions of proceeds ("nonrecourse distributions") of, partnership nonrecourse liabilities cannot have economic effect because it is the creditor that bears the economic burden corresponding to that nonrecourse deduction/distribution.[66] Consequently, absent the Special Rules, allocations and distributions attributable to partnership nonrecourse liabilities cannot have SEE and must be allocated in accordance with PIP.[67] Fortunately, the regulations provide a safe harbor for those allocations. To fall within the safe harbor, the following requirements must be met:[68]

- The partnership agreement satisfies either the Basic Test[69] or the Alternative Test.[70]
- The partnership agreement requires that nonrecourse deductions be allocated in a manner that is reasonably consistent with the allocation of some other significant partnership item attributable to the property securing the nonrecourse liability.
- The partnership agreement contains a minimum gain chargeback provision.
- All other material allocations and capital account adjustments under the partnership agreement are recognized under section 1.704-1(b) of the regulations.

In essence, the safe harbor requires each partner who is allocated nonrecourse deductions or who receives nonrecourse distributions to be allocated, over time, income or gain equal to his share of those nonrecourse deductions/distributions. This objective is achieved through the partnership "minimum gain chargeback" provisions. In order to understand the concept of minimum gain chargeback, however, one must first understand the concepts of "partnership minimum gain" and each "partner's share of partnership minimum gain."

ii. Partnership Minimum Gain

The initial step in understanding the minimum gain chargeback provisions is to understand partnership minimum gain ("PMG"). PMG equals the amount of gain[71] a partnership would realize if it sold an asset[72] securing a nonrecourse liability for an amount equal to the full amount of that liability.[73] In essence, PMG is the concept used to trace *Tufts*[74] gain. By way of illustration, assume a partnership owns a building with a current fair market value of $1,000 and an adjusted tax basis/book value of $400. Further assume that the building secures a partnership nonrecourse debt of $700. In this illustration, the PMG with respect to the building is $300 ($700-$400).

For each allocation period, the net increase or decrease in PMG is determined by comparing the PMG on the last day of the immediately preceding allocation period with the PMG on the last day of the current allocation period.[75]

(A) Increases in PMG

There are two primary reasons that PMG increases. First, PMG increases when depreciation deductions attributable to partnership property exceed the amortization of the nonrecourse liability secured by that property.[76] For instance, assume a partnership purchases a $1,000 item of equipment that is depreciable on a straight-line basis over five years at $200 per year. Assume further that the equipment was purchased with a five-year-interest-only nonrecourse debt of $1,000 secured by the equipment. In this example, PMG increases by $200 each year that depreciation is taken assuming that principal payments are not being made on the debt.

Second, PMG increases when partnership property collateralizes a nonrecourse liability and that partnership property has an adjusted basis less than the amount of that liability.[77] For example, assume a partnership owns unencumbered real estate with a value of $1,000 and an adjusted tax basis/book value of $100. Assume further that the partnership pledges that real estate on an $800 nonrecourse loan. In this example, PMG increases by $700 when the loan is obtained. In this circumstance, PMG increases regardless of whether the partnership retains the nonrecourse loan proceeds or distributes the proceeds to its partners.[78]

(B) Decreases in PMG

PMG decreases, on the other hand, when there is a reduction in the amount by which a nonrecourse liability exceeds the book value[79] of the property securing that liability.[80] The most common event leading to a decrease in PMG is the disposition of an asset that secures a nonrecourse liability. PMG may also decrease when a partnership nonrecourse liability is paid down. By way of example, assume a partnership owns real estate that secures an $800 nonrecourse loan, and the real estate has an adjusted tax basis/book value of $100. If the partnership sells the asset for $100, PMG decreases by $700. If there is a net decrease in PMG for an allocation period, that decrease results in a minimum gain chargeback, and each partner must be allocated items of partnership income and gain for that period equal to that partner's share of the net decrease in PMG.[81]

iii. Partner's Share of Partnership Minimum Gain

Each partner's share of PMG must be determined annually so that each partner who is allocated nonrecourse deductions or who receives nonrecourse distributions is allocated, over time, income or gain equal to his share of those nonrecourse deductions/distributions. Each partner's share of PMG at the end of an allocation period equals:[82]

- The aggregate nonrecourse deductions[83] allocated to that partner (and to that partner's predecessors in interest) up to the end of that period; plus
- The aggregate nonrecourse distributions[84] made to that partner (and to that partner's predecessors in interest) up to the end of that period; minus
- The aggregate share[85] of that partner's (and that partner's predecessors in interest) net decrease in PMG up to the end of that period.[86]

A partner's share of PMG is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore.[87]

iv. Minimum Gain Chargeback

A minimum gain chargeback generally occurs when there is a net decrease in PMG for an allocation period. Upon a net decrease in PMG, each partner must be allocated items of partnership income and gain for that period equal to that partner's share of the net decrease in PMG.[88] It is important to note, however, that not every PMG decrease triggers a minimum gain chargeback. Specifically, the regulations identify five situations where a PMG decrease does not trigger a minimum gain chargeback:

- *Revaluations of Partnership Assets*. The minimum gain chargeback provisions are not triggered when the partners' capital accounts are increased in accordance with section 1.704-1(b)(2)(iv) of the regulations to reflect a revaluation of partnership property subject to a nonrecourse liability.[89] A revaluation does not trigger the minimum gain chargeback provisions because the resulting PMG decrease is thereafter accounted for as 704(c) gain.[90]

- *Conversions and Refinancings*. A partner is not subject to the minimum gain chargeback provisions to the extent that partner's share of PMG decrease is attributed to the recharacterization of a nonrecourse liability as a liability that is partially or wholly recourse to that partner.[91] The reduction in PMG attributed to a conversion or refinancing of debt does not trigger the minimum gain chargeback provisions because the partner who became partially or wholly liable for that debt assumed the economic burden associated with that reduction.

- *Capital Contributions*. A partner is not subject to the minimum gain chargeback provisions to the extent that partner's share of PMG decrease is attributed to that partner's capital contributions to the partnership that are used to repay the nonrecourse liability or are used to increase the basis of the property subject to the nonrecourse liability.[92] The reduction in PMG attributed to such a capital contribution does not trigger the minimum gain chargeback provisions because the partner who made the contribution assumed, in effect, the economic burden associated with respect to that reduction.

- *Waivers*. In some instances, the minimum gain chargeback provisions may distort the economic arrangement among the partners. In those cases, the partnership may request from the IRS a waiver of the minimum gain chargeback provisions.[93]

- *Additional Exceptions*. The IRS, by revenue ruling, may provide additional exceptions to the minimum gain chargeback provisions.[94]

Even though the most common event leading to a decrease in PMG is the disposition of an asset that secures a nonrecourse liability, a disposition is not the only event giving rise to minimum gain chargeback. For instance, a minimum gain chargeback may occur with respect to a partner if another partner guarantees or otherwise assumes all or any portion of a debt that was previously nonrecourse or the partnership pays down the nonrecourse liability. Because it is possible for minimum gain chargeback to exceed gain attributable to the disposition of an asset securing a nonrecourse liability, the regulations contain the following ordering rules to ensure that a partner is allocated its share of minimum gain chargeback:[95]

- First, its share of minimum gain chargeback will consist of gain from the disposition of property subject to the partnership nonrecourse liability; and

- Second, if necessary, its share of minimum gain chargeback will consist of a pro rata portion of the partnership's other items of income and gain for that allocation period; and

- Finally, if the partner's minimum gain chargeback requirement exceeds the first and second items above, then the excess is treated as a minimum gain chargeback requirement in the immediately succeeding allocation period.

c. Partner Nonrecourse Liabilities

i. General

The second type of nonrecourse liability is a partner nonrecourse liability. A liability is a partner nonrecourse liability to the extent the liability is nonrecourse to the partnership, but a partner or related person bears the economic risk of loss.[96] A liability could be a partner nonrecourse liability when a partner or related person becomes a creditor of the partnership or a guarantor of a nonrecourse liability of the partnership.[97] Allocations of losses, deductions or section 705(a)(2)(B) expenditures ("partner nonrecourse deductions") attributable to, and distributions of proceeds ("partner nonrecourse distributions") of, a particular partner nonrecourse liability must be allocated to the partner who bears the economic risk of loss for that liability.[98]

The principles adopted by the regulations for tracking allocations relating to partner nonrecourse deductions and partner nonrecourse distributions follow the principles used for tracking allocations relating to partnership nonrecourse deductions and partnership nonrecourse distributions. Consequently, section 1.704-2(i) of the regulations (containing the provisions governing partner nonrecourse liability), in large part, simply incorporates and refers to the minimum gain chargeback provisions described in Section II.C.2.b above. Towards that end, the regulations require each partner who is allocated partner nonrecourse deductions or who receives partner nonrecourse distributions to be allocated, over time, income or gain equal to his share of those partner nonrecourse deductions/distributions. This objective is achieved through the "partner nonrecourse debt minimum gain chargeback" provisions.

ii. Partner Nonrecourse Debt Minimum Gain

Conceptually similar to the minimum gain chargeback provisions discussed in Section II.C.2.b above, the partner nonrecourse debt minimum gain chargeback operates on the basis of partner nonrecourse debt minimum gain ("PNDMG"). PNDMG equals the amount of gain a partnership would realize if it sold an asset securing a partner nonrecourse liability for an amount equal to the full amount of that liability.[99]

A net increase or decrease in PNDMG is determined at the end of each allocation period by comparing the PNDMG on the last day of the immediately preceding allocation period with the PNDMG on the last day of the current allocation period.[100] If there is a net decrease in PNDMG for an allocation period, that decrease will result in a partner nonrecourse debt minimum gain chargeback and each partner who bears an economic risk of loss for that liability must be allocated items of partnership income and gain for that period equal to that partner's share of the net decrease in PNDMG.[101]

iii. Partner's Share of Partner Nonrecourse Debt Minimum Gain

In order to ensure that each partner who is allocated partner nonrecourse deductions or who receives partner nonrecourse distributions is allocated, over time, income or gain equal to his share of partner nonrecourse deductions/distributions, each partner who bears an economic risk of loss for that liability must have his share of PNDMG calculated. Each partner's share of PNDMG at the end of an allocation period equals:[102]

- The aggregate partner nonrecourse deductions[103] allocated to that partner (and to that partner's predecessors in interest) up to the end of that period; plus

- The aggregate partner nonrecourse distributions[104] made to that partner (and to that partner's predecessors in interest) up to the end of that period; minus
- The aggregate share[105] of that partner's (and that partner's predecessors in interest) net decrease in PNDMG up to the end of that period.

A partner's share of partner nonrecourse minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore.[106]

iv. Partner Nonrecourse Debt Minimum Gain Chargeback

If there is a net decrease in a partner's share of PNDMG for an allocation period, that partner will be subject to a partner nonrecourse debt minimum gain chargeback requirement.[107] Because it is possible for a partner nonrecourse debt minimum gain chargeback to exceed gain allocable to the disposition of an asset securing a partner nonrecourse liability, the regulations contain the following ordering rules to ensure that a partner is allocated its share of partner nonrecourse debt minimum gain chargeback:[108]

- First, its share of partner nonrecourse debt minimum gain chargeback will consist of gain[109] from the disposition of property subject to the partner nonrecourse liability; and
- Second, if necessary, its share of partner nonrecourse debt minimum gain chargeback will consist of a pro rata portion of the partnership's other items of income and gain[110] for that allocation period; and
- Finally, if the partner's partner nonrecourse debt minimum gain chargeback exceeds the first and second items above, then the excess is treated as a partner nonrecourse debt minimum gain chargeback in the immediately succeeding allocation period.

III. FAMILY PARTNERSHIP ALLOCATIONS

Family partnerships first gained prominence in tax planning as income shifting vehicles—allowing an individual in a higher marginal tax bracket to shift income to his family members who were in lower marginal tax brackets.[111] Instead of addressing the income shifting concern using a pure assignment of income approach,[112] the Supreme Court in *Tower* concluded that a person would be eligible to receive allocations of partnership income—that is to say, the person would qualify as a "partner"—only if that person (i) invests capital in the partnership originating with that person, or (ii) performs vital services for the partnership.[113]

Shortly after the *Tower* decision, the Supreme Court in *Culbertson* rejected its "original capital" and "vital services" tests posited in *Tower* and replaced it with an intent test. In so doing, the Supreme Court said:

> [t]he question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[114]

Congress disagreed with the Supreme Court's analysis and believed the Supreme Court should have addressed the family partnership income shifting concern under assignment of income principles.[115] In response to its disapproval of the intent test set forth in *Culberston*, Congress enacted the family partnership rules. Those rules are currently found under Code section 704(e) and are intended to prevent family members from shifting income amongst themselves. Consequently, family partnerships must not only pass the requirements discussed in the preceding sections of this paper, but they also must pass the family partnership rules contained in Code section 704(e).

The family partnership rules apply to partnerships where capital is a material income-producing factor[116] and at least one of the partners has acquired his partnership interest by gift.[117]

Under the family partnership rules, allocations of income to a donee-partner will be respected so long as:

- The donor-partner is reasonably compensated for the services, if any, he renders to the partnership; and

- The donee-partner does not receive a proportionately greater share of income attributable to the donated capital—that is, the capital attributable to the gifted partnership interest—than the share of income attributable to the donor's capital.

IV. CONCLUSION

Any estate planning lawyer who advises a client to utilize a family limited partnership must have a basic understanding of partnership allocations. Otherwise, that lawyer is exposing his or her client to unnecessary risk. Improperly drafted allocation provisions open the door for the IRS to change previously reported allocations of income, gain, loss and deduction among partners. Such a change can be avoided in most situations by having a basic understanding of the rules governing partnership allocation.

---

[1] Gene Wolf is a partner at Kemp Smith LLP. Special thanks to Bobby Maddox, JD, CPA, of counsel at Kemp Smith LLP, and Larry Phifer, an associate at Kemp Smith LLP, for their assistance in reviewing this paper.

[2] For purposes of this paper, any reference to the "Code" or "IRC" refers to the Internal Revenue Code of 1986, as amended.

[3] Terrence Floyd Cuff, *Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements* (Pre-Publication Draft, August 15, 2006).

[4] For purposes of this paper, any reference to a "partnership" means any entity (including a partnership or limited liability company) treated as partnership for federal income tax purposes.

[5] For purposes of this paper, any reference to a "partnership agreement" means any agreement (including, a partnership agreement, limited partnership agreement or operating agreement) governing the allocation of income, gain, loss and deduction between or among owners of a partnership.

[6] IRC § 704(a), (b); Treas. Reg. § 1.704-1(b)(1)(i).

[7] If only a portion of an allocation made to a partner with respect to a partnership taxable year has economic effect, both the portion that has economic effect and the portion that is reallocated shall consist of a proportionate share of all items that made up the allocation to such partner for such year. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(e).

[8] Treas. Reg. § 1.704-1(b)(1)(iii), (iv).

[9] Remember that not all allocations can have SEE. For example, any allocation that is subject to the Special Rules cannot have SEE.

[10] Treas. Reg. § 1.704-1(b)(2)(i).

[11] *Id*. For purposes of this paper, the term "allocation period" means any period of time that begins on the date the partnership was formed (with respect to the first allocation period) or the day following the end of the immediately preceding allocation period (with respect to any other allocation periods) and ends on the first to occur of: (i) the last day of a partnership's fiscal or calendar year (as the case may be); or (ii) the day immediately preceding the date of the "liquidation" of a partner's partnership interest (within the meaning of Treas. Reg. § 1.704-1(b)(2)(ii)(g)).

[12] Treas. Reg. § 1.704-1(b)(2)(ii)(a).

[13] For purposes of determining economic effect, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and regardless of whether embodied in a document referred to by the partners as the partnership agreement. Treas. Reg. § 1.704-1(b)(2)(ii)(h). In addition, the partnership agreement includes provisions of federal, state or local law that govern the affairs of the partnership or are considered under such law to be a part of the partnership agreement. *Id.*

[14] Treas. Reg. § 1.704-1(b)(2)(ii)(b).

[15] A partner is deemed to satisfy this third requirement—the deficit restoration obligation requirement—to the extent of (i) the outstanding principal balance of any promissory note of which such partner is the maker and the partnership is the holder, provided such note must be paid to the partnership by the later of the end of the partnership taxable year in which that partner's interest is liquidated or 90 days after liquidation; or (ii) the amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by governing law) to make subsequent contributions to the partnership, provided such obligation must be paid to the partnership by the later of the end of the partnership taxable year in which that partner's interest is liquidated or 90 days after liquidation. Treas. Reg. § 1.704-1(b)(2)(ii)(c). It is useful to note that Treas. Reg. § 1.704-1(b)(2)(ii)(f) permits a partner to reduce his deficit restoration obligation without affecting the validity of prior allocations.

[16] *See supra* note 13.

[17] Treas. Reg. § 1.704-1(b)(2)(ii)(d).

[18] Treas. Reg. § 1.704-1(b)(2)(ii)(d)(3).

[19] Treas. Reg. § 1.704-1(b)(2)(ii)(d)(3)-(6).

[20] Treas. Reg. § 1.704-1(b)(2)(ii)(i).

[21] The substantiality rules include special rules that apply when the partners are look-through entities or members of a consolidated group. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(d).

[22] Treas. Reg. § 1.704-1(b)(2)(iii)(a).

[23] The strong likelihood threshold is determined on the basis of the following rebuttable presumption: If the allocation fails the test at the end of the applicable allocation period, then there was a strong likelihood that such a result would occur.

[24] Treas. Reg. § 1.704-1(b)(2)(iii)(b).

[25] *See supra* note 23.

[26] Treas. Reg. § 1.704-1(b)(2)(iii)(c).

[27] ($200/year (ordinary income) – $200/year (Applicable NOL)) x 35%

[28] $1,500 (capital gains) x 15%

[29] $100/year (ordinary income) x 35%

[30] ($100/year (ordinary income) – $100/year (Applicable NOL)) x 35%

[31] ($100 (ordinary income) x 35%) + (($750 (capital gains) x 15%)

[32] (($100 (ordinary income) – $100 (Applicable NOL)) x 35%) + (($750 (capital gains) – $500 (Remaining NOL)) x 15%))

[33] *But see infra* Section II.A.2.b.

[34] *See supra* note 23.

[35] Treas. Reg. § 1.704-1(b)(2)(iii)(c).

[36] The book value of a partnership asset generally equals its adjusted tax basis unless there has been a book-up or book-down of that asset under IRC § 704(c) or Treas. Reg. 1.704-1(b)(iv).

[37] Treas. Reg. § 1.704-1(b)(2)(iii)(c).

[38] *Id*.

[39] *Id*.

[40] Treas. Reg. § 1.704-1(b)(2)(iii)(a).

[41] *See supra* note 23.

[42] Treas. Reg. § 1.704-1(b)(2)(iii)(a).

[43] Treas. Reg. § 1.704-1(b)(2)(iii)(c).

[44] The calculations were determined using the NPV function in Excel and the discount rates set forth below. Fortunately or unfortunately, the regulations do not provide guidance on the appropriate discount rate.

[45] See *supra* Section II.A.2.a.iii(A).

[46] *See supra* note 7 and accompanying text.

[47] *See* Treas. Reg. § 1.704-1(b)(3)(i).

[48] *Id*.

[49] Treas. Reg. § 1.704-1(b)(3)(ii).

[50] *See, e.g., Estate of Bigelow v. Commissioner*, 503 F.3d 955 (9th Cir. 2007).

[51] Treas. Reg. § 1.704-1(b)(4)(i).

[52] Treas. Reg. § 1.704-1(b)(4)(ii).

[53] Treas. Reg. § 1.704-1(b)(4)(iii).

[54] Treas. Reg. § 1.704-1(b)(4)(iv); Treas. Reg. § 1.704-2.

[55] Treas. Reg. § 1.704-1(b)(4)(v).

[56] Treas. Reg. § 1.704-1(b)(4)(vi). Under this rule, if a partnership agreement is modified, prior allocations may be reallocated in a manner consistent with the modified terms of the agreement if the IRS determines that the purported modification was, in fact, part of the original agreement. Towards that end, the regulations provide that if an allocation had SEE or was in accordance with PIP and the partnership agreement thereafter is modified, both the tax consequences of the modification and the facts and circumstances surrounding the modification will be closely scrutinized by the IRS to determine whether the purported modification was part of the original agreement.

[57] Treas. Reg. § 1.704-1(b)(4)(vii).

[58] Treas. Reg. § 1.704-1(b)(4)(viii).

[59] A liability is any obligation that (i) creates or increases the basis of any of the obligor's assets (including cash); (ii) gives rise to an immediate deduction to the obligor; or (iii) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. Treas. Reg. § 1.752-1(a)(4). An obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. Treas. Reg. § 1.752-1(a)(4). Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations,

obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts and swaps. *Id.*

[60] Treas. Reg. § 1.752-2(b)(3).

[61] Treas. Reg. § 1.752-2(b)(4).

[62] 461 U.S. 300 (1983).

[63] *Id.* at 313.

[64] The determination of the extent to which a partner or related person bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (k) of Treas. Reg. § 1.752-2.

[65] Treas. Reg. § 1.704-2(b)(3); Treas. Reg. § 1.752-1(a)(2).

[66] Treas. Reg. § 1.704-2(b)(1).

[67] *Id*.

[68] *Id*.; Treas. Reg. § 1.704-2(e).

[69] *See supra* note 14.

[70] *See supra* note 17.

[71] Note that if there is a book/tax disparity, then the property's book value is used instead of its adjusted tax basis. *See* Treas. Reg. § 1.704-2(d)(3).

[72] *See* Treas. Reg. § 1.704-2(d)(2) (Setting forth debt allocation rules if a property is subject to more than one liability).

[73] Treas. Reg. § 1.704-2(d)(1).

[74] *See supra* note 62 and accompanying text.

[75] Treas. Reg. § 1.704-2(d)(1).

[76] Treas. Reg. § 1.704-2(b)(2).

[77] *Id*.

[78] If the proceeds of the nonrecourse liability are distributed to one or more partners, that distribution is referred to as a "nonrecourse distribution."

[79] *See supra* note 71.

[80] Treas. Reg. § 1.704-2(b)(2).

[81] Treas. Reg. § 1.704-2(f)(1).

[82] Treas. Reg. § 1.704-2(g)(1).

[83] Determining a partner's share of nonrecourse deduction is a two-step process. First, the partnership's aggregate nonrecourse deductions for an allocation period must be determined. Second, each partner must be allocated its share, if any, of that deduction. For the first step, the partnership's aggregate nonrecourse deduction for an allocation period equals the net increase in PMG during that period, reduced (but not below zero) by the aggregate nonrecourse distributions made during the period. Treas. Reg. § 1.704-2(c). For the second step, each partner is allocated its share of the nonrecourse deduction. The allocation of the nonrecourse deduction must be made in a manner that is reasonably consistent with the allocation of some other significant partnership item attributable to the property securing the nonrecourse liability. *See supra* note 68 and accompanying text. Because it is possible that nonrecourse deductions will exceed available depreciation, the regulations contain the following ordering rules to ensure that a partner is allocated its share of nonrecourse deductions:

- First, its share of nonrecourse deductions will consist of depreciation or cost recovery deductions attributable to the nonrecourse liability;

- Second, if necessary, its share of nonrecourse deductions will consist of a pro rata portion of the partnership's other deductions, losses and section 705(a)(2)(B) expenditures; and
- Finally, if the amount of nonrecourse deduction exceeds the first and second items above, then the excess is treated as an increase in PMG in the immediately succeeding allocation period.

Treas. Reg. § 1.704-2(c); Treas. Reg. §§ (j)(1)(ii)-(iii).

[84] A partnership may use any reasonable method to determine whether a distribution by the partnership to one or more partners is allocable to proceeds of a nonrecourse liability. Treas. Reg. § 1.704-2(h)(2). Additional rules pertaining to nonrecourse distributions are set forth in Treas. Reg. § 1.704-2(h).

[85] A partner's share of the net decrease in PMG is the amount of the total net decrease in PMG multiplied by the partner's percentage share of the PMG at the end of the immediately preceding allocation period. Treas. Reg. § 1.704-2(g)(2)

[86] A partnership that holds 704(c) gain property is subject to additional complexities when the minimum gain chargeback provisions are applied to it. *See* Treas. Reg. §§ 1.704-2(g)(1)(ii), (2).

[87] Treas. Reg. § 1.704-2(g)(1). *See supra* note 18.

[88] Treas. Reg. § 1.704-2(f)(1).

[89] Treas. Reg. § 1.704-2(d)(4).

[90] Like the other minimum gain chargeback provisions, the application of the revaluation rules under the minimum gain chargeback provisions is, at best, convoluted. *See* Treas. Reg. § 1.704-2(d)(4).

[91] Treas. Reg. § 1.704-2(f)(2).

[92] Treas. Reg. § 1.704-2(f)(3).

[93] Treas. Reg. § 1.704-2(f)(4).

[94] Treas. Reg. § 1.704-2(f)(5).

[95] Treas. Reg. § 1.704-2(f); Treas. Reg. §§ (j)(2)(i)-(iii).

[96] Treas. Reg. § 1.704-2(b)(4); Treas. Reg. § (j)(2)(i).

[97] *Id*.

[98] Treas. Reg. § 1.704-2(i)(1), (6). If more than one partner bears the economic risk of loss for a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the economic risk of loss. *Id.* If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner nonrecourse liability. *Id*.

[99] Treas. Reg. § 1.704-2(i)(3).

[100] Treas. Reg. § 1.704-2(i)(2).

[101] Treas. Reg. § 1.704-2(i)(4).

[102] *Id*.

[103] Determining a partner's share of partner nonrecourse deductions is a two-step process. First, the partnership's aggregate partner nonrecourse deductions for an allocation period must be determined. Second, each partner must be allocated its share, if any, of that deduction. For the first step, the partnership's aggregate partner nonrecourse deduction for an allocation period equals the net increase in PNDMG during that period, reduced (but not below zero) by the aggregate partner nonrecourse distributions made during the period. Treas. Reg. § 1.704-2(i)(2). Each partner is then allocated its share of the partner nonrecourse deduction in accordance with its economic risk of loss associated with that liability. *See supra* note 98. Because it is possible that partner nonrecourse deductions will exceed available depreciation, the regulations contain the following ordering rules to ensure that a partner is allocated its share of partner nonrecourse deductions:

- First, its share of partner nonrecourse deductions will consist of depreciation or cost recovery deductions attributable to the partner nonrecourse liability;
- Second, if necessary, its share of partner nonrecourse deductions will consist of a pro rata portion of the partnership's other deductions, losses and section 705(a)(2)(B) expenditures; and
- Finally, if the amount of partner nonrecourse deduction exceeds the first and second items above, then the excess is treated as an increase in PNDMG in the immediately succeeding allocation period.

Treas. Reg. § 1.704-2(i)(4); Treas. Reg. § 1.704-2(j)(1)(i), (iii). A depreciation or cost recovery deduction with respect to property that is subject to a partnership nonrecourse liability is first treated as a partnership nonrecourse deduction and any excess is treated as partner nonrecourse deduction. Treas. Reg. § 1.704-2(j)(1)(i).

[104] Treas. Reg. § 1.704-2(i)(6); *see also supra* note 84.

[105] Treas. Reg. § 1.704-2(i)(5); *see also supra* note 85.

[106] Treas. Reg. § 1.704-2(i)(4). *See supra* note 18.

[107] Treas. Reg. § 1.704-2(i)(4). Note, however, that a partner will not be subject to a partner nonrecourse debt minimum gain chargeback to the extent the net decrease in PNDMG arises because a partner nonrecourse liability becomes partially or wholly a partnership nonrecourse liability. *Id.* In that case, the amount that would otherwise be subject to the partner nonrecourse debt minimum gain chargeback is added to that partner's share of partnership minimum gain. *Id.*

[108] *Id.*; Treas. Reg. § 1.704-2(j)(2)(ii), (iii).

[109] Gain from the disposition of property subject to a partnership nonrecourse liability is allocated to satisfy a partner nonrecourse debt minimum gain chargeback only to the extent it is not allocated to satisfy minimum gain chargeback. Treas. Reg. § 1.704-2(j)(2)(ii).

[110] An item of partnership income and gain that is allocated to satisfy minimum gain chargeback is not allocated to satisfy a partner nonrecourse debt minimum gain chargeback. Treas. Reg. § 1.704-2(j)(2)(ii).

[111] *See, e.g.*, *Commissioner v. Tower*, 327 U.S. 280 (1946); *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

[112] *See, e.g., Lucas v. Earl*, 281 U.S. 11 (1930).

[113] 327 U.S. at 290.

[114] 337 U.S. at 742.

[115] S. Rep. No. 781, 82d Cong., 1st Sess. 38, 39 (1951).

[116] When capital is not a material income producing factor, family partnership allocations must be analyzed under the assignment of income principles and, possibly, *Culberson*. Treas. Reg. § 1.704-1(e)(1)(i); *Lucas v. Earl*, 281 U.S. 11 (1930); *Poggetto v. United States*, 306 F.2d 76 (9th Cir. 1962). Note that all partnership allocations must be analyzed under assignment of income principles. *See supra* note 8 and accompanying text.

[117] IRC § 704(e)(1); Treas. Reg. § 1.704-1(e)(1). Note that a partner who acquires his partnership interest by purchase from his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons, may be deemed to have acquired his interest by gift and, thus, remains subject to the family partnership rules with respect to that purchased interest. IRC § 704(e)(3); *see also* Treas. Reg. § 1.704-1(e)(4) (providing factors that may be shown to avoid application of the family partnership rules to partnership interests purchased from family members).

Exhibit A

Long-Form Partnership Allocation Provisions

V. DEFINITIONS

A. <u>Definitions</u>. As used in this Agreement, and unless otherwise expressly provided in this Agreement, the following terms have the following meanings:

The following definition is intended to satisfy the Deficit Balance Limitation requirement under the Alternative Test. *See Special Allocations*[118] § II, A, 1, b.

"Adjusted Capital Account" means, with respect to a Partner, that Partner's Capital Account after (a) crediting to that Capital Account any amount that the Partner is deemed to be obligated to restore under the penultimate sentences of sections 1.704-2(g)(1) and 1.704-2(i)(5) of the Treasury Regulations; (b) crediting to that Capital Account any amount that Partner is obligated to restore under this Agreement or any collateral document; and (c) debiting to that Capital Account the items described in sections 1.704-1(b)(2)(ii)(d)(4), (5) and (6) of the Treasury Regulations.

The following definition is intended to satisfy the Deficit Balance Limitation requirement under the Alternative Test. *See Special Allocations* § II, A, 1, b.

"Adjusted Capital Account Deficit" means, with respect to a Partner, the deficit balance, if any, in that Partner's Adjusted Capital Account. This definition of Adjusted Capital Account Deficit is intended to comply with the provisions of sections 1.704-1(b)(2)(ii)(d) and 1.704-2 of the Treasury Regulations and will be interpreted consistently with those provisions.

"Adjustment Period" means any period of time that begins on the date the Certificate was filed in the office of the Secretary of State of Delaware (in the case of the first Adjustment Period) or the day following the end of the immediately preceding Adjustment Period (with respect to any other Adjustment Periods) and ends on the first to occur of: (a) the last day of a Fiscal Year, (b) the day immediately preceding the date of the "liquidation" of a Partner's Partnership Interest (within the meaning of section 1.704-1(b)(2)(ii)(g) of the Treasury Regulations), or (c) the date on which the Partnership is terminated under Article IX.

"Assignment," or any correlative form of "Assign," means any method whatsoever, whether direct or indirect and whether voluntary or involuntary, by which the legal or beneficial ownership of all or part of a Partnership Interest is transferred or changed, including:

(a) sales, exchanges, gifts, donations, and any other forms of conveyance, assignment, distribution, or transfer, regardless of the relationship between the assignor and Assignee;

(b) mortgages, pledges, liens, or other similar encumbrances of, or grants of security interests in, any legal or beneficial interest in the Partnership, and any levy, foreclosure or similar seizure associated with a mortgage, pledge, encumbrance, or security interest;

(c) changes in the beneficial interests of any trust or estate that holds a Partnership Interest and distributions from that trust or estate;

(d) changes in legal or beneficial ownership or other forms of transfer resulting from the Bankruptcy of any Partner or any Partner's spouse;

(e) changes in legal or beneficial ownership or other forms of transfer resulting from the death or divorce of any Partner or Assignee or any Partner's or Assignee's spouse;

(f) changes in legal or beneficial ownership or other forms of transfer resulting from the incapacity of any Partner or Assignee or any Partner's or Assignee's spouse; and

(g) direct or indirect changes, including changes through assignment, contribution, merger, conversion, transformation, exchange, dissolution or otherwise, in the ownership of any Partner or Assignee (or upper-tier owner of any Partner or Assignee) that is an entity if immediately after the changes that Partner or Assignee is controlled by any person who did not control that Partner or Assignee immediately before the changes. For purposes of this definition, the term "control" means the possession, direct or indirect, of the power to direct or to cause the direction of a particular entity's management and policies, whether through the ownership of voting securities, by contract or otherwise, or through the power to elect at least 50 percent of the directors, managers, or persons exercising similar authority with respect to that entity.

The following definition is intended to satisfy the Capital Account requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

"Capital Account" means, with respect to any Partner, the capital account maintained for that Partner in accordance with the rules of section 1.704-1(b)(2)(iv) of the Treasury Regulations. Subject to section 1.704-1(b)(2)(iv) of the Treasury Regulations:

(a) The Partnership will credit to each Partner's Capital Account (i) that Partner's Capital Contribution (net of liabilities that the Partnership is considered to assume or to take subject to under section 752 of the Code) and (ii) that Partner's distributive share of Profits and any items in the nature of income or gain that are specially allocated under Section VIII.C or Section VIII.D.

(b) The Partnership will debit to each Partner's Capital Account (i) the amount of cash and the Gross Asset Value of any property distributed to that Partner under any provision of this Agreement (net of liabilities that the Partner is considered to assume or to take subject to under section 752 of Code) and (ii) that Partner's distributive share of Losses and any items in the nature of expenses or losses that are specially allocated under Section VIII.C or Section VIII.D.

(c) In the event all or a portion of a Partnership Interest is Assigned in accordance with the terms of this Agreement, the Assignee will succeed to the Capital Account of the transferor to the extent it relates to the Assigned Partnership Interest.

This Agreement's provisions relating to the maintenance of Capital Accounts are intended to comply with and will be interpreted and applied in a manner consistent with the provisions of section 1.704-1(b) of the Treasury Regulations. Without limiting the generality of Section VIII.C, the General Partner may modify the manner in which the Capital Accounts are maintained under this Agreement in order to comply with those provisions, as well as upon the occurrence of events that might otherwise cause this Agreement not to comply with those provisions. However, the General Partner may not modify the way Capital Accounts are maintained without the consent of each affected Partner if the modification would have the effect of changing the amount of distributions to which any Partner would be entitled during the operations, or upon the liquidation, of the Partnership.

"Capital Contribution" means, with respect to any Partner, the amount of money and the initial Gross Asset Value of any property (other than money) contributed at any time to the Partnership by that

Partner (or its predecessors in interest) with respect to the Partnership Interest held by that Partner. The General Partner will have the sole discretion to accept or reject any proposed Capital Contribution.

"Code" means the Internal Revenue Code of 1986 and any successor statute, as amended from time to time.

"Distributable Cash" means all cash funds of the Partnership on hand at any time after payment of all Operating Expenses payable as of that time reduced by the amount of the Working Capital Reserve, if any, at that time.

The following definition is intended to satisfy the Capital Account requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

"Gross Asset Value" means, with respect to any asset, the adjusted basis of the asset for federal income tax purposes, further adjusted as follows:

(a) The initial Gross Asset Value of any asset contributed (or deemed to have been contributed) by a Partner to the Partnership, including any asset contributed (or deemed to be contributed) in connection with the execution and delivery of this Agreement, will be the gross fair market value of that asset, as determined by the General Partner.

(b) The Gross Asset Values of all Partnership assets will be adjusted to equal the respective fair market values of the assets, as determined by the General Partner, when one of the following events occur (a "Redetermination Event"): (i) any new or existing Partner acquires an additional interest in the Partnership in exchange for more than a de minimis capital contribution; (ii) the Partnership distributes to a Partner more than a de minimis amount of Partnership property as consideration for an interest in the Partnership, if the General Partner reasonably determines an adjustment is necessary or appropriate to reflect the relative economic interests of the Partners in the Partnership; (iii) the Partnership is liquidated within the meaning of section 1.704-1(b)(2)(ii)(g) of the Treasury Regulations; (iv) the Partnership issues a Profits Interest, or (v) the General Partner determines that the adjustment is necessary or proper under section 1.704-1(b)(2)(iv)(q) of the Treasury Regulations.

(c) The Gross Asset Value of any Partnership asset distributed to any Partner will be adjusted to equal the gross fair market value of that asset, as determined by the General Partner, on the distribution date.

(d) The Gross Asset Values of Partnership assets will be increased or decreased to reflect any adjustments to the adjusted basis of those assets under section 732(d), section 734(b), or section 743(b) of the Code, but only to the extent that (i) those adjustments are taken into account in determining Capital Accounts under section 1.704-1(b)(2)(iv)(m) of the Treasury Regulations and (ii) an adjustment under clause (b) above is not required in connection with the transaction.

"Losses" has the meaning given that term in the definition of "Profits and Losses."

The following definition is intended to satisfy the Partnership Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, b.

"Nonrecourse Deduction" has the meaning given that term in sections 1.704-2(b)(1) and 1.704-2(c) of the Treasury Regulations.

The following definition is intended to satisfy the Partnership Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, b.

"Nonrecourse Liability" has the meaning given that term in section 1.704-2(b)(3) of the Treasury Regulations.

"Operating Expenses" means all ordinary and necessary costs, expenses, or charges with respect to the Partnership's operations, including payments of interest and principal and other monetary obligations due under any loan made to the Partnership (excluding loans to the Partnership from the Partners); accounting, legal, and auditing fees; taxes payable by the Partnership; public or private utility charges; sales and use taxes, and all related payroll taxes and withholding taxes; management fees; and all other advertising, management, leasing, governmental approval, and other operating costs, expenses, and capital expenditures actually paid with respect to the Partnership's Business and operations generally.

The following definition is intended to satisfy the Partner Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, c.

"Partner Nonrecourse Debt" has the meaning given that term in section 1.704-2(b)(4) of the Treasury Regulations.

The following definition is intended to satisfy the Partner Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, c.

"Partner Nonrecourse Debt Minimum Gain" means an amount, with respect to each Partner Nonrecourse Debt, equal to the Partnership Minimum Gain that would result if such Partner Nonrecourse Debt were treated as a Nonrecourse Liability, determined in accordance with section 1.704-2(i)(3) of the Treasury Regulations.

The following definition is intended to satisfy the Partner Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, c.

"Partner Nonrecourse Deductions" has the meaning given that term in section 1.704-2(i)(1) and (2) of the Treasury Regulations.

"Partnership Interest" means the interest of a Partner in the Partnership consisting of the right to share in Profits and Losses, to receive distributions of the Partnership's assets, and to receive allocations of income, gain, loss, deduction, and similar items of the Partnership. Except as expressly set forth in this Agreement or the Certificate, the rights of an Assignee of a Partnership Interest who has not been admitted as a Partner will be no greater than the rights mandated by the Act and, to the extent the rights mandated by the Act may be denied, they are hereby expressly denied. A Partnership Interest does not include the Status Rights.

The following definition is intended to satisfy the Partnership Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, b.

"Partnership Minimum Gain" has the meaning given that term in section 1.704-2(b)(2) of the Treasury Regulations. The amount of Partnership Minimum Gain, as well as any net increase or decrease in Partnership Minimum Gain, for an Adjustment Period will be determined in accordance with the rules of section 1.704-2(d) of the Treasury Regulations.

“Percentage Interest” means, at any time, with respect to any Partner, the percentage set forth on ***Exhibit [X]*** as the Percentage Interest of such Partner. The Percentage Interests will be adjusted from time to time in accordance with this Agreement. At all times, the sum of the Percentage Interests of all Partners will equal 100 percent.

The following definition is intended to satisfy the Capital Account requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

“Profits” and “Losses” mean, for each Adjustment Period, the Partnership’s taxable income or taxable loss for the Adjustment Period, as determined under section 703(a) of the Code and section 1.703-1 of the Treasury Regulations (and for this purpose all items of income, gain, loss, or deduction required to be stated separately under section 703(a)(1) of the Code will be included in taxable income or taxable loss), but with the following adjustments:

(a) Any income of the Partnership that is exempt from federal income tax and not otherwise taken into account in computing Profits and Losses under this definition of “Profits” and “Losses” will be added to taxable income or loss;

(b) Any Partnership expenditures described in section 705(a)(2)(B) of the Code or treated as section 705(a)(2)(B) expenditures under section 1.704-1(b)(2)(iv)(i) of the Treasury Regulations that are not otherwise taken into account in computing Profits and Losses will be subtracted from taxable income or loss;

(c) In the event the Gross Asset Value of any Partnership asset is adjusted under clause (b) or (c) of the definition of “Gross Asset Value” in this Section V.A, the amount of that adjustment will be taken into account as gain or loss from the disposition of that asset for purposes of computing Profits and Losses;

(d) Gain or loss resulting from any disposition of any Partnership asset with respect to which gain or loss is recognized for federal income tax purposes will be computed by reference to the Gross Asset Value of the asset disposed of, notwithstanding that the adjusted tax basis of that asset differs from its Gross Asset Value;

(e) The depreciation, amortization, and other cost recovery deductions taken into account in computing taxable income or loss will be taken into account for that Adjustment Period in accordance with section 1.704-1(b)(2)(iv)(g) of the Treasury Regulations;

(f) To the extent an adjustment to the adjusted tax basis of any Partnership asset under section 734(b) of the Code is required to be taken into account, in accordance with section 1.704-1(b)(2)(iv)(m)(4) of the Treasury Regulations, in determining Capital Accounts as a result of a distribution other than in liquidation of a Partner’s Partnership Interest, the amount of that adjustment will be treated as an item of gain (if the adjustment increases the basis of the asset) or loss (if the adjustment decreases that basis) from the disposition of that asset and will be taken into account for purposes of computing Profits and Losses; and

(g) Notwithstanding any other provisions of this definition, any items that are specially allocated under Section VIII.C or Section VIII.D will not be taken into account in computing Profits and Losses.

The amounts of the items of Partnership income, gain, loss, or deduction available to be specially allocated under Section VIII.C or Section VIII.D will be determined by applying rules analogous to those set forth in clauses (a) through (f) above.

"Profits Interest" means a profits interest as defined in Rev. Proc. 93-27, 1993-2 C.B. 343, clarified by Rev. Proc. 2001-43, 2001-34 IRB 191.

"Redetermination Event" has the meaning given that term in the definition of "Gross Asset Value" in this Section V.A.

"Regulatory Allocations" has the meaning given that term in Section VIII.D.

"Safe Harbor" means the election described in the Safe Harbor Regulation, pursuant to which a partnership and all of its partners may elect to treat the fair market value of a partnership interest that is transferred in connection with the performance of services as being equal to the liquidation value of that interest.

"Safe Harbor Election" means the election by a partnership and its partners to apply the Safe Harbor, as described in the Safe Harbor Regulation and Notice 2005-43, 2005-24 IRB 1221 (May 19, 2005).

"Safe Harbor Regulation" means Proposed Treasury Regulations Section 1.83-3(l) [REG-105346-03], issued on May 19, 2005.

"Status Rights" means, with respect to any Partnership Interest, the right to exercise the rights and powers of a Partner in the Partnership, including the right to consent to or approve certain actions of the Partnership. Status Rights do not include, however, the right to share in Profits and Losses, to receive distributions, and to receive allocations of income, gain, loss, deduction, and similar items of the Partnership.

"Tax Matters Partner" means the person designated under Section [X.X] to be the "tax matters partner" of the Partnership under section 6231(a)(7) of the Code, but not including any person who has ceased to be the "tax matters partner" of the Partnership.

"Treasury Regulation" or "Treas. Reg." means the regulations promulgated under the Code from time to time.

"Working Capital Reserve" means cash reserves (a) adequate for current and future working capital requirements of the Partnership (including Operating Expenses and capital improvements, as the case may be) as determined by the General Partner, (b) required by any loan agreements or similar arrangements to which the Partnership is subject, and (c) necessary to satisfy contingencies reasonably anticipated for, or associated with, the Partnership's Business, as determined by the General Partner.

VI. CAPITAL CONTRIBUTIONS

> The following Section is intended to satisfy the Capital Account requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

A. <u>Capital Accounts</u>. The General Partner shall maintain a separate Capital Account for each Partner. Any Partner who is both a General Partner and a Limited Partner will have a single Capital Account for both interests.

VII. DISTRIBUTIONS

A. <u>Distributions from Operations</u>. From time to time and at anytime before the Partnership's liquidation, Distributable Cash will be distributed, at the times the General Partner determines, to the Partners in proportion to their respective Percentage Interests on the distribution date.

> The following Section is intended to satisfy the Liquidation Requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

B. <u>Distributions on Liquidation</u>. Upon the Partnership's liquidation and winding up, after adjusting the Capital Accounts for all distributions made under this Article VII and all allocations under Article VIII, all available proceeds as determined under Section IX.A will be distributed to the Partners in proportion to and to the extent of the positive balances in their Capital Accounts.

C. <u>Working Capital Reserve</u>. At any time and from time to time, the General Partner may establish and maintain a Working Capital Reserve for the Partnership. If and to the extent the General Partner determines that unused funds in the Working Capital Reserve are no longer required to be maintained, those funds will be released from the Working Capital Reserve and treated as Distributable Cash.

VIII. ALLOCATIONS

> The following Section is intended to satisfy the Substantiality Test. *See Special Allocations* § II, A, 2.

A. <u>Profits</u>. Except as provided in Sections VIII.C through VIII.F, Profits for an Adjustment Period will be allocated in the following order:

1. First, to the extent Losses were allocated to the General Partner under Section VIII.B.2 for any previous Adjustment Period, Profits will be allocated to the General Partner to the extent of those Losses;

2. Second, Profits will be allocated to the Partners in proportion to their respective Percentage Interests.

B. <u>Losses</u>. Except as provided in Sections VIII.C through VIII.F, Losses for an Adjustment Period will be allocated in the following order:

1. First, Losses will be allocated to the Partners in proportion to their respective Percentage Interests to the extent of the positive balances in their Adjusted Capital Accounts, but Losses allocated to each Partner may not exceed the Adjusted Capital Account balance of that Partner immediately preceding this allocation; and

2. **Finally, Losses will be allocated to the General Partner.**

The flush language below is intended to satisfy the Deficit Balance Limitation requirement under the Alternative Test. *See Special Allocations* § II, A, 1, b.

Notwithstanding the above provisions of this Section VIII.B, if the amount of Losses for any Adjustment Period that would otherwise be allocated to a Partner under this Section VIII.B would cause or increase an Adjusted Capital Account Deficit of that Partner as of the last day of the Adjustment Period, then a proportionate part of the Losses equal to the excess will be allocated to the Partners with no Adjusted Capital Account Deficits, and the remainder of the Losses, if any, will be allocated to the Partner. (The immediately preceding sentence is intended to ensure that allocations of Losses have "economic effect" under section 1.704-1(b)(2)(ii)(d) of the Treasury Regulations and will be interpreted consistently that provision.)

C. **Special Allocations. The following special allocations will be made in the following order and priority:**

The following Section is intended to satisfy the Partnership Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, b.

1. **Partnership Minimum Gain Chargeback. Except as otherwise provided in section 1.704-2(f) of the Treasury Regulations, and notwithstanding any other provision of this Article VIII, if a net decrease in Partnership Minimum Gain occurs during any Adjustment Period, each Partner will be specially allocated items of Partnership income and gain for that Adjustment Period (and, if necessary, future Adjustment Periods) before any other allocation is made under this Agreement. This special allocation will be made in proportion to, and to the extent of, an amount equal to that Partner's share of the net decrease in Partnership Minimum Gain during that Adjustment Period determined in accordance with section 1.704-2(g) of the Treasury Regulations. The items to be allocated will be determined in accordance with sections 1.704-2(f)(6) and 1.704-2(j)(2) of the Treasury Regulations. (This Section 5.3(a) is intended to comply with the partnership minimum gain chargeback requirements of the Treasury Regulations, will be interpreted consistently with the Treasury Regulations, and will be subject to all exceptions provided in the Treasury Regulations.)**

The following Section is intended to satisfy the Partner Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, c.

2. **Partner Nonrecourse Debt Minimum Gain Chargeback. Except as otherwise provided in section 1.704-2(i)(4) of the Treasury Regulations, and notwithstanding any other provision of this Article VIII other than Section VIII.C.1, if in any Adjustment Period a net decrease in Partner Nonrecourse Debt Minimum Gain occurs with respect to a Partner's Nonrecourse Debt, any Partner with a share of that Partner Nonrecourse Debt Minimum Gain (determined under section 1.704-2(i)(5) of the Treasury Regulations) as of the beginning of the Adjustment Period will be specially allocated items of Partnership income and gain for that Adjustment Period (and, if necessary, future Adjustment Periods). This special allocation will be in an amount equal to that Partner's share of the net decrease in the Partner Nonrecourse Debt Minimum Gain during that Adjustment Period determined in accordance with section 1.704-2(i)(4) of the Treasury Regulations. The items to be allocated will be determined in accordance with sections 1.704-2(i)(4) and 1.704-2(j)(2) of the Treasury Regulations. (This Section VIII.C.2 is intended to comply with the partner nonrecourse debt minimum gain**

chargeback requirements of the Treasury Regulations, will be interpreted consistently with the Treasury Regulations, and will be subject to all exceptions provided in the Treasury Regulations.)

The following Section is intended to satisfy the Qualified Income Offset requirement under the Alternative Test. *See Special Allocations* § II, A, 1, b.

3. **Qualified Income Offset. In the event any Partner unexpectedly receives any adjustments, allocations, and/or distributions described in sections 1.704-1(b)(2)(ii)(d)(4), (5) or (6) of the Treasury Regulations, items of Partnership income and gain will be specially allocated to each Partner in an amount and manner sufficient to eliminate, to the extent required by the Treasury Regulations, the Adjusted Capital Account Deficit of that Partner as quickly as possible. However, an allocation under this Section VIII.C.3 will be made only if and to the extent that the Partner would have an Adjusted Capital Account Deficit after all other allocations this Article VIII provides for have been tentatively made as though this Section VIII.C.3 were not in this Agreement.**

The following Section is intended to satisfy the Deficit Balance Limitation requirement under the Alternative Test. *See Special Allocations* § II, A, 1, b.

4. **Gross Income Allocation. In the event any Partner has a deficit Capital Account at the end of any Adjustment Period in excess of the sum of (i) the amount that Partner is obligated to restore under any provision of this Agreement or any collateral document, (ii) the amount that Partner is deemed to be obligated to restore to the Partnership under section 1.704-1(b)(2)(ii)(c) of the Treasury Regulations, and (iii) the amount that Partner is deemed to be obligated to restore under the penultimate sentences of sections 1.704-2(g)(1) and 1.704-2(i)(5) of the Treasury Regulations, each of those Partners will be specially allocated items of Partnership income and gain in the amount of the excess as quickly as possible. However, an allocation to a Partner under this Section VIII.C.4 will be made only if and to the extent that the Partner would have a deficit Capital Account in excess of the above sum after all other allocations this Article VIII provides for have been made as though Section VIII.C.3 and this Section VIII.C.4 were not in this Agreement.**

The following Section is intended to satisfy the Partnership Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, b.

5. **Nonrecourse Deductions. Nonrecourse Deductions for any Adjustment Period will be allocated to the Partners in proportion to their respective Percentage Interests. If the General Partner determines, in its good faith discretion, that the Nonrecourse Deductions must be allocated in a different ratio to satisfy the safe harbor requirements of the Treasury Regulations promulgated under section 704(b) of the Code, the General Partner is authorized, upon notice to the Partners, to revise the prescribed ratio to the numerically closest ratio that satisfies those requirements.**

The following Section is intended to satisfy the Partner Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, c.

6. **Partner Nonrecourse Deductions. Notwithstanding anything to the contrary in this Agreement, any Partner Nonrecourse Deductions for any Adjustment Period will be allocated to the Partner who bears the economic risk of loss with respect to the Partner Nonrecourse Debt to**

which the Partner Nonrecourse Deductions are attributable in accordance with section 1.704-2(i)(1) of the Treasury Regulations.

7. **Section 754 Adjustments. To the extent an adjustment to the adjusted tax basis of any Partnership asset under sections 734(b) or 743(b) of the Code is required to be taken into account in determining Capital Accounts under section 1.704-1(b)(2)(iv)(m) of the Treasury Regulations as the result of a distribution to a Partner in complete liquidation of such Partner's interest in the Partnership, the amount of the adjustment to the Capital Accounts will be treated as an item of gain (if the adjustment increases the asset's basis) or loss (if the adjustment decreases the basis). The gain or loss will be specially allocated to the Partners in accordance with their interests in the Partnership in the event section 1.704-1(b)(2)(iv)(m)(2) of the Treasury Regulations applies, or to the Partner to whom such distribution was made in the event section 1.704-1(b)(2)(iv)(m)(4) of the Treasury Regulations applies.**

8. **Allocations Relating to Taxable Issuance of Company Units. Any income, gain, loss or deduction realized as a direct or indirect result of the issuance of a Partnership Interest to a Partner (the "Issuance Items") shall be allocated among the Partners so that, to the extent possible, the net amount of such Issuance Items, together with all other allocations under this Agreement to each Partner, shall be equal to the net amount that would have been allocated to each such Partner if the Issuance Items had not been realized.**

D. **Curative Allocations. The allocations set forth in Section C (the "Regulatory Allocations") are intended to comply with certain requirements of sections 1.704-1(b) and 1.704-2 of the Treasury Regulations. The Regulatory Allocations may effect results that are inconsistent with the Partners' intended manner of dividing Partnership distributions. Accordingly, the General Partner may divide other allocations of Profits, Losses and other items among the Partners in order to prevent the Regulatory Allocations from distorting the manner in which Partnership distributions would be divided among the Partners under Section IX.A if the Partnership made those distributions in accordance with the Partners' positive Capital Accounts but for the Regulatory Allocations. In general, the reallocation will be accomplished by specially allocating other Profits, Losses and items of income, gain, loss and deduction, to the extent they exist, among the Partners so that the net amount of the Regulatory Allocations and these special allocations to each Partner is zero. The General Partner will have discretion to accomplish this result in any reasonable manner consistent with section 704 of the Code and the related Treasury Regulations.**

E. **704(c) Allocations. In accordance with section 704(c) of the Code and the related Treasury Regulations, income, gain, loss and deduction with respect to any property contributed to Partnership capital, solely for tax purposes, will be allocated among the Partners in order to take account of any variation between the adjusted basis to the Partnership of the property for federal income tax purposes and the initial Gross Asset Value of the property (computed in accordance with the provisions of part (b) of the definition of "Gross Asset Value" found in Section V.A). If the Gross Asset Value of any Partnership asset is adjusted, any future allocations of income, gain, loss and deduction with respect to that asset will take account of any variation between the asset's adjusted basis for federal income tax purposes and its Gross Asset Value in the same manner as under section 704(c) of the Code and the related Treasury Regulations. Unless otherwise approved by Unanimous Approval, a Partner's distributive share of income, gain, loss, and deduction with respect to any such asset will be determined in accordance with the principles of the ["remedial allocation method"] set forth in section 1.704-3(d) of the Treasury Regulations. Any elections or other decisions relating to allocations pursuant to this Section VIII.E will be made in any manner that the General Partner**

determines in its sole discretion. Allocations under this Section VIII.E are solely for purposes of federal, state and local taxes and 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. Other Allocation Rules. The following rules will apply to the calculation and allocation of Profits, Losses and other items:

1. Allocations to Assignees.

a. If any Partnership Interest is Assigned in compliance with the provisions of Article [X] on any day other than the first day of any year, then Profits, Losses, each item thereof, and all other items attributable to that Partnership Interest for that year will be allocated to the assignor and the Assignee by accounting for their varying interests during the year in accordance with section 706(d) of the Code, using any permissible method the General Partner selects.

b. Solely for purposes of making the above allocations, for an Assignment that is effective under Article [X] on or before the 15th day of a calendar month, each of the items for the entire calendar month in which the Assignment occurs will be allocated to the assignor, and for an Assignment that occurs after the 15th day of a calendar month, each of those items for the entire calendar month in which the Assignment occurs will be allocated to the Assignee. However, gain or loss on a transfer of all or substantially all of the Partnership assets or on a sale or other transfer of a substantial capital asset of the Partnership not in the ordinary course of business as determined by the General Partner will be allocated to the person who is the holder of the Partnership Interest on the transfer date. Any distribution of proceeds of that transfer also will be made to that person on the transfer date.

2. Other Items. Except as otherwise provided in this Agreement, all items of Partnership income, gain, loss, deduction, and other allocations not otherwise provided for will be divided among the Partners in the same proportions as they share Profits and Losses, as the case may be, for the Adjustment Period during which those items were allocated.

G. Safe Harbor Election. The Partners agree that, in the event the Safe Harbor Regulation is finalized, the Partnership shall be authorized and directed to make the Safe Harbor Election, and the Partnership and each Partner (including any person to whom an interest in the Partnership is Assigned in connection with the performance of services) agrees to comply with all requirements of the Safe Harbor with respect to all interests in the Partnership transferred in connection with the performance of services while the Safe Harbor Election remains effective. The Tax Matters Partner shall be authorized to and shall prepare, execute and file the Safe Harbor Election.

H. Partner Acknowledgment. The Partners agree to be bound by the provisions of this Article 5 in reporting their shares of Partnership income and loss for income tax purposes.

IX. LIQUIDATION AND WINDING-UP

A. Mechanics.

The following Section is intended to satisfy the Liquidation Requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

1. **<u>Distributions</u>. All Partnership assets remaining after the payment of Partnership debts, liabilities, and obligations and the establishment of cash reserve funds in accordance with this Agreement must be distributed among the Partners in accordance with the provisions of Section VII.B. If at any time, whether before or after the Partnership terminates, any of the funds placed in reserve under this Article IX are released, the funds will be distributed in accordance with this Article IX.**

B. **<u>Insufficient Assets</u>. Partners must look solely to the assets of the Partnership for the return of their Capital Contributions. No Partner will have any recourse against any other Partner solely because the funds remaining after the payment or discharge of the Partnership debts and liabilities are insufficient to return those Capital Contributions.**

Because of the following Section, allocations under this Agreement cannot have substantial economic unless this Agreement satisfies the Alternative Test. *See Special Allocations* § II, A, 1, b.

C. **<u>Deficit Capital Accounts</u>. Except as otherwise expressly provided in this Agreement, at no time during the Partnership's term or upon the Partnership's dissolution and liquidation will a Partner with a negative balance in its Capital Account have any obligation to the Partnership, any other Partners or any other person to restore the negative balance.**

---

[118] Any reference to "Special Allocations" is a reference to *Special Allocation Provisions: Are They Necessary?*, the article to which this Exhibit is attached.

Exhibit B

Short-Form Partnership Allocation Provisions

X. DEFINITIONS

A. <u>Definitions</u>. As used in this Agreement, and unless otherwise expressly provided in this Agreement, the following terms have the following meanings:

The following definition is intended to satisfy the Deficit Balance Limitation requirement under the Alternative Test. *See Special Allocations*[119] § II, A, 1, b.

"Adjusted Capital Account Deficit" means, with respect to a Partner, the deficit balance, if any, in that Partner's capital account after (a) crediting to that capital account any amount that the Partner is deemed to be obligated to restore under the penultimate sentences of sections 1.704-2(g)(1) and 1.704-2(i)(5) of the regulations; (b) crediting to that capital account any amount that Partner is obligated to restore under this Agreement or any collateral document; and (c) debiting to that capital account the items described in sections 1.704-1(b)(2)(ii)(d)(4), (5) and (6) of the regulations. This definition of Adjusted Capital Account Deficit is intended to comply with the provisions of sections 1.704-1(b)(2)(ii)(d) and 1.704-2 of the Treasury Regulations and will be interpreted consistently with those provisions.

"Code" means the Internal Revenue Code of 1986 and any successor statute, as amended from time to time.

"Distributable Cash" means all cash funds of the Partnership on hand at any time after payment of all Operating Expenses payable as of that time reduced by the amount of the Working Capital Reserve, if any, at that time.

The following definition is intended to satisfy the Capital Account requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

"Gross Asset Value" means, with respect to any asset, the adjusted book basis (as distinguished from the adjusted tax basis) of that asset on the books of the Partnership determined under the applicable tax accounting rules set forth in section 1.704-1(b)(2)(iv) of the regulations.

"Operating Expenses" means all ordinary and necessary costs, expenses, or charges with respect to the Partnership's operations, including payments of interest and principal and other monetary obligations due under any loan made to the Partnership (excluding loans to the Partnership from the Partners); accounting, legal, and auditing fees; taxes payable by the Partnership; public or private utility charges; sales and use taxes, and all related payroll taxes and withholding taxes; management fees; and all other advertising, management, leasing, governmental approval, and other operating costs, expenses, and capital expenditures actually paid with respect to the Partnership's Business and operations generally.

"Percentage Interest" means, at any time, with respect to any Partner, the percentage set forth on ***Exhibit [X]*** as the Percentage Interest of such Partner. The Percentage Interests will be adjusted from time to time in accordance with this Agreement. At all times, the sum of the Percentage Interests of all Partners will equal 100 percent.

"Safe Harbor" means the election described in the Safe Harbor Regulation, pursuant to which a partnership and all of its partners may elect to treat the fair market value of a partnership interest that is transferred in connection with the performance of services as being equal to the liquidation value of that interest.

"Safe Harbor Election" means the election by a partnership and its partners to apply the Safe Harbor, as described in the Safe Harbor Regulation and Notice 2005-43, 2005-24 IRB 1221 (May 19, 2005).

"Safe Harbor Regulation" means Proposed Treasury Regulations Section 1.83-3(l) [REG-105346-03], issued on May 19, 2005.

"Working Capital Reserve" means cash reserves (a) adequate for current and future working capital requirements of the Partnership (including Operating Expenses and capital improvements, as the case may be) as determined by the General Partner, (b) required by any loan agreements or similar arrangements to which the Partnership is subject, and (c) necessary to satisfy contingencies reasonably anticipated for, or associated with, the Partnership's Business, as determined by the General Partner.

XI. CAPITAL CONTRIBUTIONS

The following Section is intended to satisfy the Capital Account requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

A. Capital Accounts. The General Partner shall maintain a separate capital account for each Partner in accordance with the rules set forth in section 1.704-1(b)(2)(iv) of the regulations. Any Partner who is both a General Partner and a Limited Partner will have a single capital account for both interests.

XII. DISTRIBUTIONS

A. Distributions from Operations. From time to time and at anytime before the Partnership's liquidation, Distributable Cash will be distributed, at the times the General Partner determines, to the Partners in proportion to their respective Percentage Interests on the distribution date.

The following Section is intended to satisfy the Liquidation Requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

B. Distributions on Liquidation. Upon the Partnership's liquidation and winding up, after adjusting the Capital Accounts for all distributions made under this Article VII and all allocations under Article VIII, all available proceeds as determined under Section IX.A will be distributed to the Partners in proportion to and to the extent of the positive balances in their capital accounts.

C. Working Capital Reserve. At any time and from time to time, the General Partner may establish and maintain a Working Capital Reserve for the Partnership. If and to the extent the General Partner determines that unused funds in the Working Capital Reserve are no longer required to be maintained, those funds will be released from the Working Capital Reserve and treated as Distributable Cash.

XIII. ALLOCATIONS

The following Section is intended to satisfy the Substantiality Test. *See Special Allocations* § II, A, 2. The following Section also is intended to satisfy the Deficit Balance Limitation requirement under the Alternative Test. *See Special Allocations* § II, A, 1, b.

A. Allocations of Profits and Losses. After giving effect to the special allocations set forth in Section VIII.C, Partnership income, gain, loss and deduction for each allocation period shall be allocated to the Partners in proportion to their Percentage Interests. Notwithstanding the immediately preceding sentence, if the amount of loss and deduction for any allocation period that otherwise would be allocated to a Partner under this Section XIII.A would cause or increase an Adjusted Capital Account Deficit of that Partner as of the last day of the allocation period, then a proportionate part of the losses and deductions equal to the excess will be allocated to the Partners with no Adjusted Capital Account Deficits, and the remainder of the losses and deductions, if any, will be allocated to the Partners in proportion to their Percentage Interests. (The immediately preceding sentence is intended to ensure that allocations of Losses have economic effect under section 1.704-1(b)(2)(ii)(d) of the Treasury Regulations and will be interpreted consistently that provision.)

B. <u>Special Allocations</u>. The following special allocations will be made in the following order and priority:

The following Section is intended to satisfy the Partnership Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, b.

1. <u>Minimum Gain Chargeback</u>. This Agreement incorporates the "minimum gain chargeback" provisions set forth in sections 1.704-2(f) and (g) of the regulations (which shall apply as provided in those regulations).

The following Section is intended to satisfy the Partner Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, c.

2. <u>Partner Nonrecourse Debt Minimum Gain Chargeback</u>. This Agreement incorporates the "partner nonrecourse debt minimum gain chargeback" set forth in sections 1.704-2(i)(4) of the regulations (which shall apply as provided in those regulations).

The following Section is intended to satisfy the Qualified Income Offset requirement under the Alternative Test. *See Special Allocations* § II, A, 1, b.

3. <u>Qualified Income Offset</u>. This Agreement incorporates the "qualified income offset" set forth in sections 1.704-1(d) of the regulations as if its provision were fully set forth in this Agreement.

The following Section is intended to satisfy the Deficit Balance Limitation requirement under the Alternative Test. *See Special Allocations* § II, A, 1, b.

4. <u>Gross Income Allocation</u>. In the event any Partner has an Adjusted Capital Account Deficit at the end of any allocation period, each such Partner will be specially allocated items of Partnership income and gain in the amount of the excess as quickly as possible, provided that an allocation under this Section XIII.B.4 will be made only if and to the extent that such Partner would have a deficit capital account balance in excess of that Partner's Adjusted Capital Account Deficit after all other allocations this Article VIII provides for have been made as though Section XIII.B.3 and this Section XIII.B.4 were not in this Agreement.

The following Section is intended to satisfy the Partnership Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, b.

5. <u>Nonrecourse Deductions</u>. Any "partnership nonrecourse deduction" (as defined in section 1.704-2(b)(1) of the regulations) will be allocated to the Partners in proportion to their respective Percentage Interests.

The following Section is intended to satisfy the Partner Nonrecourse Liability rules under the Special Rules. *See Special Allocations* § II, C, 2, c.

6. <u>Partner Nonrecourse Deductions</u>. Any "partner nonrecourse deduction" (as that term is defined in section 1.704-2(i)(2) of the regulations) will be allocated to the Partner that bears the economic risk of loss (as determined under section 1.752-2 of the regulations) for the partner nonrecourse debt giving rise to such deduction, all in accordance with section 1.704-2(i)(1) of the regulations.

C. **<u>704(c) Allocations</u>. In accordance with section 704(c) of the Code and the related Treasury regulations, income, gain, loss and deduction with respect to any property contributed to Partnership capital, solely for tax purposes, will be allocated among the Partners in order to take account of any variation between the adjusted basis to the Partnership of the property for federal income tax purposes and the initial Gross Asset Value of the property. If the Gross Asset Value of any Partnership asset is adjusted, any future allocations of income, gain, loss and deduction with respect to that asset will take account of any variation between the asset's adjusted basis for federal income tax purposes and its Gross Asset Value in the same manner as under section 704(c) of the Code and the related Treasury regulations. Any elections or other decisions relating to allocations pursuant to this Section XIII.C will be made in any manner that is agreed to by all of the Partners affected by such election. Allocations under this Section XIII.C are solely for purposes of federal, state and local taxes and will not affect, or in any way be taken into account in computing any Partner's capital account or share of Partnership income, gain, loss, deduction, and credit.**

D. **<u>Safe Harbor Election</u>. The Partners agree that, in the event the Safe Harbor Regulation is finalized, the Partnership shall be authorized and directed to make the Safe Harbor Election, and the Partnership and each Partner (including any person to whom an interest in the Partnership is Assigned in connection with the performance of services) agrees to comply with all requirements of the Safe Harbor with respect to all interests in the Partnership transferred in connection with the performance of services while the Safe Harbor Election remains effective. The Tax Matters Partner shall be authorized to and shall prepare, execute and file the Safe Harbor Election.**

XIV. LIQUIDATION AND WINDING-UP

A. **<u>Mechanics</u>.**

The following Section is intended to satisfy the Liquidation Requirement under the Basic Test and the Alternative Test. *See Special Allocations* §§ II, A, 1, a and II, A, 1, b.

1. **<u>Distributions</u>. All Partnership assets remaining after the payment of Partnership debts, liabilities, and obligations and the establishment of cash reserve funds in accordance with this Agreement must be distributed among the Partners in accordance with the provisions of Section VII.B. If at any time, whether before or after the Partnership terminates, any of the funds placed in reserve under this Article IX are released, the funds will be distributed in accordance with this Article IX.**

B. **<u>Insufficient Assets</u>. Partners must look solely to the assets of the Partnership for the return of their Capital Contributions. No Partner will have any recourse against any other Partner solely because the funds remaining after the payment or discharge of the Partnership debts and liabilities are insufficient to return those Capital Contributions.**

Because of the following Section, allocations under this Agreement cannot have substantial economic unless this Agreement satisfies the Alternative Test. *See Special Allocations* § II, A, 1, b.

C. **<u>Deficit Capital Accounts</u>. Except as otherwise expressly provided in this Agreement, at no time during the Partnership's term or upon the Partnership's dissolution and liquidation will a Partner with a negative balance in its Capital Account have any obligation to the Partnership, any other Partners or any other person to restore the negative balance.**

[119] Any reference to "Special Allocations" is a reference to *Special Allocation Provisions: Are They Necessary?*, the article to which this Exhibit is attached.

Exhibit C

Target Allocation Provisions

XV. DEFINITIONS

A. <u>Definitions</u>. As used in this Agreement, and unless otherwise expressly provided in this Agreement, the following terms have the following meanings:

"Code" means the Internal Revenue Code of 1986 and any successor statute, as amended from time to time.

"Distributable Cash" means all cash funds of the Partnership on hand at any time after payment of all Operating Expenses payable as of that time reduced by the amount of the Working Capital Reserve, if any, at that time.

"Partnership Capital" means an amount equal to the sum of the Partners' capital account balances determined immediately prior to the allocations under Section XVIII.A, increased by the aggregate amount of income and gain to be allocated to the Partners pursuant to Section XVIII.A.1 or decreased by the aggregate amount of loss and deduction to be allocated to the Partners pursuant to Section XVIII.A.2.

"Percentage Interest" means, at any time, with respect to any Partner, the percentage set forth on ***Exhibit [X]*** as the Percentage Interest of such Partner. The Percentage Interests will be adjusted from time to time in accordance with this Agreement. At all times, the sum of the Percentage Interests of all Partners will equal 100 percent.

"Operating Expenses" means all ordinary and necessary costs, expenses, or charges with respect to the Partnership's operations, including payments of interest and principal and other monetary obligations due under any loan made to the Partnership (excluding loans to the Partnership from the Partners); accounting, legal, and auditing fees; taxes payable by the Partnership; public or private utility charges; sales and use taxes, and all related payroll taxes and withholding taxes; management fees; and all other advertising, management, leasing, governmental approval, and other operating costs, expenses, and capital expenditures actually paid with respect to the Partnership's Business and operations generally.

"Working Capital Reserve" means cash reserves (a) adequate for current and future working capital requirements of the Partnership (including Operating Expenses and capital improvements, as the case may be) as determined by the General Partner, (b) required by any loan agreements or similar arrangements to which the Partnership is subject, and (c) necessary to satisfy contingencies reasonably anticipated for, or associated with, the Partnership's Business, as determined by the General Partner.

XVI. CAPITAL CONTRIBUTIONS

A. <u>Capital Accounts</u>. The General Partner shall maintain a separate capital account for each Partner in accordance with the rules set forth in section 1.704-1(b)(2)(iv) of the regulations. Any Partner who is both a General Partner and a Limited Partner will have a single capital account for both interests.

XVII. DISTRIBUTIONS

A. <u>Distributions from Operations</u>. From time to time and at anytime before the Partnership's liquidation, Distributable Cash will be distributed, at the times the General Partner determines, to the Partners in proportion to their respective Percentage Interests on the distribution date.

B. <u>Distributions on Liquidation</u>. Upon the Partnership's liquidation and winding up, after adjusting the Capital Accounts for all distributions made under this Article VII and all allocations under Article VIII, all available proceeds as determined under Section IX.A will be distributed to the Partners in proportion to their respective Percentage Interests.

C. <u>Working Capital Reserve</u>. At any time and from time to time, the General Partner may establish and maintain a Working Capital Reserve for the Partnership. If and to the extent the General Partner determines that unused funds in the Working Capital Reserve are no longer required to be maintained, those funds will be released from the Working Capital Reserve and treated as Distributable Cash.

XVIII. ALLOCATIONS

A. <u>Allocations of Profits and Losses</u>.

1. <u>Profits</u>. Partnership income and gain for each allocation period shall be allocated to the Partners as follows:

a. First, to the Partners in proportion to and to the extent, if any, of their negative capital account balances at the end of such period; and

b. The balance, if any, to the Partners in such proportions and in such amounts as would result in each Partner's capital account balance at the end of such period equaling, as nearly as possible, that Partner's share of the then Partnership Capital determined by calculating the amount that Partner would receive if an amount equal to the Partnership Capital were distributed to the Partners in accordance with the provisions of Section VII.B.

2. <u>Losses</u>. Partnership loss and deduction for each allocation period shall be allocated to the Partners as follows:

a. First, to the Partners in proportion to and to the extent, if any, of their positive capital account balances at the end of such period; provided, however, if the amount of loss and deduction to be allocated is less than the sum of the capital account balances of all of the Partners having positive capital account balances, then such loss and deduction shall be allocated to the Partners in such proportions and in such amounts as would result in each Partner's capital account balance at the end of such period equaling, as nearly as possible, that Partner's share of the then Partnership Capital determined by calculating the amount that Partner would receive if

an amount equal to the Partnership Capital were distributed to the Partners in accordance with the provisions of Section VII.B; and

b. The balance, if any, to the Partners in proportion to their Percentage Interests.

B. Special Allocations. The following special allocations will be made in the following order and priority:

1. Minimum Gain Chargeback. This Agreement incorporates the "minimum gain chargeback" provisions set forth in sections 1.704-2(f) and (g) of the regulations (which shall apply as provided in those regulations).

2. Partner Nonrecourse Debt Minimum Gain Chargeback. This Agreement incorporates the "partner nonrecourse debt minimum gain chargeback" set forth in sections 1.704-2(i)(4) of the regulations (which shall apply as provided in those regulations).

3. Qualified Income Offset. This Agreement incorporates the "qualified income offset" set forth in sections 1.704-1(d) of the regulations as if its provision were fully set forth in this Agreement.

4. Nonrecourse Deductions. Any "partnership nonrecourse deduction" (as defined in section 1.704-2(b)(1) of the regulations) will be allocated to the Partners in proportion to their respective Percentage Interests.

5. Partner Nonrecourse Deductions. Any "partner nonrecourse deduction" (as that term is defined in section 1.704-2(i)(2) of the regulations) will be allocated to the Partner that bears the economic risk of loss (as determined under section 1.752-2 of the regulations) for the partner nonrecourse debt giving rise to such deduction, all in accordance with section 1.704-2(i)(1) of the regulations.

XIX. LIQUIDATION AND WINDING-UP

A. Mechanics.

1. Distributions. All Partnership assets remaining after the payment of Partnership debts, liabilities, and obligations and the establishment of cash reserve funds in accordance with this Agreement must be distributed among the Partners in accordance with the provisions of Section VII.B. If at any time, whether before or after the Partnership terminates, any of the funds placed in reserve under this Article IX are released, the funds will be distributed in accordance with this Article IX.

B. Insufficient Assets. Partners must look solely to the assets of the Partnership for the return of their Capital Contributions. No Partner will have any recourse against any other Partner solely because the funds remaining after the payment or discharge of the Partnership debts and liabilities are insufficient to return those Capital Contributions.

C. Deficit Capital Accounts. Except as otherwise expressly provided in this Agreement, at no time during the Partnership's term or upon the Partnership's dissolution and liquidation will a Partner with a negative balance in its Capital Account have any obligation to the Partnership, any other Partners or any other person to restore the negative balance.

Update on the Application of the Step Transaction Doctrine to Gifts of Partnership Interests

Daniel H. McCarthy
The Blum Firm, P.C.

Update on the Application of the Step Transaction Doctrine to Gifts of Partnership Interests

Daniel H. McCarthy[1]
The Blum Firm, P.C.

In a previous article which appeared in The Texas Tax Lawyer[2], I analyzed arguments raised by the IRS to deny discounts taken by taxpayers in valuing gifts of interests in limited partnerships or limited liability companies. There have been two subsequent cases decided in favor of the IRS which provide some additional guidance as to issues left unresolved by the prior decisions.[3]

Linton v. United States

In *Linton*[4], William Linton formed WLFB Investments, LLC in November, 2002. On January 22, 2003, Mr. Linton executed documents to memorialize the following actions: (i) gift of a 50% interest in WLFB Investments to his wife, Stacy; (ii) transfer of an undeveloped parcel of real estate to WLFB Investments; (iii) authorization to transfer securities and cash to WLFB Investments. In addition, on January 22, 2003, the Lintons also created trusts for each of their four children and executed undated assignments transferring a 22.50% membership interest in WLFB Investments to the each of the four trusts.[5] The Lintons' attorney testified that he mistakenly dated the assignments January 22, 2003 but intended to date them January 31, 2003, which was the date on which the transfer of the assets to WLFB Investments was to be completed. The Lintons filed gift tax returns for 2003 reporting the gifts and disclosing that the interests were valued using a 47% discount for lack of marketability and lack of control.[6]

The IRS audited the gift tax returns and denied the discounts take by the Lintons. The Lintons paid the deficiency and filed a claim for refund.[7] The IRS set forth two arguments as a basis for denying the discounts. The first argument was that the purported gifts of membership interests were actually indirect gifts of the underlying assets in WLFB Investments, and the second argument was that the step transaction applied to the transaction.

Indirect Gift Argument

The court reviewed several Tax Court cases addressing the question of whether a purported gift of a membership interest or partnership interest was, in fact, a gift of an interest in the underlying assets of the entity. In reviewing the prior decisions of the Tax Court, the court noted that the sequence of events related to the formation of the entity and gifting of the interests is very important. Specifically, the court discussed that if the membership interests are transferred prior to the completion of the funding, then the subsequent transfer of assets to the entity can result in a gift of the underlying assets directly to the transferees and a deemed contribution of those assets by the transferees to the entity.[8]

In *Linton*, the sequence of events surrounding the formation of WFLB Investments and the gifting of the interests to the trusts was uncertain. The court found that, in spite of the

attorney's assertion that he intended to date the trust agreements and assignment documents January 31 instead of January 22, the effective date of the trusts and gift assignments was January 22. The court found that the Lintons failed to meet their burden of proof that the gifts of the membership interests occurred subsequent to the contribution of assets to WFLB Investments.

The court concluded that since the formation of the trusts and gifting of membership interests to the trusts both occurred on January 22, 2003, which was the same day that the assets were contributed to WFLB Investments, the fact situation was similar to that in *Shepherd*[9] and *Senda*[10]. As a result, the court determined that the Lintons made indirect gifts of a pro-rata share of the underlying assets to the trusts.[11]

Step Transaction Doctrine

Even though the court found in favor of the IRS on the indirect gift argument, it also addressed the other argument raised by the IRS that the step transaction applied to the gifts of the membership interests.[12]

Courts are sometimes unwilling to review the merits of a single action without considering the impact of that action in conjunction with other actions which comprise a single transaction. Such judicial review is commonly referred to as the "step transaction doctrine" and courts have developed three separate tests to analyze its applicability: (i) the binding commitment test which is satisfied when a taxpayer has a legal obligation to complete all steps comprising a transaction[13]; (ii) the interdependence test which is satisfied when a taxpayer would not have undertaken an action without planning to undertake further actions in completion of a transaction[14]; (iii) the end result test which is satisfied if a series of separate steps are really prearranged parts of a single transaction designed to reach a specific result.[15]

The court analyzed the facts of *Linton* under each of the three tests. The court found that that since the trusts and gift assignments were executed contemporaneously with the formation and asset conveyance documents, a binding commitment existed so, presumably, the Lintons were obligated to convey the assets to WFLB Investments and gift the interests to the trusts.[16] In analyzing the interdependence test, the court found that the Lintons would not have formed WFLB Investments and made the gifts to the trusts *but for* the anticipated discounts for lack of marketability and lack of control in valuing the membership interests.[17] In analyzing the end result test, the court found that the Lintons had a clear "subjective intent to convey as much property as possible to their children while minimizing their gift tax liability, pursuant to which they crafted, with the aid of an attorney and a tax advisor, a scheme consisting of 'pre-arranged parts of a single transaction.'"[18]

The court noted that it would be possible to avoid the step transaction doctrine if the underlying assets contributed to WLFB Investments were of a nature that they would fluctuate over a short period of time such as marketable securities as was the case in *Gross*[19] and *Holman*[20] and there was a meaningful period of time between the contribution of the assets to WFLB Investments and the gift of the membership interests. However, both *Gross* and *Holman*

were different from *Linton* in that that formation and funding of WLFB Investments and the gifting of the membership interests occurred simultaneously and, in addition, the assets held by WFLB Investments (cash, real property, and municipal bonds) were not of a nature to fluctuate in value so as to cause an economic risk of a decrease in value.[21]

Heckerman v. United States

In *Heckerman*[22], Mr. and Mrs. Heckerman created trusts for their two children as well as three separate limited liability companies: (i) Heckerman Investments, LLC ("Heckerman Investments"); (ii) Heckerman Real Estate, LLC ("Heckerman Real Estate"); (iii) Heckerman Family, LLC ("Heckerman Family") on November 28, 2001. Heckerman Family served as a holding company with Heckerman Investments and Heckerman Real Estate as wholly-owned subsidiaries.[23]

The Certificates of Formation for each of the three LLCs were issued by the Secretary of State of Washington on December 21, 2001. Subsequently, Mr. and Mrs. Heckerman conveyed residential real estate to Heckerman Family on December 28, 2001 and then the real estate was subsequently conveyed by Heckerman Family to Heckerman Real Estate. On January 11, 2002, Mr. and Mrs. Heckerman transferred certain cash accounts to Heckerman Investments. Finally, Mr. and Mrs. Heckerman transferred 1,217.65 units in Heckerman Family to each of trusts established for their children. Mr. and Mrs. Heckerman then executed a document admitting the trusts as substitute members in Heckerman Family as of January 11, 2001.[24]

Mr. and Mrs. Heckerman obtained an appraisal of the transferred membership interests in order to report the transfers on a gift tax return. The appraisal reflected a discount of 58% from net asset value due to lack of marketability and lack of control. Upon audit, the IRS challenged the valuation of the membership interests using two arguments. The first was that the transfer of the cash to Heckerman Investments was an indirect gift of a proportionate share of the cash to the trusts. The second was that the step transaction should apply to treat the contribution of the cash and gift of membership interests as part of the same transaction. The Heckermans then paid the additional gift tax and filed a claim for refund.[25]

Indirect Gift Argument

The *Heckerman* court first addressed the indirect gift argument and reviewed prior case law as in *Linton*.[26] The court then looked at the facts surrounding the formation and transfer of the membership interests in Heckerman Family and pointed out that the IRS did not allege that the Heckermans made an indirect gift of the real estate to the trusts for children.[27] The court found that the taxpayer was unable to meet the burden of proof to demonstrate that the contribution of the cash to Heckerman Investments was completed prior to the transfer of the membership interests in Heckerman Family to the trusts for the children. The evidence indicated that the gift assignment documents were received by Mr. Heckerman on January 11, 2002 and were prepared by the attorney to be effective as of that date. The court was unpersuaded by testimony from Mr. Heckerman that he and his wife did not actually sign the documents on January 11, 2002 and pointed to email exchanges between Mr. Heckerman and an appraiser in

which the January 11, 2002 date was used as the date of the gifts and the date of the contribution of the cash to Heckerman Investments.[28]

Step Transaction Argument

Even though the *Heckerman* court found that the taxpayers made an indirect cash gift to the trusts, that Court did address the step transaction argument raised by the IRS as in *Linton*. The court then examined in the contribution of cash and gifting of membership interests under the three separate tests developed by courts in analyzing the step transaction doctrine. The court found that the end result test was applicable because the taxpayers had a goal of transferring property to their children while minimizing their transfer tax liability.[29] The court also found the interdependence test to be applicable since the amount of cash transferred to Heckerman Investments was dependent upon the anticipated discounted value of transferring the membership interests in Heckerman Family as opposed to a direct transfer of the cash as set forth in an email sent by Mr. Heckerman. However, the court did not find that a binding commitment existed to transfer the cash to Heckerman Investments, nor make a gift of membership interests in Heckerman Family to the trusts. [30]

As in *Linton*, the court dismissed the taxpayers' argument that the step transaction doctrine should not be applied because of a lapse in time between the contribution of assets and gifting of interests as was the case in *Holman*[31] and *Gross*[32]. The court rejected this argument since the taxpayers were unable to demonstrate that there was a delay between the cash transfer and the gift of the membership interests so there was no real economic risk that the assets might decrease in value.[33]

Analysis

The decisions in both *Linton* and *Heckerman* again highlight the importance of ensuring that a taxpayer sequentially complete the steps to form and fund a partnership or LLC prior to making gifts to children in order to avoid the indirect gift argument. [34]

A taxpayer who fails to complete the funding of the entity runs the risk of making an indirect gift if the interests in the entity are gifted prior to completion of the funding. The results in *Linton* and *Heckerman* are not surprising with respect to the indirect gift argument given the decision in *Senda* and the fact that funding and gifting were done on the same day.

One important point to note with respect to the indirect gift argument is that the taxpayers in *Heckerman* contributed residential real estate to Heckerman Family on December 28, 2001 (which was then subsequently conveyed to Heckerman Real Estate) 14 days prior to the gifts of the membership interests in Heckerman Family to the trusts for their children. It does not appear that the IRS raised the argument of an indirect gift with respect to the contribution of real estate.

The decisions of the Tax Court in *Holman* and *Gross* both included language that the Tax Court may have been more willing to apply the step transaction doctrine if the assets contributed to the respective LLCs had not be heavily traded marketable securities. While the 14 day period

between contribution and gifting in *Heckerman* was longer than that in *Holman* (six days) and *Gross* (11 days), the nature of the asset transferred in *Heckerman*, residential real estate, seems to be the type of asset which the IRS could assert would not fluctuate in value between date of contribution and date of gifting.

Taxpayers may take some comfort that the IRS did not raise the indirect gift or step transaction doctrine with respect to a transfer of real estate to an LLC 14 days prior to a gift of membership interests, but the language used by the court in *Heckerman* with respect to the end result and interdependence tests under the step transaction doctrine[35] indicate that the Court may have been receptive to such an argument. It seems certain that the IRS will continue to raise the indirect gift and step transaction doctrine with respect to gifts of partnership or membership interests.

---

[1] Daniel H. McCarthy dmccarthy@theblumfirm.com.
[2] *See* Daniel H. McCarthy, *Application of the Step Transaction to Transfers of Partnership Interests*, 36 The Texas Tax Lawyer 29 (2009).
[3] *See* Holman v. Commissioner, 130 T.C. No. 12 (2008), and Gross v. Commissioner, 96 TC Memo 2008-221.
[4] Linton v. U.S., 104 AFTR 2d 2009-5176 (2009).
[5] *Id*. at 5176-77.
[6] *Id*. at 5177.
[7] *Id*. at 5176.
[8] *Id*. at 5179-80 (discussing Shepherd v. Commissioner, 115. T.C. 376 (2000) *aff'd*, 283 F.3d 1258 (11th Cir. 2002); Estate of Jones v. Commissioner, 116. T.C. 121 (2001); *Gross* at 221; and, Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006)); for a discussion of these cases *see supra* note 2.
[9] *Shepherd,* at 376.
[10] *Senda*, at 1044.
[11] *Linton*, at 5182.
[12] *Id*.
[13] *See* Commissioner v. Gordon, 391 U.S. 83, 96 (1968).
[14] *See* Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181, 197 (1989).
[15] *See* King Enterprises v. U.S., 418 F.2d 511, 516 (Ct. Cl. 1969).
[16] *Linton,* at 1183.
[17] *Id*.
[18] *Id*. citing Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987).
[19] *Gross,* at 1170 (11 day period of time between funding of LLC and gifting of membership interests sufficient time for underlying marketable securities to fluctuate in value).
[20] *Holman,* at 114 (six day period between funding of LLC with Dell stock and gift of membership interests sufficient time for fluctuation in value).
[21] *Linton,* at 5184.
[22] Heckerman v. U.S., 104 AFTR 2d 2009-5551.
[23] *Id*. at 5552.
[24] *Id*.
[25] *Id*.
[26] *Id*. at 5554-5.
[27] *Id*. at 5556.
[28] *Id*. at 5556-7.
[29] *Heckerman*, at 5559.
[30] *Id*. at 5560.
[31] *Holman*, at 114.
[32] *Gross*, at 121.
[33] *Heckerman*, at 5560.

[34] For a discussion of actions to mitigate this risk *see supra* note 2.
[35] *Heckerman,* at 5559 stating that ("the Plaintiffs clearly had a subjective intent to transfer to convey property to their children while minimizing their tax liability, pursuant to which they crafted, with the help of their attorneys and advisors, a scheme consisting of 'pre-arranged parts of a single transaction.).'"

Successor Liability for Texas Taxes in Private Foreclosure Sales – A Roadmap of Authorities

Matt Larsen and Jon Wellington
Baker Botts LLP

Successor Liability for Texas Taxes in Private Foreclosure Sales – A Roadmap of Authorities

Matt Larsen and Jon Wellington[1]
Baker Botts LLP

A rise in commercial loan defaults has led to an increased use of private, nonjudicial foreclosure sales, some of which are referred to as "friendly foreclosures," whereby the secured creditor ("Lender") and defaulting party ("Borrower") arrange for a sale of Borrower's secured assets to a third-party purchaser ("Buyer"). While nonjudicial foreclosures avoid the time and expense of a judicial foreclosure sale, they may increase the risk of Buyer and/or Lender succeeding to the Texas tax liabilities of Borrower. This is a particular concern in a distressed sale because distressed companies are more likely to have unpaid tax liabilities and are less likely to be able to indemnify purchasers against such liabilities. After providing a brief overview of the statutory and regulatory provisions governing successor liability, this article discusses the Texas authorities with which Buyer and Lender should be familiar when conducting a purchase of assets via private foreclosure.

I. Overview of Successor Liability Provisions

The purchaser of a business (or the stock of goods of the business) that is liable for any Texas tax imposed under Title 2 of the Texas Tax Code becomes liable for taxes, penalties, and interest owed by the seller unless the purchaser withholds from the purchase price an amount sufficient to pay the taxes due or the seller provides a receipt from the Comptroller showing that the amount has been paid or that no tax is due.[2] Taxes imposed under Title 2 for which the purchaser may become liable include sales and use tax, franchise tax, gross receipts tax, business permit tax and severance tax. Failure to withhold an amount sufficient to pay the taxes or to receive a certificate of no tax due will result in the purchaser becoming liable for the taxes due up to the amount of the purchase price.[3] The Comptroller has up to 90 days to issue a certificate of no tax due.[4] The Comptroller may assess the successor of a business within four years from either the date the seller sells the business or the date the Comptroller's assessment is made against the seller, whichever is later.[5]

To determine whether a "business" has been sold, the Comptroller will examine the transaction to determine what the parties intended to sell.[6] It is possible for the Comptroller to determine that a business has been sold even if few assets were transferred. Depending on the type of business, a "business" may have been sold if the owner sells one or more of the following: the business's capital assets, goodwill or name, inventory, or fixed assets and realty necessary to operate a similar business at the same location.[7] This Article does not discuss how the Comptroller has interpreted what it means to sell a business or the stock of goods of the business. Where the Borrower's "business" is transferred in a private foreclosure, and where a certificate of no tax due cannot be obtained because Borrower has unpaid Texas tax liabilities, Lender and/or Buyer may have exposure under the above provisions. As discussed below, however, a number of administrative authorities promulgated by the Texas Comptroller of Public Accounts ("Comptroller") provide a roadmap for avoiding successor liability in certain private foreclosure situations.

II. Administrative Exception to Successor Liability for Foreclosure Sales

A. Decisions Establishing Foreclosure Sale Exception

The earliest authority on this matter provided that a foreclosure sale, where all formalities are observed, is not a sale of a business or stock of goods, and therefore the successor liability statute is not applicable.[8] A 1983 ruling shed some light on the Comptroller's reasoning by explaining that successor liability requires a "sale" and "purchase" of a business - "repossession" and "foreclosure" are not a "sale" or a "purchase" under the plain meaning of these terms (Webster's Dictionary) or under the Comptroller's policy.[9]

The Comptroller has found that successor liability statute does not apply to a properly-conducted foreclosure sale even if Buyer operates Borrower's business under the same name and location. A 1981 letter ruling held that a series of transactions by which a bank foreclosed on a UCC lien on substantially all the assets of a restaurant pursuant to the procedures of the UCC, and subsequently resold these assets to an unrelated restaurant which operated the restaurant under the same name and at the same location as the old restaurant, did not give rise to successor liability for the bank or the new restaurant.[10]

The Comptroller reached the same conclusion even where a foreclosure sale served to pass title to the collateral directly from Borrower to Buyer. In Comptroller's Decision 24,563 - 24,569 (1989), the Tax Division argued that Buyer had successor liability because, under commercial law, Lender never had title to the collateral and the foreclosure deed was a conveyance directly from Borrower to Buyer. Nonetheless, the Comptroller held that in the "peculiar situation in which a creditor is the seller of the property of a debtor in possession, the creditor is not the party owing the tax to the state and therefore the purchaser does not succeed to the liability of the debtor in possession." The decision reasoned that the tax code defines a sale as being made when one party, for consideration, transfers title or possession of tangible personal property to another. At a foreclosure sale, Lender causes title or possession to transfer at Lender's time of choosing, and Borrower has no choice but to follow Lender's instructions. The Comptroller held that Lender was therefore the seller for purposes of the successor liability statute. Because Lender was not the party owing tax to the state, Buyer did not succeed to Borrower's liability.[11]

A 1996 letter ruling, which is still cited by officials at the Comptroller's Office, summarizes the Comptroller's policy regarding the application of the successor liability statute to nonjudicial foreclosure sales.[12] Even though the ruling is related to hotel occupancy tax, it is equally applicable to sales and other taxes.[13] In the ruling, the Comptroller considered the successor liability consequences of four scenarios. The first was Bank's acquisition of the assets of Hotel in a nonjudicial foreclosure and operation of the business until it was sold to Buyer. The Comptroller held that because Bank formally foreclosed on and repossessed Hotel's assets, Bank did not have successor liability for Hotel's tax. Buyer was also not liable for Hotel's tax, although Buyer was liable for any tax incurred while Bank operated the business. The Comptroller reached the same successor liability conclusion under the second scenario, in which Bank acquired Hotel's assets in a nonjudicial foreclosure and sold them to Buyer without operating them. In the third and fourth scenarios, however, Bank acquired Hotel's assets by a deed in lieu of foreclosure as opposed to in a formal foreclosure action. There, the Comptroller

held that Bank had successor liability for Hotel's tax up to the amount of Hotel's debt forgiven in exchange for the deed, and that Buyer had successor liability for any of Hotel's tax succeeded to and unpaid by Bank, up to the amount Buyer paid Bank.[14]

B. Application of Exception to Texas Private Foreclosures

Letter 9605L1409B09, cited above, indicates that the Comptroller will not apply the successor liability statute to dispositions of collateral under a valid nonjudicial foreclosure sale. As a matter of practice, nonjudicial foreclosure sales are contemplated by Article 9 of the Uniform Commercial Code (UCC). Although the Comptroller's authorities do not expressly recognize that sales conducted pursuant to Texas Business and Commerce Code (TBCC) § 9.610 are valid nonjudicial foreclosure sales, Texas court cases and commentaries make clear that such sales are in fact valid nonjudicial foreclosure sales.

As a preliminary matter, Title 1 of the TBCC is clearly intended to be Texas' implementation of the Uniform Commercial Code. TBCC § 9.610, entitled "Disposition of Collateral Under Default," contains provisions identical to those in UCC § 9-610. Courts recognize that the TBCC has been interpreted to recognize two basic types of foreclosure sales that may be made after default - a judicial sale and a nonjudicial sale by the secured party conducted under TBCC § 9.610.[15] TBCC § 9.610 provides for the nonjudicial sale of repossessed collateral in a private transaction.[16] TBCC § 9.610 provides that after default, a secured party may sell, lease, license, or otherwise dispose of any or all collateral, provided that it does so in a commercially reasonable manner.[17] If the statutory requirements are met, such sales have been held to be valid nonjudicial foreclosure sales.[18] Commentators also refer to sales of personal property under TBCC § 9.610 as nonjudicial foreclosure sales.[19]

III. Transactions Falling Outside the Administrative Exception

A. Direct Transfer from Borrower to Buyer

Notwithstanding the above authorities, if the foreclosure formalities outlined above are not strictly observed, a transfer of assets from Borrower to Buyer may not fall within the foreclosure exception to successor liability. Comptroller authorities have held that Buyer has successor liability for Borrower's tax where Borrower's assets were transferred directly to Buyer "in lieu of" the surrender of the assets to Lender, even though Lender was party to the agreement, the agreement stipulated that Lender was foreclosing on Borrower's assets, and that the direct transfer of the assets was done with Lender's approval.[20] The Comptroller found successor liability because there was a direct transfer of assets to Buyer and the transaction did not involve a formal foreclosure on the collateral by Lender.

The Comptroller reached the same conclusion even where Lender ordered Borrower to surrender possession of the collateral to Lender, but Lender requested Borrower continue its operations until a buyer could be found.[21] Because Borrower entered into an agreement to sell the collateral to Buyer, the Comptroller held that successor liability applied because Buyer bought the assets directly from Borrower. The Comptroller reached this conclusion even though Buyer argued that its purchase was excluded from successor liability because it was essentially a purchase in bankruptcy from a bankruptcy trustee. Lender's failure to foreclose on the collateral

meant that there was no nonjudicial foreclosure, despite the fact that Lender ordered Borrower to assemble the collateral and make it available to Lender pursuant to the TBCC. The Comptroller reasoned that although Lender could have foreclosed on the collateral and then sold it to Buyer, it did not do so.

B. Consideration from Lender to Borrower

If Lender gives Borrower any consideration as part of its foreclosure of its collateral, the successor liability statute will be applicable. In Comptroller's Decision 43,959 (2004), Lender sold a store to Borrower in exchange for an installment note. Borrower defaulted, and Lender sent Borrower written notice that Lender would foreclose on the note and that "it would be best to handle this as a voluntary foreclosure." Borrower then executed a general warranty deed conveying the secured assets to Lender in exchange for discharge of the installment note. Lender then leased the store to Buyer. The Comptroller held that Lender could be held liable for Borrower's outstanding tax liability because its acquisition of the installment note through the general warranty deed was a purchase of the property, the consideration for which was discharge of the installment note. The Comptroller went on to hold that Buyer did not have successor liability because at the time of the decision, no liability had been assessed against Lender, and a purchaser can succeed only to the liability of the party from whom assets are purchased directly. However, the decision suggests that if Lender had been assessed for Borrower's liabilities, Buyer could succeed to any such liabilities not paid by Lender.

C. Fraud, Collusion or Non-Arm's Length Dealing

Unsurprisingly, if a transaction involves fraud, collusion or non arms-length dealing, the Comptroller is unlikely to grant the administrative exception, as made clear in Comptroller's Decision 29,568 (1994). In that decision, the original owner sold four stores to Buyer 1, with an installment note as part of the consideration. The original owner subsequently took the stores back and sold them to Buyer 2, but no evidence was presented to confirm how the take-back of the stores was accomplished (i.e., whether through foreclosure and repossession or deed in lieu of foreclosure). The Comptroller noted that if the transaction had involved a foreclosure in which fraud, collusion, or non arms-length dealing between Buyer 2 and Original Owner or Buyer 1 had been proven, Buyer 2 would have succeeded to Buyer 1's tax liability, but no evidence of this had been presented.

IV. Application

Based on the above authorities, parties might draft their transactional documents to increase the likelihood that their transaction falls under the administrative exception to successor liability. First, the asset purchase agreement could make clear that it involves a formal foreclosure of the assets by Lender, and Lender did not discharge Borrower's debt or otherwise receive consideration from Borrower in connection with this exercise of control over the assets. Second, the asset purchase agreement could recite that Lender will make a nonjudicial, private foreclosure sale of Borrower's assets to Buyer pursuant to UCC § 9-610, with the term "UCC" defined as the Uniform Commercial Code in effect for Texas. Finally, the asset purchase agreement night make clear that Lender, not Borrower, is the seller of the assets, and might eliminate references to Borrower where possible.

[1] Matt Larsen is a partner, and Jon Wellington is an associate in Baker Botts' State and Local Tax Section. They each practice in the firm's Dallas office.
[2] Tax Code § 111.020(a).
[3] Tax Code § 111.020(b).
[4] Tax Code § 111.020(c).
[5] Tax Code § 111.020(e)
[6] 34 Tex. Admin. Code 3.7(d).
[7] Id.
[8] Comptroller's Decision 8,304 (1977).
[9] Letter Ruling 8310L1140F14 (1983).
[10] Letter Ruling 8101L0316B09 (1981).
[11] The Comptroller reached the same conclusion under similar facts in Comptroller's Decision 22,978 (1989), .
[12] Letter 9605L1409B09.
[13] This ruling was incorporated into the August 1996 edition of the Comptroller's Tax Policy News.
[14] Comptroller's Decision No. 43,959 (2004) confirmed the ongoing validity of the Comptroller's position.
[15] *Hubbard v. Lagow*, 576 S.W.2d 163 (Tex. Civ. App - Austin 1979).
[16] *Knight v. General Motors Acceptance Corporation*, 728 S.W.3d 480 (Tex. App. - Fort Worth 1987).
[17] TBCC § 9.610(a) and (b). This article does not discuss what it means for the disposition to be "commercially reasonable."
[18] *Gailani v. Riyad Bank*, No. 08-999-00139-CV (Tex. App - El Paso 2003). Although this and the other cases discussed in this section were decided under the former version of Article 9, this decision makes clear that TBCC § 9.610 is a recodification of former TBCC § 9.504.
[19] *See,* e.g., Baggett, Texas Foreclosure Law and Practice, Vol. 15 § 1.69 (2001).
[20] Comptroller's Decision 39,257 (2001).
[21] Comptroller's Decision 42,137 (2003).

State Bar of Texas Tax Section's
Annual Law Student Tax Paper Competition

James K. Rowland
University of Houston Law Center, LL.M.
Class of 2009

State Bar of Texas Tax Section's Annual Law Student Tax Paper Competition

The State Bar of Texas Tax Section's Annual Law Student Tax Paper Competition is designed to encourage and reward scholarly writings on legal subjects within the scope of the section. The State Bar of Texas Tax Section congratulates James Rowland from The University of Houston Law Center, the winner of its 2009 Annual Law Student Tax Paper Competition. James Rowland's winning article entitled "Tax Implications for Natural Resource Master Limited Partnerships" is published below.

Numerous entries were received which were all impressive in their own right. The judging panel reviewed each paper anonymously, without knowing the students' names or their law school affiliations. The papers were judged on the following four criteria:

- Legal analysis
- Legal research
- Organization and writing style
- Originality and relevance of topic to current tax matters

Notably, the Annual Law Student Tax Paper Competition provides a $1,000 award to its winner and additional awards for second and third places in the judges' discretion. All J.D. and L.L.M. degree candidates attending accredited Texas law schools either on a part-time or full-time basis at the time the paper is written are eligible. Students can write on any federal or state tax topic. Papers must be sponsored by a law school faculty member and only one paper per student may be submitted. All entries must be received after January 15th and before June 16th in the year of the competition and winners will be notified no sooner than July 15th in the same year. For additional information regarding the competition, please visit the section's website at http://www.texastaxsection.org/.

Tax Implications for Natural Resource Master Limited Partnerships

by James Rowland[1]

TABLE OF CONTENTS

Page

I. General Background of MLPs 2

A. "Master Limited Partnership" Defined 2

B. Legal Structure 2

1. The MLP as a Limited Partnership 2

2. MLP as a Limited Liability Company 3

C. Economic Structure 3

1. High Split Incentive Distribution Rights 4

2. Subordinated Units Incentive Distribution Rights 5

D. Legal Issues Regarding Formation 5

1. Asset Transfers 5

a. Assets Transferred From a Partnership 5

b. Assets Transferred From a Corporation 5

2. Securities Laws 6

II. Tax Issues – Qualifying For Partnership Treatment 8

A. History 8

1. Corporate/Partnership Determination 8

2. 1987 Revenue Reconciliation Act 8

3. Check the Box 8

B. Section 7704 8

1. Qualifying Income 9

2. Qualifying Income Defined 9

a. Dividends 9

b. Natural Resources 10

i. Step One: What Are Mineral or Natural Resources? 10

ii. Step Two: Are the MLP's Activities In Connection With Mineral or Natural Resources? 10

C. Loss of Qualifying Status 12

D. Tax Implications of an MLP Taxed as a Partnership 12

1. Tax Advantages 12

a. One Level of Tax 12

TABLE OF CONTENTS

Page

b. Basis Shield 13

c. Section 754 14

2. Tax Disadvantages 14

a. Accounting 14

b. Limitation on Mutual Fund Investors 14

c. Disadvantages for Tax Exempt Organizations 15

d. Disadvantages for Foreign Investors 15

e. Passive Loss Rules 15

III. Natural Resource MLPs 16

A. Oil and Gas MLPs 16

1. History 16

2. Upstream v. Midstream 16

3. Addressing Net-Profits Interests 17

a. Types of Oil and Gas Interests 17

b. Taxation of Energy Resources -- Economic Interest 18

c. Interests in MLPs Not Treated as Unrelated Business Taxable Income Per Se 18

d. Possible Plan for Attracting TEOs 19

e. Additional Obstacle to TEO Investment: Unrelated Debt Financed Income 21

i. Possible Solutions 21

B. "Green" Resource MLPs 22

1. Biofuels 22

2. Carbon Dioxide Storage 23

IV. Current Opportunities and Developments 24

A. Market Opportunities and Challenges 24

B. Important Legislative Developments 24

Introduction

The master limited partnership ("MLP") is an obscure, relatively unknown, and somewhat scarcely used business entity. Today, there are only about 97 MLPs that are traded on the major securities exchanges,[2] most of which are found in the energy, investment and business sectors. Some MLPs, such as the Blackstone Group and Kinder Morgan are well known, but most are not. Generally, MLPs are considered a tax advantaged way to invest in certain sectors (such as the energy sector) while retaining investment liquidity.

The first entity to use the term "master limited partnership" was Apache Petroleum Co., which was formed in 1981.[3] The concept of an MLP originated in the oil and gas industry, but soon spread to a wide variety of business ventures, "ranging from hamburger franchising (Burger King Master L.P.) to professional basketball (Boston Celtics Limited Partnership)."[4] The use of MLPs grew in popularity because an MLP offered both the tax advantages of a partnership (pass-through treatment with one level of tax) and the economic advantages of a corporation (the partnership interests could be readily sold like corporate stock). However, Congress has limited the use of the MLP entity to businesses engaged in the small number of business sectors mentioned above.[5]

Particularly in the oil and gas industry, the use of the MLP structure has followed the boom and bust cycle of the industry. Most of the oil and gas MLPs created during the 1980's failed when the price of oil fell in the latter half of that decade.[6] Then the late 1990's saw a resurgence of MLPs in the energy sector when companies created MLPs from their oil and gas pipeline businesses and similar businesses relating to the storage and shipping of oil and gas. Over half of today's MLPs concern these types of activities.[7] The use of the MLP by pipeline businesses has reduced the businesses' exposure to volatile commodities prices when compared to businesses involved in the production of oil and gas.[8]

However, with today's increased demand for the exploration and production of oil and gas, there has been a resurgence of MLPs in this sector. Linn Energy LLC marked the return of oil and gas producing MLPs when it made its initial public offering in 2006.[9] Today, there are about 11 exploration and production MLPs.[10]

Furthermore, Congress has recently passed legislation allowing businesses related to biofuels and industrial source carbon dioxide to use the MLP structure.[11] Therefore, the use of MLPs in industries related to the biofuels and industrial carbon dioxide will likely see widespread use. In addition, as the scope of MLPs is expanded to include more renewable energy activities, it is likely that the use of MLPs will increase in this sector as well.

This four-part paper provides a general understanding of MLPs, with a focus on natural resource MLPs. This paper's focus on natural resources narrows to oil and gas MLPs, biofuels MLPs and carbon sequestration MLPs. It also evaluates the potential opportunities and challenges that face natural resource MLPs resulting from current market and legislative developments. Part I of this paper defines MLPs, explaining the legal and economic structure of MLPs, and addressing legal issues with respect to formation of an MLP. Part II addresses the tax issues affecting MLPs and considers the tax advantages and disadvantages of MLPs. Part III narrows the focus to natural resource MLPs, in particular to those involved in oil and gas,

biofuel, and carbon sequestration MLPs. Part IV evaluates current opportunities and challenges facing MLPs as a result of market and legislative developments.

I. General Background of MLPs

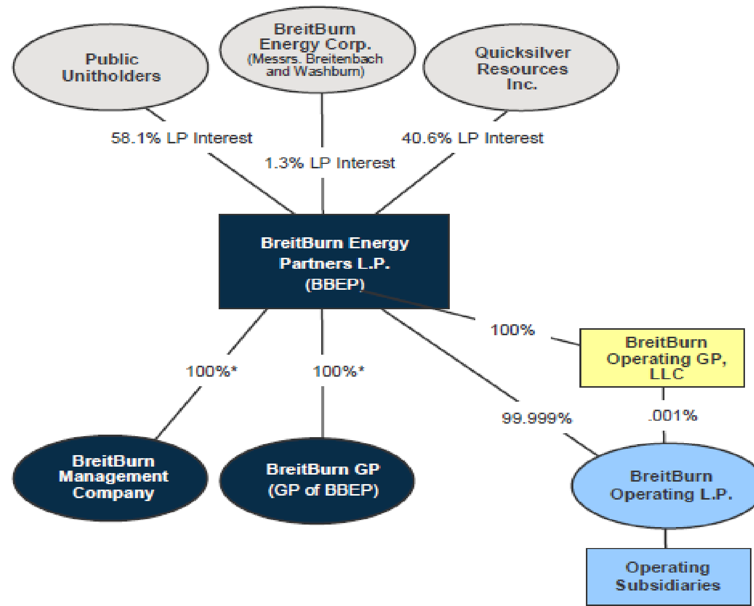
A. "Master Limited Partnership" Defined

A master limited partnership (also referred to as a "publicly traded partnership"[12]) is a foreign or domestic partnership whose partnership interests are traded on an established securities market or are readily tradable on a secondary market (or its substantial equivalent).[13] Generally, an MLP is taxed as a corporation.[14] However, certain MLPs that were grandfathered under the 1987 Revenue Reconciliation Act or that earn at least 90% of their income from certain "passive-type" qualifying income are taxed as partnerships.[15] Under state law, an MLP can be organized as any entity other than a corporation, but most often, an MLP is organized as a limited partnership.[16] When compared to other business entities, the advantages of an MLP include: "increased market valuation of underlying assets; ease in raising equity capital; and the creation of a substitute for cash in purchases or dividends through partnership units."[17]

B. Legal Structure

1. The MLP as a Limited Partnership

Typically an MLP is organized into 2 tiers. The first tier is the MLP itself, which is typically owned 2% (or less) by the general partner and 98% (or more) by the limited partners. The general partner is the promoter/original owner of the business that has been converted to an MLP. The general partner often owns many limited partner interests or "units."[18] The rest of the units are publicly owned. The second tier is an operating limited partnership ("OLP"), which owns and operates the assets of the business. The MLP will typically own a 99.999% limited partner interest and all of a limited liability company that owns the remaining interest in the OLP.[19] A look at the legal structure of Breitburn Energy Partners L.P. provides a better understanding of how MLPs are often structured.[20]



*Represents 100% membership interest.

Breitburn's organizational structure demonstrates how an MLP can be structured to protect investors from liability. At each level there is a general partner who is liable for the obligations of the partnership but has an insubstantial economic interest in the partnership. Through this structure, an MLP provides economic benefits to the limited partners while shielding them from liability. MLPs generally use the two tier structure for the same reasons that corporations use subsidiaries, to segregate the businesses "for operational accountability, liability, regulatory or state tax reason[s]."[21]

2. MLP as a Limited Liability Company

An MLP can also take the form of a limited liability company ("LLC"). LLCs are eligible entities that can elect pass-through treatment like a partnership.[22] Unlike an MLP organized as a limited partnership, the public unitholders in an MLP organized as an LLC have the right to vote on the way the business is run.[23] Additionally, an MLP organized as an LLC does not have a general partner or incentive distribution rights (explained in the section of this paper titled "Economic Structure"). However, since the public unitholders have voting rights, they can exercise those voting rights to ensure that distributions are made in a manner that is satisfactory to them.

C. Economic Structure

Investors in MLPs generally expect a consistent distribution of profits. MLP unitholders can take advantage of the MLP's deductions and credits, as well as the effective deferral of taxation on the MLP's cash distributions.[24] Since MLP units are often sought out by investors who want a higher after-tax yield on consistent distributions, MLPs are structured in a way that seeks to ensure consistent and frequent distributions. Such a structure is typically the result of the MLP's choice of industry and its partnership agreement.

To ensure a steady stream of distributions to the unitholders, an MLP requires a steady stream of income. One reason oil and gas pipeline MLPs are more common than oil and gas exploration MLPs is because pipeline businesses tend to generate a more reliable stream of cashflow than exploration businesses.[25] The relative stability enjoyed by pipeline businesses is due largely to decreased exposure to commodity price fluctuations and large capital losses such as dry holes.[26] Some MLPs seek to limit their exposure to such risks so that consistent distributions to their unitholders are possible.

An MLP generally uses its partnership agreement to incentivize the general partner to make regular distributions. Two common mechanisms used in MLP partnership agreements to incentivize the general partners to make distributions (referred to as "incentive distribution rights") are the use of "high splits" and the use of subordinated units.[27]

1. High Split Incentive Distribution Rights

A "high split" mechanism provides that the unitholders (limited partnership interest holders) get a high percentage of the distribution (e.g., 98% of the distribution to the unitholders and 2% to the general partner) until a certain fixed distribution amount is reached. After the predetermined amount is distributed, the ratio is changed so that the general partner receives a higher percentage of the distribution (e.g., 90% to the unitholders and 10% to the general partner).[28] This provides an incentive for the general partner to make a larger distribution so that it will get a larger percentage of the distributions.

As an example of a "high split" distribution agreement, assume that an MLP's partnership agreement stipulates that any required quarterly distribution of less than one dollar per unit is allocated 98% to the limited partners and 2% to the general partner. However, the partnership agreement also provides that any quarterly distribution equal to or greater than one dollar per unit is allocated 90% to the limited partners and 10% to the general partner. So, if there are 100,000 limited partnership units and the MLP makes a $0.90 per unit quarterly distribution, the total distribution is $90,000. Of that $90,000, 98% would go to the limited partners and 2% would go to the general partner. The limited partners receive $0.882 for each unit and the general partner receives $0.018 for each unit. In aggregate, the limited partners receive $88,200 and the general partner receives $1,800.

Alternatively, assume that instead of distributing $0.90 per unit, the MLP makes a $1.00 per unit distribution. In this case, the total distribution is $100,000. Of that $100,000, 90% goes to the limited partners and 10% goes to the general partner, meaning the limited partners get $0.90 for each unit and the general partner gets $0.10 for each unit. In aggregate, the limited partners receive a distribution of $90,000 and the general partner receives $10,000.

As the above examples illustrate, the high split arrangement compensates the general partner by $8,200 ($10,000 - $1,800) for meeting the distribution benchmark of $1.00 per unit rather than $.90 per unit. Even with these small numbers, it is clear that high split arrangements provide general partners significant incentives to meet distribution benchmarks. Table 1 in the Appendix summarizes the above examples.

An MLP has great flexibility in creating incentive distribution rights. Some MLPs create multiple levels of benchmarks to provide greater distribution incentives to the general partner (the general partner's share of the distribution increases for each higher distribution threshold met).[29] There is no legal limit to the number of benchmarks created by an incentive distribution rights mechanism.

2. Subordinated Units Incentive Distribution Rights

The use of subordinated units is another commonly employed incentive distribution rights mechanism. Subordinated units are limited partner units held by the general partner[30] that are subordinate to the units held by the public until a certain distribution benchmark is met. When the distribution benchmark is met, "the subordinated units convert over to ordinary limited partner units"[31] and the general partner receives a share of the distribution based on its limited partner units just like the public unitholders. If the distribution benchmark is not met, the general partner does not receive a distribution for the limited partnership units that it owns. This mechanism can provide an even greater incentive to the general partner to make distributions than the "high split" mechanism described above.

Although incentive distribution rights like those described above can result in consistent and substantial distributions to the partners, they can also jeopardize the availability of adequate capital for continued business operations and to insulate the MLP from market disruptions.[32]

D. Legal Issues Regarding Formation

1. Asset Transfers

For an MLP to be a going concern with value, assets must be transferred to it, generally from either a sole proprietorship, a partnership, or a corporation. Most asset transfers to an MLP are from a partnership or a corporation, so this discussion is limited to the law affecting transfers from those entities.

a. Assets Transferred From a Partnership

An asset transfer to an MLP from a partnership is usually accomplished through a "roll-up" transaction. A "roll-up" transaction occurs when a partnership contributes assets to an MLP in exchange for partnership interests of the MLP.[33] The contributing partnership is usually liquidated, with the partners receiving the MLP units in exchange for their partnership interest. This is generally considered a tax-free transaction.[34] The same transaction can be accomplished without the contributing partnerships liquidating.

b. Assets Transferred From a Corporation

An asset transfer to an MLP from a corporation is usually accomplished through a "roll-out" transaction. A "roll-out" transaction is a "corporate reorganization or liquidation followed by the transfer of assets to the [MLP] in exchange for partnership interests."[35] Alternatively, the corporation can transfer a portion of its assets to the MLP in exchange for a partnership interest without liquidating or merging.

The transfer of assets from a corporation to an MLP presents various potential problems. Transferring assets to the MLP in exchange for partnership interests would have the positive tax effect of transferring the assets tax-free.[36] However, practically speaking, such a transfer may be prohibited by certain debt obligations or regulatory restrictions, and may incur costs for re-obtaining certain permits, licenses and privileges.[37]

In some instances these obstacles are surmountable. Restrictions due to debt obligations, for instance, may be overcome by the MLP assuming or guaranteeing some of the debt of the corporation. However, assumption of the corporation's debt by the MLP will reduce the basis of the corporation's partnership interest and may even result in taxable gain to the corporation if the debt relieved exceeds the basis of the assets contributed.[38]

Additionally, the title transfer of oil and gas leases from one company to another can generally be accomplished with little difficulty. Generally, states treat mineral leases as real property interests[39] and simply require the transfer or "assignment" document to be filed with the county clerk of the counties where the leased property is located. Such documents can be easily produced by petroleum landmen skilled in such transactions (most companies will have databases that list all the leases it owns). Due diligence as to the title to the leases can be performed by petroleum landmen and title attorneys as well. Most likely, petroleum engineers, geologists, and appraisers will be required to value the leases, but this process is required under a corporate merger as well.

If a contributing corporation uses a merger to contribute the assets to an MLP the licensing and debt obligation issues may not arise, but it will not be a tax-free transaction.[40] Since the corporation is changing its form from a corporation to a partnership, the Internal Revenue Code's[41] tax-free reorganization provisions are inapplicable.[42] Under the tax rules, the merger of the corporation into a partnership will be treated as a deemed liquidation.[43] When a corporation is liquidated or sold in a taxable transaction, the corporation is taxed on the amount that the fair market value of its assets exceeds the basis of its assets.[44] Therefore, the tax consequences of the corporate merger might make the transaction cost prohibitive, especially if the corporation possesses appreciated assets.[45]

2. Securities Laws

When an MLP offers its limited partnership interests to the public, the units will likely be considered securities under both the Federal and state securities laws.[46] In order for the Securities and Exchange Commission ("SEC") to apply the securities regulations to transactions and individuals, the SEC must first prove that the interests at issue are "securities".[47] Both the Federal Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act") provide long "laundry lists" of interests that are considered "securities."[48]

Both the 1933 Act and the 1934 Act include "investment contracts" in the definition of securities. Courts generally use the definition of "investment contract" to determine whether a partnership interest is a security under the federal securities laws.[49] *Securities and Exchange Comm. v. W.J. Howey Co*[50] is the leading case that discusses whether an interest constitutes an investment contract.[51] In *Howey,* the Supreme Court used three elements to determine whether an interest was an investment contact: (1) an investment, (2) in a common enterprise, (3) with the

expectation that profits will be solely derived from the efforts of others.[52] Under the *Howey* analysis, it is generally accepted that limited partnership interests are securities.[53] Therefore, when an MLP issues its limited partnership interests on a public market, the issuance will most likely be subject to the federal securities laws.

As an issuer of securities, an MLP must conform to the disclosure rules of the federal securities laws, such as filing a registration statement (Form S-1) and a prospectus. These filing requirements can be onerous because MLPs are generally more complex entities than corporations.[54] Additionally, MLPs are required to make periodic filings with the SEC such as quarterly (10-Qs), annual (10-Ks), and significant event (8-Ks) filings.[55]

Lately, some MLPs have been publicly selling general partner interests as well.[56] In 2004, Crosstex Energy, Inc., was the first company to take the general partner of its MLP public with about 11 different MLP general partners going public since then.[57] General partnership interests are attractive to the public because the general partnership can get a disproportionate amount of the distributions if the incentive distribution rights benchmarks are met.[58]

The public offering of a general partnership interest confronts the same federal securities issues discussed above. Generally, courts have considered whether general partnership interests are securities by "focusing on whether a general partner has an expectation of profits derived solely from the efforts of others."[59] In most instances, the general partner exercises managerial control over the MLP so the general partnership interest is not considered a security under the federal securities laws. But, a general partnership interest can be a "security" if it is established that:

> (1) the agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes the power as would a limited partnership, or (2) the partner or venture is so inexperienced and unknowledgeable in business affairs that he or she is incapable of exercising his or her partnership or venture powers, or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he or she cannot replace the manager of the enterprise or otherwise exercise meaningful partnership of venture powers.[60]

It is unlikely that public investors that own a general partner interest in an MLP will take direct managerial control in the general partnership, and such control might not make good business sense. In most cases, public ownership of a general partnership interest in an MLP leaves little power in the hands of the public investors and more closely resembles a limited partnership interest. Therefore, the publicly held general partnership interest is often considered a security. If the general partnership interest is a security, then the issuer must comply with all of the reporting requirements mentioned above.

The implication of any additional securities laws are beyond the scope of this paper.[61] Suffice it to say that the general partner should be aware of the federal securities laws when conducting its business. Additionally, the general partner should also be aware of any state securities laws that may apply to the MLP.

II. Tax Issues – Qualifying For Partnership Treatment

A. History

1. Corporate/Partnership Determination

Prior to 1997, the classification rules for determining whether a business entity was a partnership were confusing and had uncertain outcomes. After much argument and many cases, the Internal Revenue Service ("IRS") provided regulations outlining six characteristics of a "pure" corporation.[62] These six factors were: association, objective to carry on a business and divide the gain, continuity of life, centralization of management, limited liability, and free transferability of interests.[63] The first two factors are shared by corporations and partnerships.[64] However, if the entity possessed two of the remaining four characteristics, it was classified and taxed as a corporation rather than a partnership (the "resemblance test").[65]

2. 1987 Revenue Reconciliation Act

At the time of the 1987 Revenue Reconciliation Act, publicly traded partnerships qualified for treatment as partnerships because two of the elements defining a corporation were not satisfied. Therefore, there were publicly traded partnerships that had many of the characteristics of corporations, but were only taxed once at the partner level while corporations faced double taxation.[66] In 1987, Congress, fearing that MLPs were eroding the corporate tax base, passed Section 7704 to treat an MLP as a corporation for tax purposes.[67]

In enacting Section 7704, Congress included a grandfather clause for all businesses that had been operating as MLPs prior to 1987. The statute originally provided that existing MLPs were allowed to keep their status for 10 years[68] but was extended indefinitely in 1997. However, grandfathered MLPs are taxed 3.5% on their gross income from the active conduct of trades or businesses.[69]

3. Check the Box

In 1997, the Treasury scrapped the uncertain and contentious resemblance test and replaced it with an elective "Check the Box" system.[70] Since then, business entities (except for per se corporations incorporated under state law) have the option of whether to be treated as a corporation or a partnership. This election is accomplished by simply "checking a box" on a form. However, this elective regime did not affect Section 7704. MLPs are still treated as corporations unless they meet the grandfather exception mentioned above, or they meet the qualifying income test.

B. Section 7704

Section 7704(a) sets out the general rule that an MLP will be treated as a corporation for tax purposes.[71] As stated above, a partnership qualifies as an MLP and is subject to Section 7704 if the partnership is traded on an established securities market or readily tradable on a secondary market. The Treasury Regulations state that an "established securities market" includes:

> (1) a national securities exchange registered under the Securities and Exchange Act of 1934; (2) a national securities exchange exempt from registration because of the limited volume of transactions; (3) a foreign currency exchange; (4) a regional or local exchange; and (5) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.[72]

The Treasury Regulations also state that a partnership interest is readily tradable on a secondary market (or the substantial equivalent thereof) if "taking into account all the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market."[73] The main issue is whether the partners can readily trade their partnership interests. Certain transfers of partnership interests, such as transfers upon the death of a partner or transfers between family members, are disregarded in determining whether partnerships are readily tradable.[74] The IRS's safe harbors under the readily tradable rule include: "the 'private transfers' safe harbor; the 'redemption' safe harbor; the 'private placement' safe harbor; the 'qualified matching service' ('QMS') safe harbor; or the 2% *de minimis* safe harbor."[75] Also, the general rule is subject to several exceptions for an MLP with "qualifying income."[76]

1. Qualifying Income

In spite of the general rule of Section 7704, an MLP is not taxed as a corporation if 90% or more of the gross income of the MLP comes from certain "passive-type income."[77] The passive-type income exception suggests that Congress thought there was "no reason to impose a second-tier of tax on passive income that one can generate directly, without investing in an MLP."[78] However, as discussed below, "passive type income," as defined in Section 7704, can include business activities that are very active in nature.

2. Qualifying Income Defined

Section 7704 defines qualifying income as income from: interest, dividends, real property rents, gain from the sale of real property, natural resources, gain from the sale of capital assets, and gain from commodities.[79] The discussion below is limited to dividend income and income from natural resources.

a. Dividends

Dividends generally constitute qualifying income to an MLP.[80] The Code defines a dividend as a distribution from a corporation to its shareholder out of the corporate earnings and profits.[81] An MLP is permitted to hold ownership interests in corporations and an MLP can have corporate subsidiaries.[82]

This is an important strategic advantage for an MLP that engages in activities that generate both qualifying and non-qualifying income. The MLP can drop the assets that generate non-qualifying income into a wholly-owned subsidiary, which will then make distributions up to the parent MLP. So long as the subsidiary corporation engages in business activities and the "drop down" of assets to the corporate subsidiary serves a business purpose, the business

activities of the subsidiary will not be attributed to the parent MLP.[83] If the distribution from the corporate subsidiary to the parent MLP constitutes a dividend, then the income to the MLP is qualifying income and the MLP has avoided taxation as a corporation. However, if the MLP is taxed as a partnership, then it will not be able to take advantage of the dividends received deduction available to most corporate parents.[84]

b. Natural Resources

Income generated from natural resources is also qualifying income to an MLP. The natural resource exception, which is evaluated under a two step analysis, is the broadest form of qualifying income. The first step of the analysis determines what qualifies as mineral or natural resources.[85] If the first step is satisfied, the second step considers whether the MLP's activities in connection with those mineral or natural resources are qualifying activities.[86]

i. Step One: What Are Mineral or Natural Resources?

Congress initially did not provide a definition for "mineral or natural resource" in Section 7704. But a year after Section 7704 became law Congress defined a mineral or natural resource asset as "any product of a character with respect to which a deduction for depletion is allowable under [S]ection 611,"[87] including fertilizer, geothermal energy, and timber.[88]

The term "mineral or natural resource" has recently been expanded by the Emergency Economic Stabilization Act of 2008 to include, "industrial source carbon dioxide, or the transportation of any fuel described in subsection (b), (c), (d), or (e) of [S]ection 6426, or any alcohol fuel defined in [S]ection 6426(b)(4)(A) or any biodiesel fuel as defined in [S]ection 40A(d)(1)."[89] The Joint Committee on Taxation explained that the new alternative fuel provision means:

> [T]hat qualifying income of a publicly traded partnership includes income or gains from the transportation or storage of certain fuels. Specifically, the fuels are: (1) any fuel described in subsection (b), (c), (d), or (e) of [S]ection 6424, namely alcohol fuel mixtures, biodiesel mixtures, alternative fuels (which include liquefied petroleum gas, P Series Fuels, compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process, and liquid fuel derived from biomass), and alternative fuel mixtures; (2) neat alcohol other than alcohol derived from petroleum, natural gas, or coal, or having a proof of less than 190 (as defined in [S]ection 6426(b)(4)(A)), and (3) neat biodiesel (as defined in section 40A(d)(1)).[90]

Carbon sequestration means the "capture and storage or disposal of CO_2, or other carbon compounds produced by industrial processes, in order to prevent its release into the atmosphere."[91]

ii. Step Two: Are the MLP's Activities In Connection With Mineral or Natural Resources?

Section 7704 gives a laundry list of activities undertaken in connection with minerals or natural resources. These activities include "exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource."[92] The Code and Treasury Regulations do not define or explain these activities but the apparent purpose of this list is to cover essentially all activities that are materially connected with the production and sale of natural resources.

Included on the list of approved activities, the IRS included many activities that are not normally associated with the production and sale of natural resources. For example, the IRS has ruled that the smelting of alumina qualifies as an activity related to the processing of a natural resource.[93] It has also ruled that a fertilizer company's sale of nitric acid, carbon dioxide and its purchase and sale of natural gas futures constituted qualifying activities.[94] The IRS stated that the activities qualified because nitric acid and carbon dioxide are natural by-products of the production of fertilizer and the purchase and sale of natural gas futures contracts secured the cost of the natural gas needed for the fertilizing process.[95]

The IRS has issued several Private Letter Rulings ("PLR") with respect to the transportation and storage of oil and natural gas. For example, income from "terminaling operations" related to the storage of oil fed to terminals by pipelines and barges has been determined to constitute qualifying income.[96] The IRS has also ruled that income from shuttling butane from refineries to salt domes in the warmer months and back to refineries in colder months was qualifying income.[97] The income gained from the storage of natural gas has also been deemed to be qualifying income.[98] The IRS has additionally ruled that income paid from pipeline transportation customers as reimbursement for the construction of pipeline extensions for oil and gas pipelines was qualifying income.[99]

The IRS has issued additional PLRs regarding the processing of oil and natural gas. In one such PLR, the income earned by a partnership under an agreement with a corporation to process that corporation's natural gas was ruled to be qualifying income.[100] In another PLR, the IRS ruled that income from the refinement of crude oil and from the processing of petroleum based oils into lubricating oils was qualifying income.[101]

The IRS has also issued rulings with respect to oil and gas well drilling activities. In a recent PLR, the IRS ruled that drilling services and other related well services constituted qualifying income.[102] Fracturing, a process used by oil and gas service companies to create fractures in the rock to aid retrieval of oil and natural gas, has also been held to generate qualifying income.[103] As a final example, the IRS has held that income earned from acquiring and licensing land and marine seismic data to oil and gas producers constituted qualifying income.[104]

However, the IRS does not say "yes" to every activity related to natural resources. For example, the IRS has held that income from derivative pricing activities related to natural resources did not constitute qualifying income.[105] Furthermore, the IRS has held that "income earned from marketing minerals and natural resources to the end users at the retail level" does not constitute qualifying income.[106] The sale of electricity generated by power plants that are fueled by natural resources also does not constitute qualifying income.[107] As a general rule of

thumb, the IRS appears to be reluctant to classify as a qualifying activity those natural resources activities that are related to the retail level.

C. Loss of Qualifying Status

An MLP can lose its partnership status if it fails to meet the 90% qualifying income exception.[108] If an MLP is taxed as a partnership, but later loses that status, it will be taxed as a corporation. In such a case, the reclassified MLP is deemed to have traded its assets and liabilities to a newly formed corporation in exchange for that corporation's stock, which stock is then distributed to the partners in complete liquidation of the MLP.[109] This deemed transaction will normally be treated as a non-recognition event for tax purposes.

However, under Section 7704(e), if the IRS determines that the failure to qualify was inadvertent, and the failure is corrected reasonably quickly after the failure is discovered, the MLP may be permitted to keep its partnership status as long as it complies with any adjustments required by the IRS.[110] But, if an MLP inadvertently fails to meet the 90% qualifying income standard on a consistent basis, the IRS may withhold this remedy.[111] Therefore, as a practical tip, to avoid a loss of qualifying status, the general partners of an MLP that is taxed as a partnership should remain cognizant of any effect a business transaction will have on the MLP's income status.

D. Tax Implications of an MLP Taxed as a Partnership

1. Tax Advantages

Generally, MLPs that are taxed as partnerships are attractive to investors because there is no entity level tax. This can make an MLP's units desirable to certain investors, who are in turn willing to pay a premium for the MLP's units.

a. One Level of Tax

A corporation is taxed at two levels, once at the corporate level and again at the shareholder level when dividends are paid. The income generated by a partnership, on the other hand, is only taxed at the partner level. The result is that, all other things being equal, the partner will end up having more post-tax dollars in his pocket than his corporate shareholder counterpart.

Here is an example to illustrate the point. Assume that there is a shareholder of a corporation and a partner of a partnership, both of whom are taxed in the highest income bracket of 35%. Assume that the corporate tax rate is 35% and that corporate dividends are taxed at 15%. Additionally, assume that the partnership and the corporation both have a before tax net income of $100 and both plan to distribute their entire after tax income to their respective interest holders. For the partnership, the income is not taxed at the partnership level, so the entire $100 is distributed to the partner, who will pay $35 in tax and have a net amount of $65. The corporation, on the other hand, pays a tax of $35 for the $100 it earned. The corporation then distributes the $65 to the shareholder, who will pay $9.75 in tax (65*15%) and have a net amount of $55.25. Basically, the general net effective tax rate for corporations is 44.75%, while the net effective tax rate for partnerships is 35%.[112] Table 2 in the Appendix summarizes the

above examples. There are certain other considerations, not considered here, such as deferral at the shareholder level, which can affect these calculations. Generally speaking, however, the one level of tax for partnerships is advantageous to investors, given the current corporate and individual tax rates.[113]

b. Basis Shield

Another tax advantage of owning units in an MLP that is taxed as a partnership is that an MLP can provide a "basis shield" for distributions to the unitholders. Unlike the shareholder of a corporation, the partner of an MLP that is taxed as a partnership will generally not be taxed on distributions. Rather, a distribution from an MLP to a partner decreases the partner's basis in his partnership interest.[114] Partners will be taxed on the distribution only if the distribution exceeds the partner's basis in his partnership interest. In this way, the partner is "shielded" from taxes on distributions, to the extent of his basis. A corporate shareholder, on the other hand, is generally taxed on her distribution to the extent that the corporation has earning and profits.

As an example, assume that a shareholder purchases a share of stock in a public corporation for $20.00 and partner buys a unit in an MLP that is taxed as a partnership for $20.00. They both start out with the same amount of basis in their respective share/unit, $20.00.[115] Now assume that the corporation makes a dividend of $1.00 to the shareholder out of its earning and profits and the MLP makes a distribution of $1.00 to the unitholder. The corporate shareholder will be taxed for the full amount of the dividend at a rate of 15%. Thus the corporate shareholder will end up with $0.85 in her pocket but will still have a basis in her stock of $20.00. So if she sold the stock for $20.00 at the end of year 1, she would recognize no gain on the sale.

Now, consider the partner in the MLP. Unlike the shareholder of a corporation, the unitholder in an MLP that is taxed as a partnership is allocated a portion of the MLP's income or losses.[116] The partner is taxed on the allocation of gain or loss rather than on the amount of a distribution.[117] This means that the unitholder is responsible for his share of the MLP taxable income whether the MLP makes a distribution or not.[118] In our example, assume that the partner's share of income is $0.20 (which is in the range the average income to distribution ratio for MLPs[119]) and the partner receives a $1.00 distribution from the MLP. The unitholder will be taxed on his allocation of partnership income ($0.20) at a rate of 35%, or $0.07. The $0.20 of income will act to increase the partner's basis in his unit[120] while the amount of the distribution ($1.00) will act to decrease the partner's basis in his partnership unit.[121] Thus the partner will end up with $0.93 in his pocket ($1.00 - $0.20*35%) and have a basis in his unit of $19.20. If the MLP unitholder sold his unit at the end of year 1 for $20.00, he would recognize a gain of $0.80. A portion of this gain would be capital gain and a portion of it would be ordinary gain depending on the deductions previously allocated to the unitholder.[122] Thus, the distribution from the MLP to the unitholder is "shielded" by basis or deferred until such time that the unitholder sells his interest in the MLP. Table 3 in the Appendix summarizes the above examples.

c. Section 754

A new partner buying a partnership interest in an existing MLP has the opportunity to adjust his basis in the partnership interest upward under a Section 754 election.[123] This is a great benefit to new partners, especially if the MLP's assets are highly depreciable or subject to depletion. The Section 754 election allows the new partner to raise the basis in his share of the partnership assets up their fair market value.[124] Since depreciation and deductions are only allowed to the extent there is basis, this is an extremely important election for MLPs.

2. Tax Disadvantages

Although the tax advantages of an MLP discussed above can be significant, certain taxpayers should be aware of possible adverse tax consequences of owning an interest in an MLP.

a. Accounting

By its nature as a publicly traded entity, it can be very difficult for an MLP to account for the partners' basis adjustments required under the Code. An MLP has to file a federal income tax return and deliver Form K-1s (partnership tax return documents) to every partner. Monitoring what is potentially a huge number of public partners and their constantly shifting interests has led many MLPs to impose limitations on what types of interests a partner may own, thereby eliminating some of the tax advantages partners generally enjoy.

Generally, a partnership is more flexible than a corporation in terms of tax law because a partnership can make certain "special allocations" of income and loss to their partners (provided that those allocations have "substantial economic effect").[125][126] However, because of the financial and tax accounting requirements associated with special allocations, the partnership interests some MLPs issue to the public limit or eliminate the use of special allocations.[127] For instance, the initial public offering of limited partnership units for Breitburn Energy Partners L.P. involved 6.9 million units.[128] If an MLP were to make special allocations to certain limited partners for certain tax items, those allocations would have to be reflected on every partner's K-1 (tax return) to ensure that the allocations had "substantial economic effect." Since units in the MLP are bought and sold on public exchanges, for Breitburn Energy Partners to keep track of the special allocations for each partner would be unwieldy to say the least.

b. Limitation on Mutual Fund Investors

Mutual funds are limited on their ownership in MLPs.[129] Before the American Jobs Creation Act of 2004, mutual funds were not able to invest in MLPs at all.[130] Now, mutual funds are permitted to invest in MLPs, subject to two restrictions: (1) the mutual fund cannot have more than 25% of its asset value invested in MLPs, and (2) the mutual fund cannot own more than 10% of any one MLP.[131] Nonetheless, MLPs are an attractive investment for many mutual funds. Investors also see advantages to using mutual funds to invest in MLPs. For example, if an investor uses a mutual fund to invest in an MLP, he will receive a 1099 from the mutual fund instead of a K-1 from the MLP.[132]

c. Disadvantages for Tax Exempt Organizations

Investment in MLPs can often be disadvantageous for tax exempt organizations because the MLP income often constitutes Unrelated Business Taxable Income ("UBTI"). A tax equal to the corporate tax rate is imposed by the Code on all UBTI earned by tax exempt organizations.[133] Unrelated income means any income that is not related to the organization's charitable, educational, or other related functions.[134] As a general rule, income generated by an interest in most partnerships is treated as UBTI because the partnership's business is unrelated to the organization's charitable functions. However, as discussed below, certain types of income, such as royalties, are not considered UBTI.[135]

d. Disadvantages for Foreign Investors

Foreign investors may also lose some of the tax advantages of investing in an MLP. Under Section 871(b), nonresident alien individuals who are engaged in a trade or business within the U.S. are taxed at the normal graduated tax rates.[136] Section 875 establishes that a foreign individual or entity is considered to be engaged in a U.S. trade or business if a partnership in which that individual or entity is a partner is engaged in a U.S. trade or business.[137] Under Section 1446, a withholding obligation is imposed on a foreign partner's share of the partnership net income that is effectively connected with a U.S. trade or business.[138][139] A foreign partner is "any partner that is a nonresident alien individual, foreign corporation, foreign partnership, foreign trust, or foreign estate."[140] Under the current regulations, a partnership must determine whether a partner is a foreign partner by obtaining a withholding certificate form from the foreign partner (such as Forms W-8BEN, W-8IMY, W-8ECI, W-8EXP, and W-9).[141] These general rules also apply to MLPs.[142]

Under the withholding rules, an MLP "that has effectively connected income, gain, or loss generally must pay a tax under Section 1446 by withholding from distributions to a foreign partner."[143] However, under Revenue Procedure 89-31, an MLP can elect to pay a withholding tax based on its effectively connected taxable income allocable to foreign partners, which is 31% of any distribution made to a foreign partner.[144]

Since the withholding amount of 31% of the distribution is most likely in excess of the tax ultimately owed by the foreign partner, the foreign partner will have to file a tax return to recover the excess taxes withheld. For various reasons, a foreign partner might not want to receive a K-1 or file a U.S. tax return.

e. Passive Loss Rules

Perhaps the most onerous tax consequence of investing in an MLP, is the application of the passive loss limitations. A passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not "materially participate."[145] Generally speaking, limited partners of an MLP do not materially participate in the MLP unless they are also the general partners or are active in management. Under Section 469, passive losses are usually deductible only to the extent that the taxpayer also has passive gains.[146] If a taxpayer has a business that generates passive income for the tax year and has another business that generated a passive loss, the taxpayer can use the passive loss from one business against the passive activity

gain from the other. However, the rules are much more restrictive on the passive losses recognized by a partner in an MLP, which can only be deducted against gains attributable to the same MLP.[147][148] Therefore, if a partner recognizes a loss from their interest in an MLP during one year, that partner will be unable to realize the loss until the partner recognizes a gain from his interest in the MLP in a subsequent year or until that partner disposes of his interest in the MLP. This can present a substantial tax disadvantage for the investor of an MLP that is expected to generate losses (e.g., during the start-up years) compared with an investment in a corporation or even a traditional limited partnership.

III. Natural Resource MLPs

A. Oil and Gas MLPs

1. History

Oil and gas exploration and production MLPs became popular during the 1980's but fizzled out when the price of oil dropped and they could no longer make consistent distributions.[149] These MLPs were also established with a fixed amount of assets so they did not have an income stream that could grow.[150] MLPs were absent from the oil and gas scene for many years but have made a small resurgence in recent years. Currently, there are about 97 MLPs in the US.[151] Only about 11 of these are exploration and production, or "upstream," MLPs.[152]

2. Upstream v. Midstream

Upstream companies conduct exploration and production operations, basically finding oil and gas and getting it out of the ground.[153] Midstream companies conduct operations that get the oil and gas from the wellhead (where the oil or gas comes out of the well) to locations for refinement and distribution to consumers. Midstream MLPs conduct activities such as the gathering and processing of oil and natural gas, and the transportation and storage of oil, natural gas, natural gas liquids, and refined petroleum products.[154] A good example of a midstream company is a natural gas pipeline company. The current majority of oil and gas related MLPs are involved in midstream activities because such activities can provide a consistent and reliable level of income. As noted above, consistent income levels are an important consideration for an MLP, which is often required to make disbursements to cover a partner's taxable income.

It appears that today's upstream oil and gas MLPs have learned their lessons from the failures of their predecessors.[155] The MLPs of the early 1980s over-leveraged their balance sheets, used risky drilling methods or drilled in unproven areas, and used inadequate hedging mechanisms to insulate against commodity price fluctuation.[156] Today, MLPs account for these risks by focusing on exploiting reserves that are proven and have known risk, and by using aggressive hedging strategies to lock in prices on most of its production (70-90%).[157] Today's upstream MLPs also have strong management teams and conservative balance sheets (with modest debt) to diligently guard against cash-flow shortfalls.[158]

3. Addressing Net-Profits Interests

In discussing upstream oil and gas MLPs, is it important to have an understanding of the different types of oil and gas interests. Once a basic understanding of oil and gas interests is established, the concept of net-profits interests will be discussed to explore possible planning opportunities for upstream MLPs.

a. Types of Oil and Gas Interests[159]

There are four basic types of oil and gas interests: a working interest, a royalty interest, a production payment, and a net-profits interest. The costs of production are generally born by the owner of a "working interest," or "operating interest."[160] A working interest is generally acquired through a lease of the mineral rights to a piece of property. In exchange for a working interest, the owner of the mineral rights (the lessor) usually receives a royalty right, a production payment, a net-profits interest, or some combination of the three.

A royalty interest entitles its owner to a share of the "gross" production of the well. A royalty interest holder is not responsible for any of the costs of production.[161] Another type of interest created from the operating interest is called the overriding royalty interest. Like the royalty, the overriding royalty interest is a right to share in the gross production from a mineral property.[162] The overriding royalty does not bear the costs of producing the minerals.[163] Consequently, overriding royalty interests usually pay out a relatively small percentage of the production.

Another type of interest that can be created from the operating interest is a net-profits interest or "non-operating economic interest." The holder of a net-profits interest is not responsible for drilling or operating the well, but he does bear some of the "costs to the extent of its share of the income."[164] Net-operating interests are used frequently and with great success in financing oil and gas operations.[165]

A comparison of two scenarios will help distinguish between an overriding royalty interest and a net-profits interest. In the first scenario, assume that there is an oil well that is burdened by a 25% royalty owner (the lessor), a 25% overriding royalty owner, and an operator/working interest owner. Assume that each barrel of oil is sold for $100, with a cost of $60 to produce. The royalty owner is entitled to 25% of the gross ($100), or $25. Likewise, the overriding royalty owner is entitled to 25% of the gross ($100), also $25. Now the operator is in the red for $10 (meaning the operator has lost money on the activity).

The following is a scenario which uses a net-profits interest. Assuming the same facts as the above example, except replace the overriding royalty with a net-profits interest for 25% of production. The royalty owner still receives $25. The net-profits owner is entitled to 25% of the net-profits. In this scenario, the net-profit is $40 ($100 gross-$60 cost). Therefore, the net-profits owner is entitled to $10. After covering the rest of the costs, the operator receives a profit of $5. Since a net-profits interest shares the expenses of production, operators generally prefer issuing net-profits interest to overriding royalty interests.

The use of net-profits interests in an upstream MLP is a successful tool in attracting institutional investors to the project. However, a full understanding of the advantages of a net profits interest depends on a basic understanding of the taxation of energy resources.

b. Taxation of Energy Resources -- Economic Interest[166]

The taxation of energy resources is based on the concept of "economic interest."[167] If one has an economic interest in a mineral property then that person will be taxed on the income that the property produces and will be entitled to certain deductions for that property's expenses or losses.[168] Though used many times in the Code and Regulations, the term "economic interest" is not expressly defined.[169] An interest in a mineral property is an economic interest if it is "(1) acquired by an investment in the minerals in place, (2) entitling the owner to income derived from the extraction of the minerals, and (3) to which the owner must look for a return of its capital."[170]

The courts and the IRS have established that a net-profits interest is an economic interest for tax purposes. For example, in *Burton-Sutton Oil Co., Inc. v. Commissioner*,[171] the Supreme Court held that a lessee who assigned the lease to another operator but retained a net-profits interest had an economic interest and was entitled to depletion. Likewise, in *Southwest Exploration Co. v. Commissioner*,[172] the Supreme Court held that upland landowners from a mineral interest who made no capital investment, but were granted a net-profits interest in exchange for use of their land for a drill-site, held an economic interest and were entitled to depletion. Today, the Treasury Regulations stipulate that "economic interest" includes "working or operating interests, royalties, overriding royalties, *net profits interests* and, to the extent not treated as loans under 26 U.S.C. § 636, production payments."[173] In *Kirby Petroleum v. Commissioner*, [174] the Supreme Court held that the term "economic interest" did not mean legal title to the minerals in place, but rather the possibility of profit from the extraction of those minerals. This holding is important in the context of an MLP because it means that limited partners can have an "economic interest" in the MLP without having to hold legal title to the MLP's oil and gas assets. This means that the limited partners of an MLP are able to use the deductions and depletion related to their MLP interest to reduce their taxable income.

c. Interests in MLPs Not Treated as Unrelated Business Taxable Income Per Se

As discussed above (see Tax Disadvantages) tax exempt organizations ("TEOs") that invest in MLPs often realize UBTI on the income from an MLP. While most qualifying income of an MLP will be treated as UBTI, it is not the case that all qualifying income will be treated as UBTI.

Income from an MLP is treated the same as income from privately held partnerships.[175] Section 512(c) establishes that if the business or trade of the partnership of which the TEO is a member is an unrelated trade or business, then the income from the partnership is UBTI. UBTI generally does not include passive investment income.[176] In fact, Section 512(b)(2) specifically excludes from UBTI "all royalties (including overriding royalties) whether measured by production or by gross taxable income from the property, and all deductions connected with such income."

Although a net-profits interest is not specifically mentioned in Section 512(b)(2), in 1964 the Fifth Circuit in *U.S. v. Robert A. Welch Foundation*[177] concluded that a net-profits interest is also excluded from UBTI. In that case, a decedent's estate conveyed working interests to two companies, reserving a 100% net-profits interest. Then, the decedent's estate conveyed the net-profits interest to a charity (TEO).[178] The court rejected the government's argument that the net-profits interests were actually working interests (and therefore that the income from the interest was UBTI), stating that to hold otherwise "would call for a departure of the concepts of the terms."[179]

Initially, the IRS announced that it would not follow the holding in *Robert A. Welch Foundation*.[180] Congress even responded by adding Section 512(b)(13), which states that income from controlled entities will be treated as UBTI.[181] For partnerships affected by this statute, control means "ownership of more than 50% of the profits interests or capital interests in such a partnership."[182] Section 512(b)(13) was designed so that a TEO could not use corporate controlled subsidiaries to re-characterize income into a royalty or dividend. However, in 1979, the IRS issued a General Counsel Memorandum stating that net-profits interests are properly treated as royalties under Section 512. Additionally, it stated that a TEO which conveyed working interests in wells to third parties but reserved a 100% net-profits interest still qualified for the UBTI exclusion.[183] Therefore, an MLP's income from a net-profits interests will not be UBTI to a TEO unitholder.

d. Possible Plan for Attracting TEOs

An MLP can benefit from investment by TEOs. For example, TEO investment – often from large pension funds and charities – can provide an MLP with a broader scope of possible investors from which the MLP can obtain capital. But for the potential for realizing UBTI, TEOs would most likely find MLPs to be an attractive investment. As noted above, MLPs, on average, provide higher yields and more steady cash distributions than the broader market, which is a perfect match for TEOs that seek steady cash flows to meet their obligations and objectives.[184]

Generally, TEOs invest their endowments through either corporate stock purchases or corporate loans, both of which have significant disadvantages when compared to an investment in a profitable MLP. When a TEO purchases corporate stock, the TEO gets to share in the success of the corporate venture but its return on investment is taxed at the corporate level, 35%. Therefore, the TEO stock holder only gets 65% of its share of the net income of the corporation (TEOs are not taxed on dividends).[185] For loans made to business ventures, the interest income from the loans is tax-free to TEOs.[186] However, a TEO lender does not get to share in the business venture's upside. If the business venture is highly successful, the TEO will still receive the same amount in interest payments (this assumes a normal loan arrangement without an "equity kicker").

But, if a TEO were able to invest in an MLP without paying UBTI, the TEO would be able to share in the success of the MLP without paying a corporate tax (this is not counting distribution shifts due to incentive distribution rights). As noted above, if a TEO holds a net-profits interest in an MLP, the income generated by the investment is not UBTI.

The mechanism by which a TEO is granted a net-profits interest in an MLP is that the sponsor transfers its leasehold interest to the MLP and the MLP then conveys out that interest to an unrelated third party, but reserves to itself a 100% (or maybe 90%) net-profits interest. Under this framework a TEO is able to buy units in the MLP without worrying about UBTI (but see the discussion on unrelated debt financed income, below). The net-profits MLP might have a competitive advantage over MLPs structured differently because of the large institutional TEO investors that it might attract. Such an MLP can continue to acquire assets by acquiring new leases and then conveying out the working interests and reserving the net-profits interest. Getting the net-profits interests into the hands of the MLP in this way can be advantageous because such a structure is generally able to withstand substance arguments from the IRS, although giving up some of the net profits to the third parties may be required.

An MLP can also obtain net-profits interests by creating a corporate subsidiary into which it transfers the working interest while reserving the net-profits interest. The IRS may object to the substance of the transaction, but the MLP may be able to overcome such a substance argument by showing that the corporate subsidiary significantly reduces the liability to the MLP.

A third mechanism by which an MLP can obtain net-profits interests is accomplished where the sponsor "carves out" and transfers the net-profits interests directly to the MLP with the sponsor retaining the lease. One major problem with this transaction is that the corporate sponsor may have used the working interests in its leases as collateral to finance its operations and the creditors may prevent the sponsor from conveying its net-profits interest in the lease to an MLP. However, the MLP may be able to solve this problem by assuming the liens on the leases (however, this may cause problems of its own which are described in the next section). Alternatively, if the sponsor receives some cash from the MLP when it contributes the net-profits interests to the MLP, the sponsor can use the cash to eliminate its debt and quiet the creditors. However, the receipt of cash in this transaction may constitute boot, which can cause the corporate sponsor to recognize gain. However, this gain may be offset by a deduction the sponsor may claim when it pays down its debt.[187]

A TEO might be attracted to this type of structure even though Section 512(b)(13) disallows a TEO from owning more than 50% of the equity in an MLP because MLPs generally do not require as much investor control as a corporation does. For various reasons, large institutional investors, including TEOs, generally want to control the corporations in which they are invested. In this way, a TEO can ensure that the corporation acts in the TEO's best interest, including the consistent payment of dividends. As discussed above, the incentive mechanisms in place in many MLPs provide accountability and ensure that regular distributions are made without the need for investor control.[188]

Lastly, under Section 512(b)(13), there are no adverse tax consequences for various TEOs owning a more than 50% interest in a company in the aggregate. The adverse consequences are triggered only if a single TEO owns more than 50%. Therefore, an MLP could theoretically be 90% owned by three TEOs (30% each) and no adverse tax consequences would be triggered as to each TEO.

e. Additional Obstacle to TEO Investment: Unrelated Debt Financed Income

Under Section 514, if a TEO acquires income producing assets by means of debt financing, then the percentage of the TEO's gross income attributed to the income producing assets is treated as UBTI.[189] Section 514 defines debt financed property as "any property which is held to produce income and with respect to which there is an acquisition indebtedness." [190] Basically, if the TEO receives income from property for which there is "acquisition indebtedness," then that income will be considered UBTI unless the TEO can prove that the acquisition of the debt-financed property is substantially related to the TEO's tax exempt purpose.[191]

"Acquisition indebtedness" means any debt incurred by the organization before, during, or after the acquisition or improvement of the property, which would not have been incurred otherwise.[192] Also, when the property acquired by the organization is subject to a lien or mortgage, then the lien or mortgage is treated as acquisition indebtedness of the organization even though the organization did not assume or agree to pay such indebtedness.[193] However, interest and dividends from stock securities of debt financed property is not considered unrelated debt-financed income.[194]

This presents some problems for TEOs that invest in an upstream oil and gas MLP. As discussed above, an MLP may have to take some of the net-profits interest or leases subject to liens of the sponsor's creditors. If this occurs, it is likely that these assets will be debt-financed property. Once a TEO buys an interests in the MLP, the debt-financed property assets of the MLP will be imputed to the TEO's partnership interest. This will make the income from the TEO's partnership interest UBTI.

Also, upstream oil and gas MLPs generally rely on debt financing for their acquisitions.[195] Even if an MLP starts out with no debt, if the MLP uses debt financing to renew its depleting asset base, those newly acquired assets will be unrelated debt-financed income to a TEO limited partner.

i. Possible Solutions

An upstream MLP that holds net-profits interests may be able to avoid the unrelated debt-financed property obstacle of Section 514 if it receives the net-profits interests upon formation. This can be accomplished by the sponsor or the MLP paying off the existing creditors so that the assets (net-profits interests or leases) are not encumbered by creditor's liens. In the event that either the corporation or the MLP is not able to pay off the debt with cash, the sponsor can attempt to convert the creditor's security interests into equity interests. If the creditors accept this proposal, they will generally want to ensure that they are paid before the regular unitholders and the general partner are paid on distributions and will therefore require a three-tiered subordination incentive distribution mechanism (see section title "Economic Structure" for a review). Such a three-tiered distribution mechanism would have three types of limited partnership interests: the former creditor limited partnership interests, the limited partnership interests held by the public, and the limited partnership interests held by the general partner. In the first tier, only the former creditor limited partnership interests will receive distributions. In

the second tier, once a certain distribution benchmark is met, the former creditor limited partnership interests and the public limited partnerships interests will receive the distributions. In the third tier, once a higher distribution threshold is met, all three limited partnership interests will receive distributions. Such a structure ensures that the former creditors are paid before the other partners.

If an MLP incurs debt to acquire new assets, as discussed above, these new assets will be unrelated debt-financed property to the MLP's TEO limited partners. To avoid this result, an upstream MLP can attempt to acquire additional net-profits interests solely through cash acquisitions. Because, it is unlikely that most MLPs will be able to operate competitively while using its cash to purchase assets, an MLP with TEO investors might be forced make a secondary offering to raise the cash it needs to acquire additional assets.[196]

Nevertheless, even if an MLP has debt-financed property that would cause a TEO to have UBTI, investment in an MLP may still be tax advantaged over investing in corporations. For instance, assume that an upstream oil and gas MLP generates 10% of its income from debt-financed property. Imagine that the MLP earns a net income (income minus expenses) of $1 per unit all of which is distributed to its unitholders, which includes a TEO. For the TEO unitholder, $0.10 per unit is unrelated taxable income. Assuming that the tax rate for the unrelated business taxable income is 35%, the TEO would pay $0.035 and be left with $0.965 after taxes.

Conversely, consider the consequences to the same TEO if it purchased stock in an upstream oil and gas corporation instead of units in the MLP. Like the MLP, the corporation generates 10% of its income from debt-financed property. The corporation earns a net income of $1 per share which it distributes to it's shareholders, including the TEO. Assuming that the corporation's tax at the entity level is 35%, it pays $0.35 in taxes and pays $0.65 to each shareholder. The TEO is not taxed on the dividend it received and it does not owe additional taxes on the income from the debt-financed property. Although the TEO has no unrelated business taxable income,[197] the TEO shareholder ends up with only $0.65 per share.

As demonstrated by the above examples, even though a TEO may recognize UBTI if it invests in an upstream oil and gas MLP that uses debt financing, the TEO may still end up better off than had it invested in a corporation. Nonetheless, a TEO investor might seek assurances, for example through provisions in the MLP partnership agreement, that the amount of debt financing will be kept below certain levels to ensure an acceptable levels of UBTI.

B. "Green" Resource MLPs

1. Biofuels

While no biofuel MLPs have yet emerged since the Emergency Economic Stabilization Act of 2008 added the biofuel provisions to Section 7704(d)(1)(E), there has been significant investment in biofuel technologies over the last several years. Much of the investment has come from big oil companies.[198] For example, British Petroleum has committed $1.5 billion over the last two years and Shell has quadrupled its biofuel research spending since 2007.[199]

The recent investment in alternative fuels, such as biofuels, is partly due to legislation, which has encouraged such investments. For example, in the Energy Independence and Security Act of 2007 (the "Act"),[200] Congress appropriated $500 million in grants for the development of advanced biofuels, including $50 million for the research and development of cellulosic ethanol, [201] and $75 million for additional biofuels research.[202] Additionally, the Act provided $1.4 billion in grants for programs directed toward renewable fuel infrastructure such as "renewable fuel blend stations."[203] Congress followed these measures by expanding the accelerated 50% bonus depreciation, which had been limited to cellulosic biomass ethanol operations, to include all "cellulosic biofuel" operations.[204] The Act also provided a grant to advanced energy facilities related to renewable energy (including biofuels) in the amount of $2 billion.[205]

These grants and accelerated depreciation provisions are direct attempts to create a biofuels market and has increased large oil companies' interest in biofuels.[206] The changes in Section 7704(d)(1)(E) will likely have the same encouraging effect. The expansion of the natural resources exemption to include biofuels and other alternative fuels will provide tax advantaged structures for refining, processing, transporting, and storing these alternative fuels just as it has with oil and natural gas. Existing midstream MLPs that store, transport and refine oil and natural gas are now able to expand into the alternative fuels market.

2. Carbon Dioxide Storage

The Emergency Economic Stabilization Act of 2008 also opened the door for the use of MLPs for carbon sequestration businesses. Both BP and Shell have increased their investments in the carbon sequestration and storage area.[207]

Like the investments in biofuel, the investments in carbon sequestration have been spurred by recent legislation. For example, the Act appropriated $1.2 billion in grants for the research and development of carbon sequestration technology.[208] Additionally, the Act provided $1 billion for projects that attempt to capture and remove carbon from industrial sources like power plants.[209] The Act supplemented these measures with expenditures for several studies and programs with respect to carbon sequestration.[210]

Congress followed up on these actions by increasing the carbon sequestration tax credits to $20 per metric ton of industrial carbon dioxide that is captured and stored in a geological storage and $10 per metric ton of industrial carbon dioxide that capture and used as an injectant in an enhanced oil or natural gas recovery project.[211] Congress has recently stipulated the geological storage must be secure so that the carbon dioxide does not escape into the atmosphere in order to qualify for the credit.[212]

Carbon sequestration is the logical future business of an upstream oil and gas MLP. As upstream oil and gas MLPs deplete their well reserves as time goes by they can use carbon dioxide in a process called "enhanced oil recovery" to force more oil out of their wells and get paid for keeping the carbon dioxide underground.[213] In fact, carbon dioxide has been used in enhanced oil recovery projects for many years.[214] There are several companies and organizations in Oklahoma, for instance, which are eager to employ carbon dioxide sequestration in oil and gas operations.[215] Some speculate that the use of carbon dioxide could "more than double Oklahoma's oil production."[216]

It appears that the government will continue to provide incentives for carbon sequestration while reducing incentives for oil and gas production.[217] Oil and gas companies are uniquely situated to go into the carbon sequestration business because they have access to the depleted underground reserves and they have the technology to implement the sequestration. However, most oil and gas leases continue only while there is production of oil and gas in paying quantities. Therefore, the upstream companies will have to amend their leases so that they can continue to operate on the mineral owner's land that has the underground storage.

IV. Current Opportunities and Developments

A. Market Opportunities and Challenges

Some might wonder, "Why doesn't Exxon become a MLP, it would save a bunch of money on taxes, right?" Wrong. Exxon doesn't want to become an MLP because, for Exxon, becoming an MLP would most likely be a taxable transaction. Exxon would have to liquidate for tax purposes and recognize all of the built-in gain on its assets.[218] For Exxon, converting to an MLP would be prohibitively expensive, but that might not be the case for all oil and gas companies. Given current economic conditions, the fair market value of many assets are depressed. Some companies might have built-in losses in their assets. For instance, on April 6, 2009, Chesapeake Energy had a price/book ratio of 0.78.[219] This means that its stock value (which can be viewed as a fair market value indicator) had the company valued at less than its book value. Although, accounting book value and tax book value do not necessarily reflect the same figures, the ratio gives an indicator as to the fair market value of a company's assets compared to the basis in those assets. Therefore, if a company that is carrying built-in losses was thinking about becoming an MLP, it might be able to take advantage of any built-in losses.

Even if the business's assets do not have built-in losses, it is unlikely that that the assets will be valued lower in the near future than they are now, possibly making now a good time for some oil and gas businesses to convert to MLPs.

However, the current market conditions have also decreased the demand for new oil and gas companies, meaning a newly formed MLP might not have a successful initial public offering. Thus the dilemma: the oil and gas business might get a break on the taxes when it converts to an MLP, but it is not able to obtain the asking price in the IPO. Financial analysts can sort out the specifics, but, if the business thinks that the MLP is being undersold at the initial public offering, it can acquire a larger limited partnership interests than it had originally planned and wait until the market improves.

B. Important Legislative Developments

There are several proposed legislative developments that might impact the MLP market in general and the natural resources MLP market in particular. Proposals from the Obama administration and Congress include: lowering the nominal corporate rate and raising the tax rate for the highest individual income bracket,[220] allowing the expiration of the taxation of dividends to individuals at the capital gains rates,[221] repealing tax incentives for the oil and gas industry such as intangible drilling cost deductions and percentage depletion,[222] and treating carried interest used by financial MLPs as ordinary non-qualifying income.[223]

The proposed changes in the relative corporate and individual rates call into question whether the partnership "one level of tax" remains advantageous. President Obama has hinted that the corporate rate will be reduced to 30% and the highest individual rate will be increased to 39.4%.[224] If implemented, this change in rates might make an MLP investment slightly less attractive than it is with the current tax rates.

The Obama administration has also suggested that the corporate level tax rate can be lowered if some of the corporate tax "loopholes" are eliminated.[225] The tax incentives for the oil and gas industry have been identified by the Obama Administration as such "loopholes." For example, the Administration has proposed repealing the intangible drilling costs deduction and the percentage depletion deduction for oil and gas companies.[226] Additionally, in April, Senator Charles Schumer introduced a bill titled the Oil Industry Tax Break Repeal Act of 2009 that seeks to repeal additional tax incentives for the oil and gas industry.[227] If these changes are enacted, MLP unitholders will not be able to use these deductions to reduce the amount of taxable income allocated to them, reducing the cash-flow needed for distributions.

Additionally, due to some particularly bad press about MLPs such as Blackstone, Congress has proposed treating carried interests that resemble fees for financial services to be treated as non-qualifying income.[228]

However, there is currently a bill in the Senate that would expand qualifying income under Section 7704(d)(1)(E) to include wind energy,[229] which indicates that Congress may be content with the MLP structure and change only the industries and activities that the MLP structure currently favors.

Recently, the green energy industry has conducted a great amount of lobbying in Washington, D.C., to procure the estimated $100 billion in loan guarantees, grants and other funding allocated in the American Recovery and Reinvestment Act of 2009.[230] These lobbying efforts are so intense that Mitch Tyson, chief executive officer of Advanced Electron Beams, remarked that, "'[e]merging technology companies in the energy space are landing in Washington like locusts.'"[231] Lobbying efforts will likely make the business prospects of these "green technologies" (such as biofuels, carbon sequestration, wind and solar energy) more attractive for investors. These lobbying efforts and the legislative trend indicate that "green technologies" will be the beneficiaries of the MLP structure in the future.

Conclusion

Investors in MLPs with qualifying income have certain tax advantages over investors in corporations because MLP qualifying income is taxed only at one level and tax recognition on some distributions can be deferred to future years. Businesses and investors that are considering an MLP should carefully consider the legal, economic and tax aspects of an MLP.

With careful planning, upstream oil and gas MLPs can use net-profits interests to overcome obstacles that might otherwise prevent some investors, like TEOs from investing in an MLP. Additionally, there have been several economic and legislative developments that may increase the attractiveness of the MLP structure for certain businesses and investors. However, recently proposed legislation suggests that the government might repeal certain tax incentives

for oil and gas companies while providing additional tax incentives for "green energy" companies. Current legislative trends also indicate that the natural resources exception of Section 7704 will continue to be expanded to provide tax advantaged vehicles for these "green energy" enterprises.

Appendix

Table 1		
Distribution Examples[232]	Distribution 1	Distribution 2
Distribution Per Unit	$0.90	$1.00
Distribution split: Limited Partners vs. General Partners	98% vs. 2%	90% vs. 10%
Limited Partners' Distribution Per Unit	$0.882	$0.90
Limited Partners' Distribution in the Aggregate	$88,200	$90,000
General Partner's Distribution Per Unit	$0.018	$0.10
General Partner's Distribution in Total	$1,800	$10,000

Table 2		
Entity	Corporation	Partnership
Pre-Tax Income	$100.00	$100.00
Entity Level Tax	35%	0%
Distribution to Shareholder/Partner	$65.00	$100.00
Shareholder/Partner Level Tax	15%	35%
Net Income to shareholder/partner	$55.25	$65.00

Table 3		
Entity	Corporation	Partnership
Pre- Distribution Basis in Stock/Unit	$20.00	$20.00
Dividend/Distribution	$1.00	$1.00
Return of Capital /"Basis Shield"	0% [233]	80%
Taxable Income	$1.00	$0.20
Shareholder/Partner Level Tax	15%	35%
Tax Paid	$0.15	$0.07
Net Income	$0.85	$0.93

[1] James Rowland earned his LL.M. at the University of Houston Law Center in May 2009. He can be contacted via email at jameskeenerowland@yahoo.com.

[2] MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 21 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf (the major exchanges referred to are the NYSE, AmEx, and NASDAQ).

[3] ARTHUR B. WILLIS & PHILLIP F. POSTLEWAITE, PARTNERSHIP TAXATION ¶ 3.04[1] (2009).

[4] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:1 (2009).
[5] This will be discussed in further detail in the "History" section of PART III of this paper.
[6] MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 16 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf.
[7] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 61 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 116, 208, 122 Stat. 3765, 3831, 3865(2008); I.R.C. § 7704(d)(1)(E) (West 2009).
[12] For purposes of this paper, "master limited partnerships" refer to what are called "publicly traded partnerships" in the Code because this is the term commonly used in the industry, though some have pointed out that there can be differences between the two (See MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 8 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf).
[13] Treas. Reg. § 1.7704-1(a)(1) (West 2009).
[14] I.R.C. § 7704(a) (West 2009).
[15] I.R.C. §§ 7704(c), (g) (West 2009).
[16] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 2 (September 9, 2005) (unpublished manuscript, on file with author).
[17] 541-3d T.M. IV-G-2., *Publicly Traded Partnerships.*
[18] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 2-3 (September 9, 2005) (unpublished manuscript, on file with author).
[19] *Id*.
[20] RANDALL H. BREITENBACH, WACHOVIA PIPELINE AND ENERGY MLP CONFERENCE, at 6 (2008), http://files.shareholder.com/downloads/BBEP/612932535x0x257532/32fd119b-59f1-4c2c-8de4-362cc718fb14/Dec%202008%20Wach%20Pipeline%20Presentation%20NY_vFINAL.ppt.pdf.

[21] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 3 (September 9, 2005) (unpublished manuscript) (on file with author).
[22] Treas. Reg. 301.7701-3(a) (West 2009).
[23] MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 33 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf.
[24] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:22 (2009). This will be discussed in further detail below in the section titled "Tax Issues."
[25] *Id*.
[26] A "dry hole" is a term describing an oil or gas well that is drilled but does not produce oil or gas in paying quantities (meaning that the well makes no profit over its operating expenses).
[27] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 39 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[28] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:3 (2009).
[29] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 40 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf (providing an example of a four-tier distribution table).
[30] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 5 (September 9, 2005) (unpublished manuscript, on file with author).
[31] *Id*. JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:3 (2009).

[32] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 41 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf (providing an example of a four-tier distribution table).
[33] 541-3d T.M. IV-G-2., *Publicly Traded Partnerships*; 700-3d T.M. II-H., *PubliclyTraded Partnership*.
[34] 541-3d T.M. IV-G-2., *Publicly Traded Partnerships.*
[35] 700-3d T.M. II-H., *PubliclyTraded Partnership.*
[36] I.R.C. § 721(West 2009).
[37] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 9 (September 9, 2005) (unpublished manuscript, on file with author).
[38] I.R.C. §§ 752(b), 722 (West 2009).
[39] MICHAEL P. PEARSON, USE OF NET PROFITS INTEREST IN FINANCING OIL AND GAS TRANSACTIONS 9 (Apr. 4, 2008)(unpublished article, 34th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute) (noting that some states, such as Kansas, treat leasehold interests as personal property, and suggesting that one contact local counsel to determine the treatment of leases in unfamiliar states) (on file with author) *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=925.
[40] I.R.C. § 368 (West 2009).
[41] Unless otherwise noted, all subsequent uses of "Code" refer to the Internal Revenue Code of 1986, as amended (the "Code"). All uses of "Section" refer to sections of the Code.
[42] I.R.C § 368(a)(1) (West 2009)(although, a corporation may avail itself of the reorganization provisions if the new MLP is treated as a corporation under §7704, but this would defeat the purpose of the MLP).
[43] *Id.* at ¶ 10.5[2][c].
[44] I.R.C. §§ 311(b), 336(a) (West 2009).
[45] BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 10.5[1] (7th ed. 2000).
[46] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:29 (2009).
[47] George K. Chamberlain, Annotation, *Partnership and Joint Venture Interests as Securities Within the Meaning of Federal Securities Act of 1933 and Securities Exchange Act of 1934,* 58 A.L.R. 408 (1982).
[48] Federal Securities Act of 1933 §2(1), 15 U.S.C. § 77b(1) (West 2009); Securities and Exchange Act of 1934 § (3)(a)(10), 15 U.S.C. §78c(a)(10) (West. 2009).
[49] George K. Chamberlain, Annotation, *Partnership and Joint Venture Interests as Securities Within the Meaning of Federal Securities Act of 1933 and Securities Exchange Act of 1934,* 58 A.L.R. 408 (1982).
[50] 328 US 293 (1946).
[51] George K. Chamberlain, Annotation, *Partnership and Joint Venture Interests as Securities Within the Meaning of Federal Securities Act of 1933 and Securities Exchange Act of 1934,* 58 A.L.R. 408 (1982)(citing *Securities and Exchange Comm. v. W.J. Howey Co*., 328 US 293 (1946)).
[52] *Id.*
[53] 69A AM. JUR. 2D *Securities Regulations- State* §32 (2008); J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 31:3 (2008).
[54] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 13 (September 9, 2005) (unpublished manuscript, on file with author).
[55] *Id.*
[56] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 58 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[57] *Id.*
[58] *Id.*
[59] J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 31:2 (2008).

[60] 69A AM. JUR. 2D SECURITIES REGULATION- FEDERAL § 46.
[61] See J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 31 (2008), for more information about partnerships and securities laws.
[62] ARTHUR B. WILLIS & PHILLIP F. POSTLEWAITE, PARTNERSHIP TAXATION ¶ 3.04[3] (2009).
[63] *Id*.
[64] *Id.*
[65] *Id.*
[66] BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 85.6.1 (2009).
[67] *Id.*
[68] *Id*. at ¶ 85.6.4.
[69] *Id.*
[70] Treas. Reg. § 301.7701-3 (West 2009).
[71] I.R.C. § 7704(a) (West 2009).
[72] Treas. Reg. §1.7704-1(b) (West 2009).
[73] Treas. Reg. § 1.7704-1(c). (West 2009) (there are other notable exceptions in this regulation).
[74] Treas. Reg. § 1.7704-1(e) (West 2009).
[75] 736-1st T.M. IV-C, *Publicly Traded Partnership Limitations*
[76] I.R.C. § 7704(b) (West 2009).
[77] *Id.*
[78] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 15 (September 9, 2005) (unpublished manuscript, on file with author).
[79] I.R.C. § 7704(d)(1)(A-G) (West 2009).
[80] Cite
[81] I.R.C. § 316 (West 2009).
[82] Cite
[83] Barry R. Miller & Tim Fenn, *The Tax Treatment of Publicly Traded Partnerships ("MLPs")* 13 (January 11, 2008)(unpublished memo, on file with author).
[84] I.R.C. § 243 (West 2009).
[85] Cite.
[86] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 17 (September 9, 2005) (unpublished manuscript, on file with author).
[87] *Id*. at 18.
[88] I.R.C. § 7704(d)(1)(E) (West 2009).
[89] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 116, 208, 122 Stat. 3765, 3831, 3865(2008); I.R.C. § 7704(d)(1)(E) (West 2009).
[90] Joint Comm. Tax Rep. JXC-75-08 ¶ 5026 (2008).
[91] Tom Skilling, *Ask Tom Why*, Chicago Tribune, April 9, 2009, at Live!, Zone C, Weather Report, pg. 8.
[92] I.R.C. § 7704(d)(1)(E) (West 2009).
[93] I.R.S. Priv. Ltr. Rul. 95-38-016 (Jun. 21, 1995).
[94] I.R.S. Priv. Ltr. Rul. 93-39-014 (Jun. 28, 1993).
[95] *Id.*
[96] I.R.S. Priv. Ltr. Rul. 93-40-031 (Jul. 6. 1993).
[97] I.R.S. Priv. Ltr. Rul. 94-16-033 (Jan. 24, 1994).
[98] I.R.S. Priv. Ltr. Rul. 94-52-013 (Sept. 26, 1994).
[99] I.R.S. Priv. Ltr. Rul. 2008-45-035 (Nov. 7, 2008).
[100] I.R.S. Priv. Ltr. Rul. 96-39-011 (Sept. 27, 1996).
[101] I.R.S. Priv. Ltr. Rul. 2008-48-018 (Nov. 28, 2008); I.R.S. Priv. Ltr. Rul. 2007-18-010 (May 4, 2007).

[102] I.R.C. § 7704(d)(1)(E) (West 2009); I.R.S. Priv. Ltr. Rul. 2008-27-022 (Jul. 4, 2008).
[103] I.R.C. § 7704(d)(1)(E) (West 2009); I.R.S. Priv. Ltr. Rul. 2008-27-014 (Jul. 4, 2008).
[104] I.R.S. Priv. Ltr. Rul. 2009-09-006 (Feb. 27, 2009).
[105] I.R.S. Priv. Ltr. Rul. 96-19-011 (Jan. 30, 1996).
[106] I.R.S. Priv. Ltr. Rul. 2008-48-018 (Nov. 28, 2008).
[107] I.R.S. Priv. Ltr. Rul. 2008-21-021 (May 23, 2008).
[108] I.R.C. § 7704(c)(2) (West 2009); BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 85.6.3 (2009).
[109] I.R.C. § 7704(f) (West 2009).
[110] *Id*; BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 85.6.3 (2009).
[111] *Id*.
[112] Note that this assumes that the highest level tax under the tax rates established by the 2004 Jobs Act. These rates have a sunset provision which is set to expire in 2011 (See "Legislative Developments" below).
[113] See the "Legislative Developments" section below.
[114] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:22 (2009); I.R.C. §§ 702, 731(a) (West 2009).
[115] I.R.C. § 1012 (West 2009).
[116] Cite.
[117] Cite.
[118] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 43 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[119] *Id*.
[120] I.R.C. § 705(a)(1)(A).
[121] I.R.C. § 705(a)(2); *see also*, JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:22 (2009).
[122] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 44 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[122] *Id.*
[123] I.R.C. § 754 (West 2009).
[124] *See* JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:20 (2009).
[125] I.R.C. § 704(b)(2) (West 2009).
[126] See WILLIAM S. MCKEE ET AL, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 11.02 (4th ed. 2007), for a comprehensive explanation of "substantial economic effect."
[127] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:19 (2009); Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C. L. REV. 1, 87-88 (2003).
[128] RANDALL H. BREITENBACH, WACHOVIA PIPELINE AND ENERGY MLP CONFERENCE, at 4 (2008), http://files.shareholder.com/downloads/BBEP/612932535x0x257532/32fd119b-59f1-4c2c-8de4-362cc718fb14/Dec%202008%20Wach%20Pipeline%20Presentation%20NY_vFINAL.ppt.pdf.
[129] I.R.C. § 851(b)(3) (West 2009).
[130] American Jobs Creation Act of 2004 Pub. L. No. 108-548 §331, 118 Stat. 1418, 1476-77; H.R. Rep. No. 108-548 at 151 (2004).
[131] I.R.C. §§ 851(b)(3)(A)(ii), (b)(3)(B)(iii) (West 2009).
[132] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 58 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[133] I.R.C. § 511 (West 2009).
[134] I.R.C. § 513 (West 2009).
[135] I.R.C. § 512(b)(2) (West 2009).
[136] I.R.C. § 871(b)(1) (West 2009).

[137] I.R.C. § 875 (West 2009).
[138] I.R.C. § 1446 (West 2009).
[139] I.R.C. 1446(c) (West 2009); Joel D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C.205[3] (2009).
[140] Joel D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C.205[2][a] (2009).
[141] Treas. Reg. § 1.1446-1(c)(2) (West 2009).
[142] Treas. Reg. § 1.1446-4(e) (West 2009).
[143] Joel D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C.205[8] (2009).
[144] *Id.* (citing Rev. Proc. 89-31, 89-1 CB 895).
[145] I.R.C. § 469(c)(1) (West 2009).
[146] I.R.C. § 469 (West 2009).
[147] AMY SUTTON & LAURA HOWELL-SMITH, FEDERAL INCOME TAXATION OF PASSIVE ACTIVITIES ¶ 13.02[1] (2009).
[148] It is unclear why this limitation exists. Most likely, this measure was borne from Congress's concern during the 1980's that partnerships were being used as tax shelters for investors to trade in losses. Though other laws have been enacted to prevent such shelters, it likely that this provision was aimed at preventing the use of MLPs from being used as such a shelter.
[149] Greg Barr, *IPOs Swim Back Upstream*, HOUS. BUS. J., Nov. 9, 2007, at 1.
[150] *Id.*
[151] MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 21 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf
[152] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 39 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[153] *Id.*
[154] *Id*. at 20.
[155] *Id*.
[156] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 61 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[157] *Id*.
[158] *Id.*
[159] See 605-2d T.M. II., *Acquisition of Interest*, for a full discussion of the different types of oil and gas interests,
[160] 605-2d T.M. II-C-2-b., *Working and Operating Interests*.
[161] 605-2d T.M. II-C-1-c., *Royalty.*
[162] 605-2d T.M. II-D-1., *Overriding Royalty.*
[163] *Id.*
[164] 605-2d T.M. II-D-2-c-3., *Net Profits Interest*.
[165] *See* MICHAEL P. PEARSON, USE OF NET PROFITS INTEREST IN FINANCING OIL AND GAS TRANSACTIONS 1 (Apr. 4, 2008)(unpublished article, 34th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute) (on file with author) *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=925.
[166] See MICHAEL P. PEARSON, USE OF NET PROFITS INTEREST IN FINANCING OIL AND GAS TRANSACTIONS 1 (Apr. 4, 2008)(unpublished article, 34th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute) (on file with author) *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=925, for a concise, substantive treatment of the judicial development of the "economic interest" concept.
[167] 605-2d T.M. II-B., *Economic Interest.*
[168] PATRICK A. HENNESSEE & SEAN P. HENNESEE, OIL AND GAS FEDERAL INCOME TAXATION ¶201 (2d ed. 2008).
[169] PATRICK A. HENNESSEE & SEAN P. HENNESEE, OIL AND GAS FEDERAL INCOME TAXATION ¶201-02 (2d ed. 2008).
[170] 605-2d T.M. II-B., *Economic Interest*. (citing Treas. Reg. 1.611-1(b)(1)).
[171] 328 U.S. 25, 34-37 (1946).

[172] 350 U.S. 308 (1956).
[173] Treas. Regs. § 1.614-1(a)(2) (West 2009) (emphasis added).
[174] 326 U.S. 599, 604 (1946).
[175] H.R. REP. NO. 103-213 at 617 (1993).
[176] MICHAEL P. PEARSON, USE OF NET PROFITS INTEREST IN FINANCING OIL AND GAS TRANSACTIONS 14 (Apr. 4, 2008)(unpublished article, 34th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute) (on file with author) *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=925.
[177] 334 F.2d 774 (5th Cir. 1964).
[178] *Id.*
[179] *U.S. v. Robert A. Welch Foundation*, 334 F.2d at 775.
[180] Rev. Rul. 69-162 1969-1 C.B. 158.
[181] I.R.C. § 512(b)(13) (West 2009).
[182] *Id.*
[183] I.R.S. Gen. Couns. Mem. 38,216 (Dec. 28, 1979)(the memo did mention that net-profits interest could still be treated like a working interest if it closely resembled one).
[184] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 5 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[185] I.R.C. § 512(b)(1) (West 2009).
[186] *Id.*
[187] I.R.C. §§ 731 (a), 162 (West 2009).
[188] Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1477-79 (2006).
[189] I.R.C. § 514 (a) (West 2009); PAMELA D. PERDUE, QUALIFIED PENSION AND PROFIT SHARING PLANS ¶ 20.03[1] (2d ed. 2009).
[190] I.R.C. § 514(b)(1) (West 2009).
[191] PAMELA D. PERDUE, QUALIFIED PENSION AND PROFIT SHARING PLANS ¶ 20.03[1] (2d ed. 2009).
[192] I.R.C. § 514(c)(1) (West 2009).
[193] I.R.C. § 514(c)(2) (West 2009).
[194] PAMELA D. PERDUE, QUALIFIED PENSION AND PROFIT SHARING PLANS ¶ 20.03[1] (2d ed. 2009) (citing Rev. Rul. 79-122, 1979-1 CB 204).
[195] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 61 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[196] Here is another example of how MLPs are better than royalty trusts. MLPs can make subsequent offerings to raise more cash and finance their activities while royalty trusts are limited to the number of interests in their original offering. Telephone Interview with Tim Fenn, Partner, Vinson and Elkins (May 29, 2009).
[197] PAMELA D. PERDUE, QUALIFIED PENSION AND PROFIT SHARING PLANS ¶ 20.03[1] (2d ed. 2009) (citing Rev. Rul. 79-122, 1979-1 CB 204).
[198] Clifford Krauss, *Once Antagonists, Big Oil and Biofuels Mix*, INT'L. HERALD TRIB., May 27, 2009, at 13.
[199] *Id.*
[200] Energy Independence and Security Act of 2007, Pub. L. No. 110-140, 121 Stat. 1492.
[201] Energy Independence and Security Act of 2007 § 230.
[202] Energy Independence and Security Act of 2007 §§ 207, 223.
[203] Energy Independence and Security Act of 2007 § 244.
[204] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 201, 122 Stat. 3765, 3832; I.R.C. § 168(l) (West 2009).
[205] American Recovery and Reinvestment Act of 2009, Pub. L. No 111-5, § 1302, 123 Stat. 115, 345.
[206] Clifford Krauss, *Once Antagonists, Big Oil and Biofuels Mix*, INT'L. HERALD TRIB., May 27, 2009, at 13.

[207] *Terry Macalister, Financial: BP Sheds 620 Jobs at Solar Power Business: Oil Group Accused of Undermining Green Energy: Campaigners Say Move is a Great Leap Backwards*, THE GUARDIAN, Nov. 5, 2008, at 26(these moves have been to the detriment of some of their other green projects such as solar).
[208] Energy Independence and Security Act of 2007, Pub. L. No. 110-140, § 702, 121 Stat. 1492, 1704-08.
[209] Energy Independence and Security Act of 2007 § 703.
[210] Energy Independence and Security Act of §§ 705, 711-14.
[211] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 115, 122 Stat. 3765, 3807.
[212] American Recovery and Reinvestment Act of 2009, Pub. L. No 111-5, § 1131, 123 Stat. 115, 325.
[213] See Phillip M. Marston & Patricia A. Moore, *From EOR to CCS: The Evolving Legal and Regulatory Framework for Carbon Capture and Storage,* 29 ENERGY L.J. 421 (2008), for a substantive discussion of the current and future uses of carbon dioxide in the oil and gas industry.
[214] Phillip M. Marston & Patricia A. Moore, *From EOR to CCS: The Evolving Legal and Regulatory Framework for Carbon Capture and Storage,* 29 ENERGY L.J. 421, 428-29 (2008).
[215] Janice Francis-Smith, *New Energy Technology Spawns Regulatory Jurisdiction Questions in Oklahoma*, J. REC. (OKLAHOMA CITY, OK), Nov. 5, 2008.
[216] *Id.*
[217] See the discussion in "Legislative Developments."
[218] I.R.C. §§ 311(b), 336(a) (West 2009).
[219] Yahoo! Finance, http://finance.yahoo.com/q/ks?s=CHK (last visited May 26, 2009) (at the date last visited, Chesapeake's price/book value was 1.13).
[220] Jonathan Weisman, *Obama Makes Overtures for Cooperation of CEOs,* WALL ST. J., Mar. 13, 2009, at A3.
[221] Jim Kunhenn, *Obama's Tax Policy is a Matter of Interpretation Critics Blast the President's Claims, but Devil is in the Details,* HOUS. CHRON., Mar. 6, 2009, at A3.
[222] Ben Geman, *Obama's Budget Plan Seeks Repeal of Oil and Gas Industry Tax Breaks*, GREENWIRE, Feb. 26, 2009.
[223] H.R. 1935, 110th Cong. (2009).
[224] Weisman, *supra* note 254, at A3.
[225] *Id*.
[226] Geman, *supra* note 257.
[227] S. 888 111th Cong. (2009).
[228] H.R. 1935 111th Cong. (2009).
[229] S. 826 111th Cong. § 5 (2009).
[230] Scott Kirsner, *Green Energy Sets Up Shop in Washington, Green Energy Firms Ramp Up Lobbying*, BOSTON GLOBE, May 17, 2009, at Business Section, 1.
[231] *Id*.
[232] This table reflects the examples' assumption that there were 100,000 units.
[233] This example assumes that the corporation's earnings and profits are greater than the distribution, so that the entire distribution would be characterized as a dividend.

Recent IRS Guidance Indicates that Auto Dealerships Face Increased Federal Income Taxes and Complexity

by Stephen A. Beck
Meadows, Collier, Reed, Cousins & Blau, L.L.P.

Recent IRS Guidance Indicates that Auto Dealerships Face Increased Federal Income Taxes and Complexity

by Stephen A. Beck[1]
Meadows, Collier, Reed, Cousins & Blau, L.L.P.

I. Introduction.

Recent guidance issued by the IRS indicates that the auto dealership industry should buckle its seatbelt because increased audits resulting in higher tax liabilities and more burdensome compliance requirements are headed its way.

The first item of IRS guidance is Technical Advice Memorandum 200736026 (the "**TAM**"), in which the IRS provided its conclusions with regard to the impact of the uniform capitalization rules under Internal Revenue Code (the "**Code**") Section 263A (the "**UNICAP**" rules) as applied to a specific auto dealership.

- The TAM suggests that the IRS will require auto dealerships to capitalize and include in inventory many types of costs that dealerships are presently deducting as such costs are paid or incurred. This increased capitalization could cause a significant one-time increase in an auto dealership's federal income tax liability.

- In addition, the TAM indicates that the IRS will likely take the position that many, if not most, auto dealerships are not eligible to use the simplified resale method for determining costs that must be included in inventory. Instead, an ineligible auto dealership will be required to use more complicated and ambiguous cost allocation methods.

- Most auto dealerships will be required to extensively rework their cost accounting methodology in order to comply with the UNICAP rules in the manner prescribed by the IRS.

The second item of guidance is that the IRS's Large and Mid-Size Business Division has designated the capitalization of costs within the auto dealership industry as a "Tier III" issue, meaning that the IRS is devoting heightened scrutiny to this issue. The IRS has publicly stated that it believes the auto dealership industry is "virtually completely non-compliant" with the TAM.[2] Thus, the IRS has clearly expressed its intent to step up enforcement and remedy the perceived noncompliance.

II. TAM 200736026.

The TAM discusses a wide range of federal income tax capitalization issues relating to a specific, unnamed auto dealership taxpayer who sold new and used vehicles. The dealership's service department sold and installed new and replacement parts on vehicles owned by customers and on new and used vehicles owned by the dealership.

The TAM is not binding legal authority on the IRS in connection with any other taxpayer and cannot be used or cited as legal precedent. But the TAM provides valuable insight regarding the potential IRS treatment of other auto dealers. Some of the issues discussed in the TAM potentially having broader significance are summarized below.

A. The Dealership's Service Department Engaged in Production Activities.

The IRS first concluded that the dealership's service department performed "production" activities, for purposes of the UNICAP rules, to the extent the department made repairs to or installed parts on a vehicle making the vehicle more readily marketable, such as installing air conditioning or replacing a defective part. The IRS also concluded that the new and used vehicles owned by the dealership on which the service department made the repairs or installed the parts constituted "produced" property for purposes of the UNICAP rules.

As a result, the IRS concluded that, for repairs or improvements made by the dealership's service department to new or used vehicles owned by the dealership increasing the marketability of the vehicle, the dealership was required to capitalize all direct material costs (including the cost of the installed parts), direct labor costs and indirect costs properly allocable to the produced property.

The consequence of this IRS conclusion was that the dealership was required to capitalize additional costs that had not previously been capitalized. Before, the dealership had capitalized only the costs of parts and labor that were reflected on the dealership's "internal repair order" and had not capitalized any other indirect costs, aside from a limited amount of mixed service costs. As a result of the TAM, the dealership was required to allocate additional indirect costs to the dealership's repaired new and used vehicles.

B. The Dealership's Other Repair/Installation Costs were Handling Costs.

The dealership's repair and installation work on customer owned vehicles was also not immune from the UNICAP rules. The IRS concluded that the cost of the work performed on customer owned vehicles constituted handling costs that could be required to be capitalized. The IRS likened automobile repairs to assembling a bicycle! On the basis of this analogy, the IRS reasoned that, like a bicycle purchaser, an automobile customer has the choice of buying and installing the automobile parts themselves or paying a fee to have the dealership install the parts.

In addition, the IRS stated that certain minor activities performed by the service department, such as replacing fluids or cleaning, may constitute production activities, depending on the particular facts and circumstances. To the extent such minor activities did not constitute production activities, such activities would constitute handling activities that would potentially be required to be capitalized.

As handling costs, the costs relating to the repair and installation of customer owned vehicles and minor activities performed on dealership owned vehicles are required to be capitalized, unless they are incurred at a retail sales facility with respect to property sold to retail customers at the

facility (or the on-site portion of a dual function storage facility). *See* Treas. Reg. § 1.263A-3(c)(4)(i).

C. The Dealership did not Qualify as a Retail Sales Facility.

In order to qualify as a "retail sales facility," the facility must be a place where the taxpayer sells merchandise *exclusively* to retail customers in on-site sales. *See* Treas. Reg. § 1.263A-3(c)(5)(ii)(B). Accordingly, the sale must be to the final purchaser of the vehicle who is physically present at the facility. *See* Treas. Reg. § 1.263A-3(c)(5)(ii).

The TAM addressed the dealership's primary and secondary locations. The dealership's primary location was its main sales facility where it stored vehicles and which housed its service department. The dealership also stored vehicles at its secondary location, which was essentially an overflow lot located approximately one-half mile from the primary location. The secondary location did not have a sales office.

The IRS determined that the dealership's primary location did not qualify as a "retail sales facility," but instead was a dual function facility, because the primary location was not used exclusively for making sales to retail customers in on-site sales. It was also used for selling vehicles to other dealerships at cost, leasing vehicles, selling vehicles or parts at wholesale, and selling vehicles as part of a fleet sale.

As a result, the dealership was required to determine the amount of handling and storage costs properly allocated between the on-site and off-site functions of the primary location. *See* Treas. Reg. § 1.263A-3(c)(4)(i); Treas. Reg. § 1.263A-3(c)(5)(iii)(B). To the extent the handling and storage costs are properly allocated to off-site sales, the costs are generally required to be capitalized into inventory. *See* Treas. Reg. § 1.263A-3(c)(5)(iii)(A).

The dealership's secondary location was determined to be an off-site facility because no sales to retail customers were made at the secondary location and the secondary location was not physically attached to, or an integral part of, a retail sales facility. Thus, all of the storage costs attributable to the secondary location were required to be capitalized into inventory.

D. It was Unclear Whether the Dealership Was Eligible to Use the Simplified Resale Method.

A taxpayer generally cannot elect to use the simplified resale method for allocating costs to inventory under the UNICAP rules if the taxpayer engages in both resale and production activities. *See* Treas. Reg. § 1.263A-3(a)(4)(i). Thus, the fact that the dealership was found to conduct production activities in connection with its parts repair and installation activities generally had the effect of precluding the dealership from using the simplified resale method.

An exception, however, is provided through which the simplified resale method may be used by a taxpayer if its production activities with respect to inventory are de minimis and incident to the resale of such inventory. *See* Treas. Reg. § 1.263A-3(a)(4)(ii). The determination of whether a taxpayer's production activities are de minimis is made on the basis of all the facts and

circumstances, including the volume of the production activities in the taxpayer's trade or business. *See* Treas. Reg. § 1.263A-3(a)(2)(iii)(*1*). The UNICAP rules presume that the production activities are de minimis if: (i) the gross receipts from the sale of the property produced by the taxpayer are less than ten percent of the total gross receipts of the trade or business; and (ii) the labor costs allocable to the trade or business' production activities are less than ten percent of the taxpayer's total labor costs allocable to its trade or business. *See id.*

The IRS concluded that the dealership did not satisfy the de minimis presumption because the "gross receipts from the sale of the property produced" must include the sales price of the entire dealership owned vehicle on which the repairs were made or parts were installed, rather than merely the sales price of the parts installed. The inclusion of the sales price of the entire vehicle in gross receipts makes it unlikely that many dealerships will be able to qualify for the de minimis presumption. Because the dealership could not satisfy the presumption, the dealership was required to establish that its production activities were de minimis on the basis of all the facts and circumstances.

Thus, the IRS's analysis indicates that an auto dealership performing repair and installation of parts on dealership owned vehicles will generally be precluded from using the simplified resale method unless the dealership can show on the basis of all the facts and circumstances that the dealership's production activities are de minimis and incident to its resale activities.

E. The Dealership did not qualify for Exemptions from the UNICAP Rules.

The dealership did not qualify for the exception from the UNICAP rules applying to property that is provided to a customer incident to the provision of services under Treasury Regulations Section 1.263A-1(b)(11) because such exception applies only to property that is not inventory in the hands of the taxpayer, and the parts installed on customer vehicles were inventory held by the dealership for resale to customers in conjunction with the dealership's installation activities.

The dealership also was not eligible for the de minimis exception from the UNICAP rules under Treasury Regulations Section 1.263A-1(b)(12) because the dealership's total indirect costs exceeded $200,000.

III. Audit Risk.

As mentioned above, the IRS has designated the application of the UNICAP rules by auto dealerships as a Tier III issue, which reflects that the IRS believes this issue represents the highest compliance risk for the auto dealership industry.

The IRS believes that the application of UNICAP rules by auto dealerships involves a significant compliance risk because of: (i) uncertainty regarding how the TAM should be applied; (ii) inconsistent treatment by IRS examiners; and (iii) "an industry of 20,000+ that is virtually completely non-compliant (with the TAM)." LMSB Tier III Issue: Motor Vehicle Dealerships and IRC 263A (Uniform Capitalization/UNICAP).[3]

It is clear that, due to this perceived compliance risk, the IRS intends to increase its enforcement efforts relating to this issue. In fact, the IRS has already developed an "Audit Plan" to guide IRS revenue agents examining auto dealerships. The audit plan lays out a twelve step approach, with numerous sub-steps, to streamline the process for determining the amounts of tax deficiencies resulting from improper capitalization of costs.

---

[1] Stephen A. Beck is an attorney with Meadows, Collier, Reed, Cousins, & Blau, L.L.P. in Dallas, Texas, practicing in the areas of income tax and business planning, real estate, corporate and securities, and Texas and multi-state tax. Email: sbeck@meadowscollier.com. The author would like to thank William R. ("Trey") Cousins, III, Josh O. Ungerman and David E. Colmenero for their contributions in finalizing this article.

[2] *See* LMSB Tier III Issue: Motor Vehicle Dealerships and IRC 263A (Uniform Capitalization/UNICAP), available at: http://www.irs.gov/businesses/article/0,,id=200856,00.html.

[3] Available at: http://www.irs.gov/businesses/article/0,,id=200865,00.html.

<u>IRS Pointers On Worker Classification</u>

by Robert W. Wood
Wood & Porter

IRS Pointers On Worker Classification

by Robert W. Wood[1]
Wood & Porter

If you are a small business owner, whether you hire people as independent contractors or as employees will impact your own taxes as well as the taxes you withhold from worker paychecks. Plus, it will affect many costs, including worker compensation and unemployment insurance, liability insurance, employee benefit costs, and more. It will influence your record-keeping and information return filing requirements and your liability for compliance with many federal and state laws impacting the workplace.

The IRS and many other agencies expect you to know this. Still, the IRS occasionally tries to offer a bit of advice, directing it not to tax practitioners where most of their guidance goes, but rather to business owners. That's what the IRS did in August of 2009 in releasing "Summertime Tax Tip 2009-20."[2]

You can't help but notice the IRS' cutesy title. Perhaps giving tax advice a title that sounds more like BBQ advice may make it more palatable. The IRS often strives to clean up its nomenclature.

Recently, for example, the revamped IRS changed the moniker for its network of IRS "Service Centers" where millions of returns and other tax filings are processed. They are now called "IRS Campuses." Maybe this will make you feel better. It may give you a kind of college-bound euphoria when you mail off your tax return and a big check.

In the meantime, here from the IRS are the top ten things every business owner should know about hiring people as independent contractors versus hiring them as employees. The IRS text appears in bold. My unofficial comments appear thereafter.

1. Three characteristics are used by the IRS to determine the relationship between businesses and workers: Behavioral Control, Financial Control, and the Type of Relationship.

Most people think of the IRS as having a 20 factor standard. It is based on the common law right of control test that is so prevalent in the case law (tax and non-tax alike). However, the IRS set out its 20 factor hit list in Revenue Ruling 87-41.[3]

Lately, though, the IRS thought it might be easier for people to consider three factors or groups of factors, and that's what the IRS is referring to here. You can use either approach, and for most taxpayers, the old 20 factor view is superior. Among other things, these 20 factors invite scrutiny into some quite concrete issues:

a. Instructions. The more instructions that are given, the more likely is employee status.

b. Training. The more training, the more likely is employee status.

c. Integration. The more closely integrated the work is with the employer's business, the more likely is employee status.

d. Services rendered personally. If the worker must personally do the work, employee status is likely.

e. Hiring, supervising, and paying assistants. A person who does these things will often be an independent contractor.

f. Continuing relationship. The longer the arrangement's term, the more likely is employment status.

g. Set hours of work. Set hours indicate employment status.

h. Full-time required. Working full-time indicates employment status.

i. Doing work on employer's premises. Working on the employer's premise may suggest employment status.

j. Order or sequence set. Performing services in a particular order or sequence set suggests employment status.

k. Oral or written reports. Reports to an employer tend to suggest employment status.

l. Payment by hour, week, or month. Payment by the hour, week, or month suggests employment status.

m. Payment of business and traveling expenses. Payment of business and traveling expenses suggests employment status.

n. Furnishing of tools and materials. Furnishing significant tools, materials, and other equipment suggests employment status.

o. Significant investment. A worker's significant investment tends to indicate independent contractor status.

p. Realization of profit or loss. A worker's potential to realize a profit or suffer a loss suggests independent contractor status.

q. Working for more than one firm at a time. Working for more than one firm at the same time suggests independent contractor status.

r. Making service available to the general public. Making services available to the general public on a regular and consistent basis suggests independent contractor status.

s. Right to discharge. The right to discharge a worker suggests employment status.

t. Right to terminate. A worker's right to terminate the relationship without incurring a liability suggests employment status.

2. <u>Behavioral Control covers facts that show whether the business has a right to direct or control how the work is done through instructions, training or other means.</u>

If you are going to use the new three factor approach, Behavior Control is arguably the most important. The essence of an employer-employee relationship is that of master and servant. The employee can be ordered to do just about anything.

One common way of describing the issue is that an independent contractor can only be ordered to produce the widget. An employee can be ordered to produce the widget in a particular way and using particular means. It's the difference between an end result and a process.

As the old 20 factor IRS test makes clear, the more you train the workers, the more likely they will be employees. Similarly, the more you require an order or sequence (rather than just the end result), the closer toward employment you get. Of course, this is not so much about whether you actually do these things. It is more about whether you have the right to do them.

If your form of contract gives you the right to control every aspect of the arrangement, the mere fact that you do not exercise those rights may not save you from employee status for the workers.

3. <u>Financial Control covers facts that show whether the business has a right to direct or control the financial and business aspects of the worker's job.</u>

You'll get more out of reading the 20 factors than this amorphous financial control test. Consider such aspects as whether you pay the worker by the hour, week, month, or by the job. Flat fees for certain work ($10,000 to build a fence) sound more "independent" than $20 per hour.

Also consider whether the worker can experience a profit or loss. The loss side of the equation is particularly important. For example, if you buy all the tools, you supply all the fence materials, and you pay the worker $20 per hour, the worker can't experience a loss. On the other hand, if you pay a flat fee of $10,000, and that is to include materials, supplies, tools, and the fee for construction, the worker might actually suffer a loss.

4. <u>The Type of Relationship factor relates to how the workers and the business owner perceive their relationship.</u>

This factor arguably isn't too important, since in most disputes, there is a written document that says what the relationship is and how the parties will treat it. Usually, there is a written contract that says the worker is an independent contractor and not an employee. The authorities (both inside and outside of the tax arena) seem uniform in saying that written documents supporting independent contractor treatment won't save you from recharacterization if the actual practice and experience of the relationship is materially different.

Nevertheless, there's at least some stock put in what the parties say and understand about the nature of their working relationship. In the recent IRS Summertime Tax Tip 2009-20, they use this issue as a jumping off point for a more detailed discussion of the right of control.

5. If you have the right to control or direct not only what is to be done, but also how it is to be done, then your workers are most likely employees.

This one is obvious. Of course, bear in mind that even in a bona fide independent contractor relationship, the principal will necessarily control a number of things. For example, if you contract with a pool installer to put a swimming pool in your back yard, you surely will tell them exactly where you want the pool and how deep you want it. That does not make the installer your employee.

6. If you can direct or control only the result of the work done -- and not the means and methods of accomplishing the result -- then your workers are probably independent contractors.

It is important to distinguish legal rights from actual practice. Do not merely consider whether you as the employer actually control the details of the work being done, but whether you can control it. That means if your contract with your "independent contractors" says that you can tell the worker the order of work, where to do it, how to do it, how to dress, what hours to work, to do it themselves rather than to delegate it, etc., the worker is likely to be your employee. This will be true even if you don't exercise any of these rights. The mere fact that you possess these rights will be enough.

7. Employers who misclassify workers as independent contractors can end up with substantial tax bills. Additionally, they can face penalties for failing to pay employment taxes and for failing to file required tax forms.

This IRS comment is hardly a surprise. One of the inherent difficulties in this area is temporal. Often, by the time you realize you have a problem, it is a very large problem. If you are required to start treating a class of your workers as employees prospectively, that might not sting too much. But a retroactive recharacterization is a different story.

The IRS will often seek retroactive recharacterization, and will provide the employer with what may be a staggering calculation of what the IRS thinks the employer owes. There can be ways to ameliorate the numbers, as by proving (if the employer is able) that all of its independent contractors in fact paid all of their own taxes. Even then, the figure can still be large.

One further answer is to try to negotiate a deal with the IRS in which the employer admits no liability for the past, but agrees to treat the workers as employees prospectively. This kind of compromise is far more common than you might think.

8. Workers can avoid higher tax bills and lost benefits if they know their proper status.

This is a curious comment by the IRS. The second part of the sentence is clear, since most employees receive at least some "employee benefits." In fact, some benefit packages can be positively enormous.

If workers have a choice, that can make the choice between contractor and employee an easy one from the worker's perspective. Conversely, the prevalence and cost of employee benefits is a prime reason that many companies want to push the independent contractor envelope as far as they reasonably can.

The first part of the IRS sentence above (suggesting that workers can avoid higher tax bills) is curious. So, workers who are being treated as independent contractors will have a higher tax bill if they are converted to employee status? That seems counterintuitive.

I think the IRS is alluding to the fact that an independent contractor normally files a Schedule C (as a proprietor) to his IRS Form 1040. The contractor/proprietor would include all gross income, and then would deduct all business expenses on the Schedule C. If the worker is recharacterized and must be treated as an employee, many of these expenses will not be deductible.

Employees can usually deduct business expenses only as miscellaneous itemized deductions, which are subject to many limits. In fact, the IRS recently issued a notice on just this point.[4] This is another recent IRS release, addressing (and trying to answer) commonly asked questions once a worker is recharacterized from independent contractor to employee.

In Notice 989, the IRS made clear that workers who are recast from independent contractor to employee status may lose out on many deductions. Plus, the IRS said that in such a case, the worker must file amended tax returns to correct this. The latter point is troubling, since the Treasury Regulations state that a person should file an amended return, but do not make the obligation mandatory.[5] Whether the IRS can trump a Regulation with an IRS Notice is an open question.[6]

9. Both employers and workers can ask the IRS to make a determination on whether a specific individual is an independent contractor or an employee by filing a Form SS-8 – Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding – with the IRS.

The IRS is right that either worker or company can file this form. In fact, it is surprising that more of these forms are not filed. If you supply accurate information, you can at least show your good faith, which can help in any subsequent dispute over worker status.

Plus, achieving a favorable determination (that is, that the worker in question is a bona fide independent contractor) can have a kind of estoppel effect. Such a determination may help you later with the IRS (and sometimes even with other parties) when the status of workers is being called into question.

One reason more Forms SS-8 are not filed may simply be fear of the unknown and an understandable desire for anonymity. There is also the concern that a Form SS-8 filed by an employer can backfire. As an old saying goes, if you can't stand the answer, don't ask the question.

10. You can learn more about the critical determination of a worker's status as an Independent Contractor or Employee at IRS.gov by selecting the Small Business link. Additional resources include IRS Publication 15-A, Employer's Supplemental Tax Guide, Publication 1779, Independent Contractor or Employee, and Publication 1976, Do You Qualify for Relief under Section 530? These publications and Form SS-8 are available on the IRS Web site or by calling the IRS at 800-829-3676 (800-TAX-FORM).

This last IRS tidbit is very good advice, for the IRS is giving suggestions where you should go for further information. These IRS resources are worth reading, no matter what your stake is in worker status issues. Bear in mind, though, that you will get a one-sided view of the matter.

As you might expect, the IRS is giving its view of worker status matters, not the views of taxpayers or even the courts. As a kind of baseline, however, you should be familiar with the IRS resources and the IRS views. They can help keep you out of trouble.

Conclusion

If you are a worker working as an independent contractor, or own or represent a company with some of its workforce working on an independent contractor basis, you may find that you know less about this area than you should. This is particularly the case for companies. It is not overly dramatic to say that companies may be playing a form of Russian Roulette if they don't periodically assess both their contracts with putative independent contractors and their actual practice.

If you are a lawyer, accountant or business adviser to companies using such workers, you should also reflect on your role and on how the business is using independent contractors. If you are an officer or director of a company, you should consider whether you should voice concerns over such matters. It is not far-fetched to suggest that even outside directors may conceivably face personal liability in some cases of worker misclassification.

The IRS may not have brightened anyone's summer with its latest "Summertime Tax Tips." Like an inoculation at a holiday picnic, though, this medicine clearly has value.

---

[1] Robert W. Wood practices law with Wood & Porter, in San Francisco (www.woodporter.com), and is the author of Legal Guide to Independent Contractor Status (4th Ed. 2007), and Taxation of Damage Awards and Settlement Payments (3rd Ed. 2008), both available at www.taxinstitute.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.
[2] See Summertime Tax Tip 2009-20, August 21, 2009, http://www.irs.gov/newsroom/article/0,,id=173423,00.html.
[3] 1987-1 C.B. 296.
[4] See Notice 989 (Rev. 7-2009), 2009 TNT 140-39, Dec. 2009 – 16579.
[5] See Treas. Reg. §§ 1.451-1(a) and 1.461-1(a)(3).
[6] For discussion, see Robert W. Wood, "Ten Things IRS Wants Workers to Consider When Contractors Become Employees," Vol. 9, No. 156, Daily Tax Report (Aug 17, 2009), p. 5-1.

Simple Will Commentary and Form

by Catherine C. Scheid
Law Offices of Catherine C. Scheid

Simple Will Commentary and Form

by Catherine C. Scheid
Law Offices of Catherine C. Scheid

Below is an example of a simple will which is a will without any federal estate tax planning. Everyone needs at least a simple will because by having a properly drafted simple will the process of transferring property from one person to another on death is easier.

There are 9 articles in the simple will example which are Article 1 Identification, Article 2 Memorandum, Article 3 Specific Bequests, Article 4 Residue, Article 5 Fiduciary Appointments, Article 6 Fiduciary Provisions, Article 7 Contingent Trusts, Article 8 Miscellaneous and Article 9 No Contest Clause. The Identification Article is just that, it informs your family for whom you have provided in your will without hiding the ball. Maybe more importantly, the Identification Article addresses for whom you have *not* provided in your will.

Article 2 is intended to make the distribution of personal property easier and gives a person a more economical way to change his or her mind when it comes to giving away the kitchen table and chairs. Article 2 provides for a Memorandum wholly in the testator's handwriting and signed by the testator which is essentially a codicil and could be probated if the division of the personal property among family members becomes litigious.

Article 3 gives away personal property and Article 4 gives away the rest. Article 4 also provides for the testator's property to be given to her heirs if all of the named beneficiaries fail to survive the testator. Heir is a defined term in the will which is an attempt to avoid an intestacy situation.

Articles 5 and 6 are intended to give the executor and trustee guidance in performing his or her fiduciary duties. Article 5 does provide for an independent administration without requiring the executor to purchase a bond to guard against theft by the executor. An independent administration is an economical and streamlined approach to administer the testator's estate.

Some would disagree with my approach in Article 6 and would include less rather than more in Article 6. In Article 7 there are 2 contingent trusts. One contingent trust is for a minor who by law may not have the money or young adult who is not mature enough to manage the money. The other contingent trust is for an incapacitated person to avoid a guardianship of the incapacitated person's estate. If moneys actually end up in either contingent trust, it is because something unexpected and most likely tragic has taken place and guidance such as is found in Article 6 is welcomed in those situations.

Article 8 is filled with definitions. Article 9, the No Contest Clause gives the beneficiaries pause for thought before they hire a lawyer and contest the testator's will.

The simple will example is a combination of will forms that I have read over the last 20 years. In the simple will example there are paragraphs from wills drafted by Chamberlain,

Hrdlicka, White, Williams & Martin, the Estate Planning Study Group in Houston, Texas, Cenatiempo & Ditta,L.L.P., ProDoc, papers and forms from the State Bar Advanced Estate Planning and Probate Courses, other estate planning attorneys and probate litigators with whom I have consulted over the years and interestingly enough some comments from clients. The simple will example is a work in progress and will always continue to be so.

I would like to thank Beth Hearn Owens and Ray J. Black, Jr. for their assistance in preparing this commentary and will form.

LAST WILL AND TESTAMENT

OF

JANE DOE

I, JANE DOE, of Harris County, Texas, make this my Last Will and Testament, and I revoke all Wills and Codicils previously made by me. I am a citizen of the United States of America.

ARTICLE I.

Memorandum

A. **My Estate**. By this will, I dispose of all my property of every nature and description, separate, real, personal and mixed, and wherever situated ("my estate" or "my property"), but I do not intend to exercise any power of appointment.

B. **Children**. I have no children.

C. **Parents**. My father is Bobby Doe who has predeceased me. My mother is Ann Doe and I have not provided for my mother in this Will other than as an heir.

D. **My brothers**. I have two brothers, Robert Doe and John Doe. All references in this Will to "my brothers" are to them. I have not provided for the descendants of either of my brothers in this Will other than as an heir.

E. **My friend**. I have one friend, Louis Smith . All references to "my friend" are to him. I have not provided for the family or descendants of Louis in this Will.

F. **Extended Family**. I have an uncle, John Earl Doe and I have not provided for my uncle in this Will other than as an heir. I have not provided for the descendants of my uncle in this Will other than as an heir.

ARTICLE II.

Memorandum

I request that the beneficiaries of my estate and my Executor honor the provisions of any memorandum written wholly in my handwriting and signed by me (which is not to be a part of this Will) directing the disposition of any portion of my personal and household effects.

ARTICLE III.

Specific Bequests

A. **Personal Property**. I give all of my interest in any motor vehicles, personal watercraft, club memberships, household goods, appliances, furniture and furnishings, pictures, silverware, china, glass, books, clothing, jewelry or other articles of personal use or ornament, and other personal property of a nature, use or classification similar to the foregoing, except as may be provided in a memorandum authorized by Article 2, to my friend Louis Smith provided if Louis Smith fails to survive me, I give my personal property as described in this Article 3 to my brother Robert Doe, provided if Robert Doe fails to survive me I give my personal property as described in this Article 3 to my brother, John Doe. If any beneficiary hereunder is a minor, my Executor may distribute such minor's share to such minor or for such minor's use to any person with whom such minor is residing or who has the care or control of such minor without further responsibility, and the receipt of the person to whom such minor's share is distributed shall be a complete discharge of my Executor. Any cost of packing and shipping such property to a Beneficiary who resides more than 100 miles from me at the time of my death, shall be charged against my estate as an expense of administration. If all my beneficiaries designated under this Article 3, fail to survive me, then this gift shall lapse.

ARTICLE IV.

Residue

I give all of the residue of my estate to my friend Louis Smith. If Louis Smith fails to survive me, I give all of the residue of my estate to my brother Robert Doe. If Robert Doe fails to survive me, I give all of the residue of my estate to my brother John Doe. If all of the beneficiaries listed above fail to survive me, then I give all of the residue of my estate to my heirs.

ARTICLE V.

Fiduciary Appointments

A. **Executor and Trustee**. I appoint my friend, Louis Smith, as sole Independent Executor of my Will and estate and sole Trustee of all trusts created by my Will. If Louis Smith, for any reason, fails to qualify, dies, resigns, becomes incapacitated, or otherwise ceases to serve, I appoint my brother, Robert Doe, as sole Independent Executor of my Will and estate and sole

Trustee of all trusts created by my Will. If Robert Doe, for any reason, fails to qualify, dies, resigns, becomes incapacitated, or otherwise ceases to serve, I appoint my brother, John Doe, as sole Independent Executor of my Will and estate and sole Trustee of all trusts created by my Will.

B. Bond; Independent Administration. No bond or other security shall be required of my Executor or of my Trustee in any jurisdiction. No action shall be required in any court in relation to the settlement of my estate other than the probating and recording of my Will and the return of an inventory, appraisement and list of claims of my estate.

C. Expenses and Compensation. Every fiduciary shall be reimbursed for the reasonable costs and expenses incurred in connection with such fiduciary's duties. Unless waived, every corporate fiduciary shall be entitled to fair and reasonable compensation for services rendered by such fiduciary in an amount not exceeding the customary and prevailing charges for services of a similar character at the time and place such services are performed. No individual fiduciary shall be entitled to fair and reasonable compensation for services rendered by such fiduciary.

D. Ancillary Fiduciaries. If my estate or any trust created by this Will contains property located in another state or a foreign jurisdiction and my Executor or Trustee cannot or chooses not to serve under the laws thereof, my Executor or Trustee shall have the power to appoint an ancillary individual or corporate Executor or Trustee of such property.

E. Executor, Trustee and Fiduciary. Unless another meaning is clearly indicated or required by context or circumstances, the term "Executor" or "Trustee" shall also mean and include any co-fiduciaries, alternates or successors. The term "fiduciary" shall include any Executor or Trustee. Except as otherwise specifically provided in this Will, if two or more fiduciaries are named or serving hereunder and any one or more, but not all, decline, fail or cease to serve for any reason, then the remaining fiduciary or fiduciaries, as the case may be, shall be appointed or continue to serve in such capacity. In all matters relating to my estate or to any trust created by my Will, the decision of a majority of the Executors or Trustees then serving shall control. Any writing signed by the persons whose decision shall control shall be valid and effective for all purposes as if signed by all such Executors or Trustees.

F. Reliance on Legal Opinion. In acting or declining to act, each Executor or Trustee may rely upon a written opinion of a competent attorney, any facts stated in a written document believed true, or any other evidence such Executor or Trustee deems sufficient. Each Executor and Trustee shall be saved harmless from liability for any action taken or for the failure to take any action, if done in good faith and without gross negligence.

G. Fiduciary Principles. Notwithstanding any other provision of this Will, my trustee and my executor shall always be bound by those principles of equity that are the foundation of fiduciary capacity and shall not have the power to enlarge or shift any of the beneficial interests in this Will, except as an incidental consequence of the discharge of my trustee's or my executor's duties.

H. Exculpation Provision. My executor or my trustee shall not be liable for any loss or depreciation in value of the properties of my estate or of the trust estates, except any loss attributable to fraud, gross negligence, a willful breach of trust or bad faith on his or her part; provided however, my executor and trustee shall not be released from any self-dealing that is not otherwise allowed by this Will or applicable statutory or regulatory law. My executor or trustee shall not be accountable or held liable for any act or omission of any agent, if he or she has used good faith and ordinary care in the selection of the agent, and in any such event, any liability shall be solely that of the agent.

ARTICLE VI.

Fiduciary Provisions

A. Powers. Each fiduciary shall act independently and free from the control of any court as to my estate and as to every trust established under this Will (and as to all of the property of my estate and all of the property of every trust created under this Will), and shall have and possess all powers and authorities conferred upon trustees by the Texas Trust Code, and by any future amendments to the Texas Trust Code or any corresponding statute, except for any instance in which the Texas Trust Code, as amended, or any such other statutory provisions may conflict with the express provisions of this Will, in which case the express provisions of this Will shall control. In addition to such powers and authorities, each fiduciary shall have and possess the following powers and authorities (each of which shall be exercisable in the discretion of such fiduciary) with respect to my estate and every trust established hereunder, and the following provisions shall apply to my estate and every trust established under this Will:

1. To retain, without liability for any depreciation or loss occasioned by such retention, any property transferred to the Executor or Trustee by the Testatrix when my Executor or Trustee determines that, because of the circumstances involved, my estate or a trust created hereunder would be better served by not diversifying the investment in such property;

2. To exchange, sell or lease (including leases for terms exceeding the duration of all trusts created by this Will) for cash, property or credit, or to partition, publicly or privately, at such prices, on such terms, times and conditions and by instruments of such character and with such covenants as my Executor or Trustee deems proper, all or any part of the properties of my estate and of each trust, and no vendee or lessee shall be required to look to the application made of any funds paid to my Executor or Trustee;

3. To use the cash and any of the securities or other property owned by me to satisfy any loans or other debts for which my estate is liable or to continue all or any portion of such loans or debts;

4. To borrow money from any source (including any Executor or Trustee) and to mortgage, pledge or in any other manner encumber all or any part of the properties of my estate or of any trust as may be advisable in the judgment of my Executor or Trustee for the advantageous administration of my estate or of any trust;

5. To invest and reinvest the properties of my estate and each trust in any kind of property whatsoever, real or personal (including oil, gas and other mineral leases, royalties, overriding royalties and other interests), whether or not productive of income and without regard to the proportion that such property or property of a similar character held may bear to my entire estate or to the entire trust, and to make loans to any beneficiary of any trust with adequate security and at an adequate interest rate;

6. To employ attorneys, accountants, investment managers, specialists and such other agents as my Executor or Trustee shall deem necessary or desirable; to have the authority to appoint an investment manager or managers to manage all or any part of the assets of my estate or any trust, and to delegate to said manager investment discretion and such appointment shall include the power to acquire and dispose of such assets; and to charge the compensation of such attorneys, accountants, investment advisors, investment managers, specialists and other agents and any other expenses against my estate or such trust;

7. To enter into any transaction on behalf of my estate or of any trust (including loans to beneficiaries for adequate security and adequate interest) despite the fact that another party to any such transaction may be (i) a trust of which any Executor or Trustee under this Will is also a trustee, including any trust established by this Will; (ii) an estate of which any Executor or Trustee under this Will is also an executor, personal representative or administrator, including my estate; (iii) a business or trust controlled by any Executor or Trustee under this Will or of which any such Executor or Trustee, or any director, officer or employee of any such corporate Executor or corporate Trustee, is also a director, officer or employee; or (iv) any beneficiary, Executor or Trustee under this Will acting individually;

8. To make, in the discretion of my Executor or Trustee, any distribution required or permitted to be made to any beneficiary under this Will, or under any trust established by this Will, in any of the following ways when such beneficiary is a minor or a person who is incapacitated in the judgment of my Executor or Trustee by reason of legal incapacity or physical or mental illness or infirmity: (i) to such beneficiary directly; (ii) to the guardian of such beneficiary's person or estate; (iii) by utilizing the same, directly and without the interposition of any guardian, for the health,

support, maintenance, or education of such beneficiary; (iv) to a person or financial institution serving as custodian for such beneficiary under a uniform gifts to minors act or a uniform transfers to minors act of any state; (v) by reimbursing the person who is actually taking care of such beneficiary (even though such person is not the legal guardian) for expenditures made by such person for the benefit of such beneficiary; and (vi) by managing such distribution as a separate fund on the beneficiary's behalf, subject to the beneficiary's continuing right to withdraw the distribution; and the written receipts of the persons receiving such distributions shall be full and complete acquittances to my Executor or Trustee;

9. To store personal property given to a person who is a minor (or a person who my Executor deems incapacitated) for later distribution to such person, or to sell such property and add the proceeds of sale to a trust of which such person is a beneficiary;

10. To make divisions or distributions of estate or trust property in money or in kind, or partly in each (including composing shares differently), to compose shares including undivided interests, to partition undivided interests, and to divide or distribute particular assets on a pro rata or non pro rata basis; whenever required or permitted to divide or distribute all or any part of my estate or of any trust; and, in making any such divisions or distributions, the judgment of my Executor or Trustee in the selection and valuation of the properties to be so divided or distributed shall be binding and conclusive;

11. To release, in the discretion of my Executor or Trustee, any fiduciary power at any time, in whole or in part, temporarily or permanently, by acknowledged instrument;

12. To register and carry any securities or other property in the name of the nominee of any corporate Executor or corporate Trustee (or to hold any such property unregistered); to exercise any put or call option, right or privilege to purchase or to convert bonds, notes, stocks (including shares or fractional shares of stock of any Executor or Trustee), securities or other property; to vote any stock owned by my estate or any trust; and if two or more Executors or Trustees are serving hereunder and no such Executor or Trustee is a corporate Executor or Trustee, to open any type of account in such a manner that all activities associated with such account may be handled by one of the Co-Executors or Co-Trustees acting alone;

13. To invest in any life insurance policies (including term insurance) on the life of one or more of the beneficiaries of my estate or any trust, or on the

life of any person or persons in whom such beneficiaries have insurable interests;

14. To invest and reinvest all or part of the properties of my estate or any trust in any common trust fund of any corporate Executor or corporate Trustee;

15. To open margin accounts or similar accounts with brokerage firms, banks or others for purposes of investing the properties of each trust; to conduct, maintain and operate these accounts, directly or through designation of another as agent, for purchase, sale and exchange of stocks, bonds, commodities and other securities; and in connection therewith, to borrow money, obtain guarantees and engage in all other activities necessary or incidental to conducting, maintaining and operating such accounts;

16. To continue any business (whether a proprietorship, corporation, partnership, limited partnership or other entity) which I own or in which I am financially interested for such time as my Executor or Trustee deems it to be in the best interests of my estate or any of the trusts; to employ in the conduct of any such business such properties of my estate or any trust as my Executor or Trustee deems proper; to borrow money for use in any such business alone or with other persons financially interested in such business, and to secure such loan or loans by mortgage, pledge or any other manner of encumbrance of not only my interest in such business, but also such other properties of my estate or any trust as my Executor or Trustee deems proper; to organize, either alone or jointly with others, new corporations, partnerships, limited partnerships or other entities; and generally to exercise with respect to the continuance, management, sale or liquidation of any business which I own or in which I am financially interested or of any new business or business interest all the powers I could have exercised during my lifetime;

17. To execute lease, pooling or unitization agreements (including agreements of such nature extending beyond the terms of all trusts created by this Will) with respect to any mineral or royalty interest held or acquired by my estate or any of the trusts; to drill or contract for the drilling of wells for oil, gas or other minerals; to make dry hole or bottom hole contributions; to enter into any operating agreements with reference to any mineral leases or properties held or acquired by my estate or by any trust; and generally, with reference to oil, gas and other mineral properties and operations, to enter into such agreements and to do all such other things (whether or not presently recognized as common or proper practice by those engaged in the business of prospecting for, developing, producing, processing, transporting or marketing oil, gas or other minerals) as my Executor or Trustee may deem to be advantageous;

18. To make, in the discretion of my Executor or Trustee, elections permitted under Section 643(g) of the Code to treat estimated tax payments made by my estate or any trust as estimated tax payments by any one or more of the beneficiaries of my estate or such trust;

19. To administer undivided interests held by multiple trusts created under this Will as one fund; and

20. To maintain bank accounts, savings and loan accounts, credit union accounts, brokerage accounts, mutual fund accounts, or any other type of accounts for the trusts created hereunder in such a manner as the Trustee shall deem appropriate, including the power to permit investment decisions and the signing of checks or withdrawal orders by a single Trustee when more than one Trustee is serving hereunder;

21. To delegate, by the written agreement of a majority of then acting Trustees, all powers or certain powers to a designated individual Trustee or group of Trustees who shall exercise such powers on behalf of all Trustees until such time as such authorization is withdrawn by a majority of then acting Trustees; and

22. The Trustee has a duty to keep the beneficiaries of a trust reasonably informed. The Trustee shall be deemed to have kept the beneficiaries reasonably informed if the Trustee complies with the Inspection paragraph in this Will.

B. Notice. Any notice or election required or permitted to be given by or to a fiduciary acting under this Will must be given by acknowledged instrument actually delivered to the person or fiduciary to whom it is required or permitted to be given. Any notice required or permitted to be given to a minor or an incapacitated person shall be given to such minor's parents or guardian or to such incapacitated person's guardian or attorney-in-fact. If such notice concerns a trusteeship, it shall state its effective date and shall be given at least 30 days prior to such effective date, unless such period of notice is waived. Any action permitted to be taken by a minor or an incapacitated person shall be taken by such minor's parent or guardian or by such incapacitated person's guardian or attorney-in-fact.

C. Allocation of Principal and Income. My Executor or Trustee, in his or her capacity, shall determine the allocation or apportionment of all receipts and disbursements between income and principal, including whether or not (and to what extent) to establish reserves for depreciation or depletion; in exercising this discretion, my Executor or Trustee may consider the provisions of the Texas Uniform Principal and Income Act.

D. Inspection. The Trustee shall make available for inspection and copying by the Beneficiary of a trust or any person designated by the Beneficiary, all properties, books of account and records of the trust every six (6) months for five (5) consecutive business days,

which are agreed upon by the Trustee and Beneficiary, at the place of the Trustee's choosing from 9:00 a.m. to 4:00 p.m., Central Standard Time. Any copies of the books of account and/or records of the trust for the Beneficiary shall be made by the Trustee but at the expense of the Beneficiary. The Beneficiary shall pay, by cash or certified check, the Trustee for the copies when the copies are delivered to the Beneficiary.

E. **Accounting**. Within 60 days of receiving a written request from a beneficiary of a trust created by my Will, my Trustee shall furnish an accounting to such beneficiary. Any such accounting shall comply with the requirements of the Texas Trust Code and shall be deemed correct and binding one year after receipt by the requesting beneficiary.

ARTICLE VII.

Contingent Trusts.

A. **Contingent Trust for Incapacitated Individuals**. Notwithstanding anything to the contrary in this Will, if any share of my estate that is to be distributed to a person who is, in the discretion of my Executor, incapacitated by reason of legal incapacity (as defined herein), shall be held by my Trustee as a separate trust for the benefit of such Beneficiary (referred to herein as the "Beneficiary"). Each trust created by this Article shall be known by the initials of the beneficiary for whom it is created followed by the words "Contingent Trust." My Trustee shall distribute to the Beneficiary of each trust such amounts of the net income and principal of such trust as my Trustee, in my Trustee's discretion, deems desirable from time to time to provide for such Beneficiary's health, support, maintenance or education, directly and without the interposition of any guardian. Notwithstanding anything to the contrary in this Will, each trust created by this Article for a person who is incapacitated shall terminate when the Beneficiary of such trust, in the discretion of my Trustee, is legally, mentally and physically capable of receiving the outright ownership of the property of such trust. If a Beneficiary who is incapacitated should die before his or her trust is terminated, the remaining property of such trust shall be distributed to the Beneficiary's estate.

B. **Contingent Trust for Individuals Under the Age of 20**. Notwithstanding anything to the contrary in this Will, if any share of my estate that is to be distributed to a person who is under the age of 18 (referred to herein as the "Beneficiary"), shall be held by my Trustee as a separate trust for the benefit of such Beneficiary. Each trust created by this Article shall be known by the initials of the beneficiary for whom it is created followed by the word "Contingent Trust." My Trustee shall distribute to the Beneficiary of each trust such amounts of the net income and principal of such trust as my Trustee, in my Trustee's discretion, deems desirable from time to time to provide for such Beneficiary's health, support, maintenance or education, directly and without the interposition of any guardian. Each trust created by this Article shall terminate when the Beneficiary thereof attains age 20 or dies, whichever event occurs earlier. If such Beneficiary has already attained age 20 on the date such Beneficiary's trust is to be funded, then such trust shall terminate on such date. Upon the termination of a trust created by this Article, all of the property of such trust shall be distributed to the Beneficiary thereof or, if such

Beneficiary's death is the event that terminates such trust, such property shall be distributed to such Beneficiary's then living descendants per stirpes, or if no descendant of such Beneficiary is then living, such property shall be distributed to such Beneficiary's estate. Any distribution which is made to an individual upon the termination of a trust created by this Article shall be distributed outright if such individual has attained age 20 or, if such individual has not attained that age, shall be held by my Trustee in a separate trust for the benefit of such individual (who will be the "Beneficiary" of such trust) to be administered as provided in this Article.

ARTICLE VIII.

Miscellaneous

A. Spendthrift Provisions. Each trust created by this Will shall be a spendthrift trust to the fullest extent allowed by law. Prior to the actual receipt of property by any beneficiary, no property (income or principal) distributable under this Will or under any trust created by this Will shall, voluntarily or involuntarily, be subject to anticipation or assignment by any beneficiary, or to attachment by or to the interference or control of any creditor or assignee of any beneficiary, or taken or reached by any legal or equitable process in satisfaction of any debt or liability of any beneficiary, and any attempted transfer or encumbrance of any interest in such property by any beneficiary hereunder prior to distribution shall be void.

B. Survivorship Provisions. No person shall be deemed to have survived me if such person shall die within 90 days after my death. Any person who is prohibited by law from inheriting property from me shall be treated as having failed to survive me.

C. Payment of Debts. I direct that all of my legal debts, funeral and testamentary expenses, costs and expenses of administration of my estate, and all estate, inheritance, transfer and succession taxes (Federal, State and others) upon or with respect to any property required to be included in my gross estate under the provisions of any law, and whether or not passing hereunder, shall be paid as soon after my death as in the opinion of my Executor is practical and advisable. If at the time of my death any of my property is subject to a mortgage, lien, or other debt, I direct that the devisee taking such property shall take it subject to such mortgage, lien, or other debt, and that such person shall not be entitled to have the obligation secured thereby paid out of my general estate. My Executor is specifically given the right to renew, refinance and extend, in any form that my Executor deems best, any secured or unsecured debt or charge existing at the time of my death. Under no circumstances shall my Executor be required to prepay any debt of mine.

D. Descendants. References to "descendant" or "descendants" mean lineal blood descendants of the first, second or any other degree of the ancestor designated; provided, however, such references shall include, with respect to any provision of this Will, descendants who have been conceived at or before my death and who thereafter survive birth; and provided, further, an adopted child and such adopted child's lineal descendants by blood or adoption shall be considered under my Will as lineal blood descendants of the adopting parent or parents and of

anyone who is by blood or adoption a lineal ancestor of the adopting parent or of either of the adopting parents, provided the adoption occurs before the child's 18th birthday. The definition of descendants shall include individuals born during the time the parents are married and during a time the parents are not married, therefore, the definition of descendants shall include illegitimate individuals and legitimate individuals.

E. Incapacity. Any beneficiary under this Will shall be presumed to be incapacitated or to have capacity, as the case may be, upon the written certification of one medical doctor, including the individual's personal physician, who is a board certified neurologist or gerontologist, who may rely in part on the opinion of a licensed psychologist. The Executor and/or Trustee shall be fully protected as to any action taken based on such a determination of incapacity or capacity of any beneficiary under this paragraph.

F. Heirs. References to "heirs" are to those persons who would inherit separate personal property from the person designated under the statutes of descent and distribution of the State of Texas, if such person died intestate and single at such time.

G. Governing Law. The construction, validity and administration of each trust created under this Will shall be controlled by the laws of the State of Texas unless my Trustee designates the laws of another jurisdiction as the controlling law with respect to the administration of a particular trust, in which event the laws of such designated jurisdiction shall apply to such trust as of the date specified in such designation. Any such designation shall be in writing and shall be delivered to each income beneficiary of the affected trust.

H. Beneficiary. The term "beneficiary" shall refer to any beneficiary under this Will.

I. Separate Property. All transfers to the trusts for less than adequate consideration and all distributions to a beneficiary, including distributions characterized as income, shall be considered gifts to the beneficiary and no one else. Testatrix further intends and directs that all distributions to a beneficiary shall be the beneficiary's sole and separate property and shall not be characterized as community property or the marital property of the beneficiary's spouse regardless of how the distribution is characterized for tax or trust purposes.

J. Per Stirpes. When a distribution is to be made to a person's descendants "per stirpes," property shall be divided into as many equal shares as there are (i) members of the nearest generation of descendants who are then living, and (ii) deceased members of that generation who leave descendants who are then living. This division into shares shall begin at the generation nearest to such person regardless of whether that generation has a living member. Each living member of the nearest generation of descendants with a member who is then living shall receive one share, and the share that would have passed to each deceased member of that generation who leaves descendants who are then living shall be divided in a similar manner (by reapplying the preceding rule) among his or her then living descendants. For example, if a person has deceased children and living children when a distribution is to be made, the assets will be divided into equal shares at the child level and distributed per stirpes below that level;

however, if the person has no living children at that time, that equal division will still be made at the child level and distributed per stirpes below that level. This definition is intended to override any conflicting or contrary common law definition. In the case of a distribution which is to be made "per stirpes" in the event of my death, references in this Section to "then living" or to "living" shall mean persons who survive me.

ARTICLE IX.

No Contest Clause

If any beneficiary of my estate or of a trust created hereunder in any manner, directly or indirectly, contests the probate or validity of this Will or any of its provisions, or institutes or joins in, except as a party defendant, any proceeding to contest the probate or validity of this Will or to prevent any provision hereof from being carried out in accordance with the terms hereof, provided probable cause does not exist for bringing the action and the action was not brought and not maintained in good faith, then all benefits provided for such beneficiary are revoked and such benefits shall pass as if such contesting beneficiary had failed to survive me, and such benefits shall pass to the other beneficiaries of this Will, other than such beneficiary, in the proportion that the share of each such other beneficiary receives to the total of my estate. Each benefit conferred herein is made on the condition precedent that the beneficiary receiving such benefit shall accept and agree to all of the provisions of this Will or any trust created hereunder, and the provisions of this Article are an essential part of each and every benefit. Every fiduciary shall be reimbursed for the reasonable costs and expenses, including attorneys' fees, incurred in connection with the defense of any such contest. Such reimbursement shall be made from my estate if the contest involves my estate, or from the affected trust if the contest involves a trust.

[THIS SPACE IS INTENTIONALLY LEFT BLANK]

I, JANE DOE, hereby declare this to be my Last Will (typewritten on sixteen [16] pages, including the attestation clause, signatures of witnesses and my self-proving affidavit and the affidavits of the attesting witnesses) and herewith sign my name to same, in the presence of the undersigned attesting witnesses, all present at the same time, each of whom signs this Will at my request, in my presence and in the presence of each other, all done this ______ day of ________________________, 2009, at Houston, Texas.

____
JANE DOE

The undersigned, each being over the age of fourteen (14), hereby declare that JANE DOE declared to us that the foregoing instrument is her Last Will and that she requested us to act as witnesses to same and to her signature thereon. She thereupon signed said Will in our presence, all of us being present at the same time. And we now, at her request, in her presence and in the presence of each other, do hereunto sign our names as attesting witnesses, all done this ______ day of ________________________, 2009, at Houston, Texas. We and each of us declare that we believe the said Testatrix to be of sound mind and memory.

___________________________________	___________________________________
Witness	Witness
Address ___________________________	Address___________________________
___________________________	___________________________

SELF-PROVING AFFIDAVIT

THE STATE OF TEXAS	§
	§
COUNTY OF HARRIS	§

BEFORE ME, the undersigned authority, on this day personally appeared JANE DOE, and ___________________________, known to me to be the Testatrix and the Witnesses, respectively, whose names are subscribed to the annexed or foregoing instrument in their respective capacities, and, all of such persons being by me duly sworn, the Testatrix declared to me and to the Witnesses in my presence that such instrument is her last will and testament, and that she had willingly made and executed it as her free act and deed; and the Witnesses, each on his or her oath stated to me, in the presence and hearing of the Testatrix, that the Testatrix had declared to them that such instrument is her last will and testament, and that she executed same as such and wanted each of them to sign it as a witness; and upon their oaths each Witness stated further that they did sign the same as witnesses in the presence of the Testatrix and at her request; that she was at that time 18 years of age or over (or being under such age, was or had been lawfully married, or was then a member of the armed forces of the United States or of an auxiliary thereof or of the Maritime Service) and was of sound mind; and that each of the Witnesses was then at least 14 years of age.

____
JANE DOE, Testatrix

____
Witness

____
Witness

SUBSCRIBED AND SWORN TO before me by JANE DOE Testatrix, and by _________________________ and _________________________ , Witnesses, on the _____ day of ____________________, 2009.

____
Notary Public, State of Texas

Overview of the United States Tax Court

Mary A. McNulty
Thompson & Knight LLP

Overview of the United States Tax Court

Mary A. McNulty[1]
Thompson & Knight LLP

Statutory Mandate/Mission Statement	To determine the correct amount of the deficiency, even if the amount determined is greater than the amount set forth in the statutory notice of deficiency. (I.R.C. § 6214(a))
Procedural Rules	United States Tax Court Rules, which "shall be construed to secure the just, speedy, and inexpensive determination of every case." (Tax Ct. R. 1) If there is no applicable rule in the U.S. Tax Court Rules, the Court or judge may prescribe the procedure, giving particular weight to the Federal Rules of Civil Procedure to the extent that they are suitably adaptable to govern the matter at hand. (Tax Ct. R. 1) Trials are conducted in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia. (I.R.C. § 7453, Tax Ct. R. 143)
Burden of Proof	The taxpayer generally has the burden of proof. Under Code § 7491, the burden of proof shifts to the government after the taxpayer introduces credible evidence with respect to any factual issue. In addition, under Code § 7491, the government bears the burden of proof on penalties and in cases in which any item of income is reconstructed by the Commissioner solely through the use of statistical information on unrelated taxpayers. Also, the government has the burden of proof for (i) new matters, (ii) affirmative defenses, and (iii) fraud. (Tax Ct. R. 142)
Privileges	Attorney-Client (no special Tax Court rule) Work Product (no special Tax Court rule) Tax Practitioner (Code § 7525)
Pre-Payment Forum	A taxpayer does not pay the proposed deficiency before filing a petition with the Tax Court, but interest continues to accrue on any deficiency until it is paid. (I.R.C. §§ 6213(a), 6601(a))

Ticket to the Court	Notice of Deficiency (I.R.C.§ 6213, Tax Ct. R. 13)
Initial Pleadings	Petition (90 days) (Tax Ct. R. 20) Answer (60 days) (Tax Ct. R. 36) Reply (45 days) (Tax Ct. R. 37)
Standing Pretrial Order	Issued with notice of trial at the direction of the trial judge "to facilitate the orderly and efficient disposition of all cases on a trial calendar." Failure to comply with the standing pretrial order may subject a party or its counsel to sanctions. (Tax Ct. R. 131) A sample Standing Pretrial Order is attached.
Duty to Disclose (Informal Discovery)	The Court expects the parties to attempt to attain the objectives of discovery through informal consultation or communication before utilizing the discovery procedures provided in the Tax Court rules. Tax Ct. R. 70(a)(1). *See Branerton v. Commissioner*, 61 T.C. 691, 692 (1974). This rule "is akin to so much of Fed. R. Civ. P. 26(a) as imposes on the parties an affirmative duty to disclose basic information." Explanation of Prop. Tax Ct. R. 71(a). Standing pretrial order typically requires parties to exchange all documents and other evidence that they intend to use at trial (except for impeachment documents) at least 14 days before trial. Court may exclude documents not exchanged in accordance with standing pretrial order unless good cause is shown.
Formal Discovery	Interrogatories (Tax Ct. R. 71). Proposed limit of 25, including all discrete subparts, to encourage voluntary exchange of information, to enhance efficiency, and to allow the Court to exercise greater control over the use of interrogatories. Requests for Production of Documents or Things (Tax Ct. R. 72) Requests for Admissions (Tax Ct. R. 90) Witness Interviews Depositions Allowed with consent of parties. (Tax Ct. R. 74) Court may order the taking of a deposition of an Expert witness on its own motion. (Tax Ct. R. 76(f). Proposed amendment to Rule 75 to allow a party to move to take the deposition of another party or the Court may order the deposition of a party sua sponte. Considered extraordinary method of discovery. (Tax Ct. R.

	75, 76) Depositions upon written questions allowed with special reason, such as deponent located in foreign country. (Tax Ct. R. 74(e), 84) Proposed Rule 70(b) extends the scope of discovery to electronically stored information. A cooperative effort may be required to ensure that such information is disclosed in a format that would be useful to the parties and the Court. A protective order may be obtained upon a showing that the information is not reasonably accessible because of undue burden or cost. The Court may specify conditions for e-discovery. Absent exceptional circumstances, sanctions may not be imposed for failing to provide electronically stored information that was lost as a result of the routine, good-faith operation of an electronic information system. Prop. Tax Ct. R. 104(a). Discovery must be completed and any motion to compel discovery filed at least 45 days before trial or as required in standing pretrial order. (Tax Ct. R. 70(a)(2))
Stipulations	The stipulation process if the "bedrock of Tax Court practice." *Branerton Corp. v. Commissioner*, 61 T.C. 691 (1974). Parties are required to stipulate, "to the fullest extent to which complete or qualified agreement can or fairly should be reached, all matters not privileged which are relevant to the pending case, regardless of whether such matters involve fact or opinion or the application of law to fact." The scope of this rule includes all facts, documents, and evidence that fairly should not be in dispute. A party may not refuse to stipulate on the basis of relevancy or materiality or because the information has been obtained through other discovery means. If a party fails or refuses to stipulate, the other party may file a motion to compel stipulation no later than 45 days before trial. (Tax Ct. R. 91)
Expert Reports	Expert reports must be exchanged 30 days prior to trial or otherwise per standing pretrial order and a copy must be submitted to the Court. Expert reports must set forth the qualifications of the expert witness, the expert's opinion, and the facts or data on which that opinion is based. (Tax Ct. R. 143) The standing pretrial order may allow rebuttal reports to be exchanged, or the judge may request rebuttal reports. A party may discover (i) the identity and qualifications of the expert, (ii) the subject matter to be addressed by the expert and the substance of the facts and opinions to which the expert is expected to testify, and (iii) the grounds for each of the expert's opinions. (Tax Ct. R. 71(d))

Pretrial Memorandum	The standing pretrial order generally requires pretrial memorandum to be submitted 14 days before trial. The pretrial memorandum includes the following: (i) the amount in dispute, (ii) the status of the case, (iii) an estimate of trial time, (iv) possible motions, (v) status of stipulation of facts, (vi) list of issues, (vii) list of witnesses and brief summary of expected testimony, (viii) summary of facts in chronological narrative form, (ix) brief synopsis of the legal authorities, and (x) statement of evidentiary problems.
Pretrial Conferences	In appropriate cases, the Court will hold pretrial conferences "with a view to narrowing issues, stipulating facts, simplifying the presentation of evidence, or otherwise assisting in the preparation for trial or possible disposition of the case in whole or in part without trial." In a case set for trial, any party may request a pretrial conference or the Court may set a pretrial conference. (Tax Ct. R. 110) The judge who will preside at trial generally conducts pre-trial conferences, except for in camera proceedings on privilege issues and lengthy discovery proceedings. In addition, to encourage settlement, the Court has held experimental trial sessions at which a special trial judge serves as mediator.
Pretrial Motions	Motion for Judgment on Pleadings A party may move for judgment on the pleadings. (Tax Ct. R. 120) Motion for Summary Judgment Matters outside of the pleadings are presented to the Court with supporting affidavits. Summary judgment may be requested upon all or any part of the legal issues in controversy. A decision will be rendered as a matter of law if there is no genuine issue as to any material fact. (Tax Ct. R. 121) Motion to Submit Case without Trial A party may move to submit a case without trial if the submission of evidence is not needed because, for example, sufficient facts have been admitted, stipulated, established by deposition, or included in the record in some other way. (Tax Ct. R. 122) Motion in Limine Motion to exclude certain evidence or expert report on grounds that it is privileged, its relevancy is substantially outweighed by a risk of undue prejudice or confusion of the issues, or it is cumulative. (*See* Fed. R. Ev. 403)

Alternate Dispute Resolutions	The parties may move that any factual issue in controversy be resolved through voluntary binding arbitration. A joint stipulation must accompany the motion, stating the issues to be resolved through arbitration and the parties' agreement to be bound by the findings of the arbitrator. The arbitrator will be appointed by Court order. (Tax Ct. R. 124) Mediation and other forms of voluntary disposition of cases are allowed. (Tax Ct. R. 124)
Trial/Hearing	Opening Statements Documents Stipulated or exchanged before trial, except for impeachment documents Witness Testimony (Fact and Expert) An expert's report is received in evidence as the direct testimony of the expert witness. Additional direct testimony may be allowed to clarify or emphasize matters in the report, to cover matters arising after the preparation of the report, or otherwise at the discretion of the Court. (Tax Ct. R. 143(f)) Proposed Rule 143(b) allows testimony in open Court by contemporaneous submission from a different location "for good cause in compelling circumstances and with appropriate safeguards." Out of court testimony may best serve the interests of justice when a witness is unable to attend a trial for unexpected reasons and substantial delay or significant additional costs would be incurred or when other witnesses may not be available at a later time. Closing Statements The presiding judge may permit or direct the parties to make oral argument in addition to or in lieu of briefs. (Tax Ct. R. 151(a)) Trials are recorded and transcribed if the Court or presiding judge deems a permanent record to be appropriate. (Tax Ct. R. 150(a))
Opening of Record	The judge has discretion to reopen the record, but the exercise of such discretion is rare.
Post-Trial Briefs	The filing of briefs is required unless otherwise directed by the presiding judge. The Court may require simultaneous briefs to be filed within the time periods it directs. In the absence of specified time periods or contrary directions, simultaneous briefs are due 75 days after the conclusion of trial and answering briefs 45 days

	thereafter. The Court may require seriatim briefs to be filed within the time periods it directs. In the absence of specified time periods or contrary directions, an opening brief is due 75 days after the conclusion of trial, the answering brief is due 45 days thereafter, and the reply brief is due 30 days thereafter. The briefs generally contain a table of contents and table of authorities; a statement of the nature of the controversy, the tax involved, and the issues to be decided; proposed findings of facts; a concise statement of the points on which the party relies; and argument. The Court often imposes page limits. (Tax Ct. R. 151)
Opinion	Code § 7459(a) requires the Tax Court to issue a report and a decision in all Tax Court proceedings "as quickly as practicable." The report include findings of fact and an opinion or a memorandum opinion. I.R.C. § 7459(b). This statutorily prescribed "report" is the opinion that is published in the official reports of the Tax Court. I.R.C. § 7462. Opinions are typically written by the presiding judge. All opinions are reviewed by the chief judge. An opinion automatically becomes the report of the Tax Court unless within 30 days the chief judge directs that the report is to be reviewed by the entire Court. I.R.C. § 7460(b). An opinion is typically reviewed by the entire Court if it involves a change in position or a response to a decision of a court of appeals. The chief judge determines whether an opinion will be issued as a regular or memorandum decision. The chief judge will label a decision as a memorandum decision if the decision involves primarily factual determinations and the application of only settled legal principles. Regular opinions are officially reported in Tax Court Reports and have greater precedential value than memorandum opinions. Memorandum decisions are not officially reported and are not binding precedent. *See, e.g., Nico v. Commissioner*, 67 T.C. 647, 654 (1977), *aff'd in part and rev'd in part*, 565 F.2d 1234 (2d Cir.).
Entry of Decision	The parties submit computations of the tax liability in accordance with the Court's determination of the issues. If the parties cannot agree on the correct amount of the deficiency to be entered as the decision, the parties may submit their proposals to the Court. The other party has the opportunity to object. Any argument is confined strictly to consideration of the correct computation of the amount to be included in the decision resulting from the findings and

	conclusions made by the Court. (Tax Ct. R. 155)
Post-Trial Motions	Motion for reconsideration of findings or opinion may be filed within 30 days after issuance of opinion. (Tax Ct. R. 161) Motion to vacate or revise decision may be filed within 30 days after entry of decision. (Tax Ct. R. 162) Motion to enforce overpayment may be filed once the Tax Court decision has been final for 120 days. (Tax Ct. R. 260) Motion to redetermine interest may be filed within one year after the Tax Court decision becomes final. (Tax Ct. R. 261)
Appeal	U.S. Circuit Court of Appeals Based on location of taxpayer's residence (individuals) or principal place of business (corporations) when petition was filed. The taxpayer and the government may agree to appeal to a different circuit. (I.R.C. § 7482) Notice of appeal must be filed within 90 days after entry of decision. (I.R.C. § 7483, Tax Ct. R. 190).

[1]Prepared by Mary McNulty, a partner in the Dallas office of Thompson & Knight LLP. She represents taxpayers in tax controversies against the Internal Revenue Service with specific emphasis on cases for large corporate taxpayers and on cases involving interest on federal tax refunds and deficiencies, penalties, statutes of limitations, oil and gas issues, and partnerships.

Sample Timetable vs. Commissioner

Mary A. McNulty
Thompson & Knight LLP

SAMPLE TIMETABLE
TAXPAYER
v.
COMMISSIONER,

United States Tax Court Docket No. _______________

Mary A. McNulty
Thompson & Knight LLP

Event	Deadline
Taxpayer Filing of Petition[1]	Within 90 days after IRS mails notice of deficiency.
U.S. Filing of Answer[2]	Within 60 days from date of service of Petition
Taxpayer Filing of Reply[3]	Within 45 days from date of service of Answer
Amended and Supplemental Pleadings[4]	Before responsive pleading is served or, if none is permitted, within 30 days. Otherwise, with leave of Court or party's consent.
IRS Appeals[5]	After docketing of case until case appears on a trial calendar or no progress is made towards settlement
Commencement of Discovery[6]	May begin 30 days after joinder of issue
Discovery Responses[7]	Within 30 days of service of discovery request
Close of Discovery	No later than 45 days before trial date
Stipulations[8]	At or before commencement of trial or as required by pre-trial order
Motions for Summary Judgment[9]	Any time beginning 30 days after pleadings are closed
Expert Witness Reports[10]	Not later than 30 days before calendar call or trial date
Trial[11]	Generally 12-18 months after petition is filed
Post-Trial Briefs[12]	Generally, 75 days after trial for opening brief; another 45 days for answering brief; and, for seriatim briefs, another 30 days for reply brief
Tax Court Opinion[13]	Generally, 1-2 years after submission of briefs
Motion for Reconsideration[14]	Within 30 days of Tax Court Opinion

Litigation Costs[15]	Within 30 days of Tax Court Opinion
Entry of Decision[16]	When parties agree on computations or Court determines correct amount due
Motion to Vacate[17]	Within 30 days after entry of decision
Notice of Appeal[18]	Within 90 days after entry of decision
Motion to Redetermine Interest[19]	Within one year after decision becomes final

SUMMARY OF TAX COURT RULES FOR TIMETABLE

1. Petition. A case is commenced in the Tax Court by filing a petition with the Court to redetermine a deficiency set forth in a notice of deficiency. Tax Ct. R. 20(a). The petition must be filed within 90 days after the IRS mails a notice of deficiency. I.R.C. § 6213(a).

Pleadings and papers must be filed with the Clerk in Washington, D.C. Tax Ct. R. 22. The clerk will serve the petition on the Commissioner. Tax Ct. R. 21.

Only one signed original of a petition is required to be filed. Tax Ct. R. 34(e). (For each paper filed, there must be a signed original and four copies. Tax Ct. R. 23(b)).

A single petition may be filed seeking a redetermination with respect to all notices of deficiency directed to a husband and a wife individually. Tax Ct. R. 34(a).

The filing fee is $60. Tax Ct. R. 20(c).

2. Answer. The Commissioner shall have 60 days from the date of service of the petition to file an answer. The Commissioner has 45 days from the date of service to file a motion with respect to the petition. The time period is the same with respect to amended petitions or amendments to the petition. Tax Ct. R. 36(a).

The answer shall contain a specific admission or denial of each material allegation. The answer shall contain a clear and concise statement of every ground, together with the facts in support thereof on which the Commissioner relies and has the burden of proof. Tax Ct. R. 36(b).

Every material allegation set out in the petition and not expressly admitted or denied is deemed admitted. Tax Ct. R. 36(c).

3. Reply. Petitioner has 45 days from date of service of answer to file a reply. Petitioner has 30 days from that date to file a motion with respect to the answer. The time periods are the same for amended answers or amendments to the answer. Tax Ct. R. 37(a).

A reply is required to be filed if the answer contains material allegations on which the government has the burden of proof. T.C. 37(b). The reply must contain a specific admission or denial, or state insufficient knowledge or information. The reply must also contain a statement of every ground (and supporting facts) on which petitioner relies affirmatively or in avoidance of any matter on which the Commissioner bears the burden of proof. Tax Ct. R. 37(b).

Where a reply is filed, every affirmative allegation not expressly admitted or denied is deemed admitted. Where a reply is not filed, the affirmative allegations in the answer are deemed denied unless Commissioner files a motion (within 45 days of deadline for filing reply) that specified allegations in the answer be deemed admitted. Tax Ct. R. 37(c).

4. Amended and Supplemental Pleadings. A party may amend a pleading once as a matter of course at any time before a responsive pleading is served. If the pleading is one to which no responsive pleading is permitted and the case has not been placed on a trial calendar, then a party may so amend it at any time within 30 days after it is served. Otherwise a party may amend a pleading only by leave of Court or by written consent of the adverse party, and leave shall be given freely when justice so requires. Tax Ct. R. 41.

5. IRS Appeals. Docketed cases are referred to IRS Appeals for consideration of settlement unless Appeals issued the statutory notice of deficiency. Cases in which Appeals issued the statutory notice of deficiency may be referred to Appeals unless Counsel determines that there is little likelihood that a settlement of all or a part of the case can be achieved in a reasonable period of time. Cases involving deficiencies (defined to include tax and penalties per taxable period) of more than $10,000 will be promptly returned to Counsel when no progress is made toward settlement, or when a case appears on a trial calendar, unless Counsel agrees to extend the period of Appeals' consideration of the case. Cases involving deficiencies of $10,000 or less, including "S" cases, will be referred to Appeals for a period of six months or until one month before the trial calendar call in regular cases or 15 days before the trial calendar call in "S" cases, if earlier. At the end of the period described in the foregoing sentence or at such time as Appeals determines the case is not susceptible of settlement in whole or in part, the case will be returned to Counsel. Where appropriate, Counsel and Appeals may agree to extend the period of Appeals' consideration, or return the case to Appeals, if there is a likelihood of settlement. Rev. Proc. 87-24, 1987-1 CB 720.

6. Discovery. Discovery may not begin without leave of court before expiration of 30 days after joinder of issue (generally, once the answer and reply are filed). Discovery must be completed, and any motion to compel discovery must be filed, no later than 45 days prior to the trial date (unless otherwise authorized by the Court.) Tax Ct. R. 70(a)(2).

7. Specific Types of Discovery.

a. *Depositions*. Discovery by deposition may not be commenced before a notice of trial has been issued or the case has been assigned to a Judge or Special Trial Judge. Tax Ct. R. 70(a)(2).

b. *Interrogatories*. A party must answer interrogatories within 30 days of service. The Court may allow a shorter or longer time. Tax Ct. R. 71(c). A party may use an interrogatory to require the other party to disclose expert witnesses. Tax Ct. R. 71(d).

c. *Request for Production*. Response is due within 30 days of service of request. Tax Ct. R. 72(b).

d. *Requests for Admission*. Requests for admissions shall not be commenced before 30 days after joinder of issue. Requests for admission shall be completed no later than 45 days before calendar call. A party has 30 days to respond to the request or each matter is deemed admitted. Tax Ct. R. 90(a), (c).

8. Stipulations. The parties are required to stipulate to the fullest extent to which agreement can be reached, all mattes not privileged which are relevant to the pending case, whether fact, opinion, or application of the law. Tax Ct. R. 91(a). Stipulations must be filed in duplicate and only one set of exhibits is required. Tax Ct. R. 91(b). Stipulations and related exhibits must be filed at or before commencement of the trial, unless otherwise required by the Court's pre-trial order. Tax Ct. R. 91(c).

9. Summary Judgment Motions. Either party may move for summary judgment at any time commencing 30 days after the pleadings (petition, answer, and reply) are closed but within such time as not to delay trial. Tax Ct. R. 121(a).

10. Expert Witness Reports. Any party who calls an expert witness shall cause that witness to prepare a written report for submission to the Court and to the opposing party. Once the case is calendared for trial or assigned to a judge or Special Trial Judge, expert witness reports are due not later than 30 days before the call of the trial calendar. Tax Ct. R. 143(f).

11. Trial. Each case, when at issue, will be placed upon a calendar for trial. The Clerk shall notify the parties of the place and time for which the calendar is set. At the calendar call, counsel or the parties shall give their estimate of the time required for trial. The cases will be tried in due case, but not necessarily in the order listed. Tax Ct. R. 131. Special or other calendars may be scheduled by the Court, upon motion or its own initiative, for any purpose which the Court may deem appropriate. Tax Ct. R. 132. A case may be continued by the Court upon motion or at its own initiative. Continuances are granted only in exceptional circumstances. Tax Ct. R. 133.

12. Post-Trial Briefs. Briefs may be filed simultaneously or seriatim, as the presiding Judge directs. For simultaneous briefs, opening briefs must be filed within 75 days after conclusion of trial, and answering briefs 45 days thereafter. For seriatim briefs, the opening brief is due within 75 days after the conclusion of the trial, the answering brief within 45 days thereafter, and the reply brief within 30 days after the due date for the answering brief. The presiding Judge may set different deadlines. A party who fails to file an opening brief is not permitted to file an answering or reply brief, except with leave of Court. Tax Ct. R. 151(b).

13. Tax Court Opinion. The Tax Court must issue a report and a decision in all Tax Court proceedings "as quickly as practicable." I.R.C. § 7459(a). The report include findings of fact and an opinion or a memorandum opinion. I.R.C. § 7459(b). This statutorily prescribed "report" is the opinion that is published in the official reports of the Tax Court. I.R.C. § 7462. Opinions are typically written by the presiding judge.

The Judge may exercise discretion to orally state the findings of fact or opinion if the Judge is satisfied as to the factual conclusions to be reached and that the law to be applied thereto is clear. Oral findings of fact or opinion are recorded in the transcript of the trial and must be served by the Clerk on all parties. Tax Ct. R. 152.

All opinions are reviewed by the chief judge. An opinion automatically becomes the report of the Tax Court unless within 30 days the chief judge directs that the report is to be reviewed by the entire court. I.R.C. § 7460(b). An opinion is typically reviewed by the entire court if it

involves a change in position or a response to a decision of a court of appeals. The chief judge determines whether an opinion will be issued as a regular or memorandum decision. The chief judge will label a decision a memorandum decision if the decision involves primarily factual determinations and the application of only settled legal principles. Regular opinions are officially reported in Tax Court Reports and have greater precedential value than memorandum opinions. Memorandum decisions are not officially reported and are not binding precedent. *See, e.g., Nico v. Commissioner*, 67 T.C. 647, 654 (1977), *aff'd in part and rev'd in part*, 565 F.2d 1234 (2d Cir.).

14. Motion for Reconsideration of Findings or Opinion. Any motion for reconsideration shall be filed within 30 days after service of a written opinion or the pages of the transcript that contain oral findings of fact or opinion. Tax Ct. R. 161.

15. Litigation Costs. Where a party has substantially prevailed or is treated as the prevailing party in the case of a qualified offer made under section 7340(g) and wishes to claim litigation and administrative costs, a claim must be made within (A) 30 days after service of written opinion; (B) 30 days after service of transcript containing oral findings of fact; or (C) after the parties have settled all issues except for litigation/administrative costs. Tax Ct. R. 231(a). The prevailing party must meet the net worth requirements of section 28 U.S.C. § 2412(d)(2)(B). Tax Ct. R. 231(b).

16. Entry of Decision. Where the Court has filed or stated its opinion determining the issues in a case, it may withhold entry of the decision until the parties submit agreed upon computations showing the correct amount to be included in the decision or the Court determines the correct amount. Tax Ct. R. 155.

17. Motion to Vacate. Any motion to vacate or revise a decision shall be filed within 30 days after the decision has been entered, unless the Court otherwise permits. Tax Ct. R. 162.

18. Notice of Appeal. The notice of appeal must be filed with the clerk of the Tax Court within 90 days after the decision is entered in a case. Tax Ct. R. 190(a).

19. Motion to Redetermine Interest. The Tax Court has jurisdiction under Code § 7481(c) to redetermine interest assessed by the Commissioner with respect to deficiencies determined by Tax Court or to redetermine interest on an overpayment determined by the Tax Court. Code § 7481(c) applies to both overpayments of interest by the taxpayer and underpayments of interest by the government.

This supplemental proceeding is commenced by motion filed by petitioner within one year after the Tax Court decision becomes final. The Commissioner must file a written response within 60 days specifically addressing each of the contentions and the computations made by petitioner and attaching a schedule detailing the computation of interest claimed to be owed to or due from the Commissioner. Tax Ct. R. 261(c). These proceedings are generally resolved without a hearing unless there is a bona fide factual dispute that cannot be resolved otherwise. Tax Ct. R. 261(d).

Outline For Determination of Partnership and Corporation Taxable Income

Ryan T. Gardner
Locke Lord Bissell & Liddell LLP

Outline For Determination of Partnership and Corporation Taxable Income

Ryan T. Gardner[1]
Locke Lord Bissell & Liddell LLP

Partnership Taxable Income

(Same as individual taxable income – Section 61 and 63) but with the following adjustments:

I. Separately stated items (via 702(a) and 1.702-1(a)(8)(i)):
   (a) STCG and STCL;
   (b) LTCG and LTCL;
   (c) G/L from sales, exchanges and involuntary conversions of property described in § 1231;
   (d) Charitable contributions;
   (e) Dividends received deduction income;
   (f) Qualified dividend income eligible for CG treatment tax rate;
   (g) Income that would qualify for foreign tax credit;
   (h) Recoveries of tax benefit income such as recovery of state franchise taxes due to credit;
   (i) G/L from gambling under 165(d);
   (j) Soil and water conservation expenses under 175;
   (k) Nonbusiness production of income expenses under 212;
   (l) Medical expenses under 213;
   (m) Alimony payments under 215;
   (n) Taxes and interest paid to cooperative housing corporations under 216;
   (o) IDC and development costs of mining exploration expenses under 263(c);
   (p) Income, gains, losses to partnership under 751(b) from sale of hot assets;
   (q) Domestic partnership's allocable share of REMIC taxable income or net loss;
   (r) Items of income/gain/loss/deduction or credit that are specially allocated;
   (s) Other items that if "separately stated" would alter partners tax liability, including, but not limited to:
      (1) Rental activities and the 469 passive loss rules;
      (2) Portfolio income (dividend and interest) and the 469 passive loss rules;
      (3) Net G/L under 1256 contracts;
      (4) Depletion deduction for oil and gas wells;
      (5) Interest expense that must be capitalized;
      (6) 179 expensed property;
      (7) Recapture of 179 expensed property;
      (8) Deductions related to portfolio income and 469 rules;

(9) Investment interest deductions and 165(d);
(10) Tax credits;
(11) Self employment income;
(12) Items treated as adjustment for preference items in AMT calculation;
(13) Guaranteed payments;
(14) Royalties;
(15) Collectibles (28%) gain/loss;
(16) Unrecaptured Section 1250 gain;
(17) Discharge of indebtedness income;
(18) Self charged interest (interest between a partner and a partnership);
(19) Tax exempt interest income;
(20) Rehabilitation credit from rental real estate activities;
(21) Unrelated business taxable income;
(22) Foreign tax credit information;

II. Deductions are not allowed for the following (703(a)(2) and 1.703-1(a)(2)):
(a) Personal exemptions;
(b) Taxes paid to foreign country or US possession that can claim FTC;
(c) Charitable contributions;
(d) NOLs;
(e) Additional itemized deductions for individuals including nonbusiness expenses for the production of income (212), medical, dental, etc expenses (213), alimony (216), taxes paid to cooperative housing cooperative (216) and retirement savings (219);
(f) Oil and gas depletion; and
(g) Deductions for capital loss carryover.

See Code §§ 702, 703 and regulations. See Checkpoint Paragraphs B-1901 and B-1903. See also K-1 and K-1 Instructions thereto for *italics* items above.

Corporation Taxable Income

I. Start with taxable income under 63 and modify as follows:

(a) Ordinary income and capital gain/loss are all taxed as the same rate (1201(a));

(b) Increase tax if applicable for penalty tax for accumulated earnings (531);

(c) Increase tax for personal holding company tax (541);

(d) Reduce for foreign tax credit (881, 891);

(e) Increase for environmental tax (59A);

(f) Charitable gifts limited to 10% of TI (carryover for 5 years) (162(b) and 170);

(g) Capital losses limited to capital gains;

(h) Losses allowed to be deducted not limited as they are for individuals (165);

(i) Bad debts not limited like they are for individuals (166(d));

(j) Investment expenses are not limited like they are for individuals (212);

(k) Interest not limited as it is for individuals (163);

(l) Hobby loss rules do not apply, unless less S Corp (183);

(m) Reduce for NOL deductions (carryover or back reduces TI) (172(a));

(n) Reduce for certain shareholder taxes paid by corporation (164);

(o) At risk rules only apply if less than 5 shareholders (DNA to S corps) (465);

(p) Passive loss rules only apply if less than 5 shareholders (DNA to S corps) (469);

(q) Increase for certain percent limitations on corporate tax preference items, including (291):

  (1) Certain 1250 property (which is treated as if it were 1245 property for recapture purposes);

  (2) Percent depletion on iron ore and coal;

  (3) Interest expenses related to exempt state and local bond interest income of financial institutions;

  (4) Exempt foreign sales income of CFCs;

  (5) Amortization of pollution control devices;

  (6) IDC and mineral exploration and development costs;

(r) Reduce by dividend received deduction (243 and 245);

(s) Amortize organizational expenses (248);

(t) Reduce deductions / losses for payments to related parties (267);

(u) No loss or deduction for corporation on distribution of depreciable property (311(a));

(v) Limit on deductions of bond premium on repurchase of issuing corporation (249);

(w) No deductions on expenses the Treasury deems abusive (269);

(x) No deduction for certain interest on debt incurred to acquire another corporation (279);

(y) No deduction for golden parachute payments (280G);

(z) Deduction limited if personal service corporation choosing fiscal year (280H);
(aa) Certain limitations on public corporations for compensation in excess of $1 million to certain key execs. (162(m));
(bb) Deferral of so called excess interest paid to a related tax-exempt person (163(j));
(cc) Denial of installment treatment on sale of depreciable property to controlled entity (453(g));
(dd) Reallocation of income amount related taxpayers (482);
(ee) No loss on distribution of corporation property to related party (336(d));
(ff) Deductions not allowed by corporation in connection with redemption of its stock (162(k)); and
(gg) No deduction for fines and penalties paid for violations of securities and other laws (162(f)).

See Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders Chapter 5 (Par. 5.01, 5.02, 5.03, 5.04, 5.05, and 5.06).

PLEASE NOTE THAT A CORPORATION IS ALSO SUBJECT TO ALTERNATIVE MINIMUM TAX WHICH IS CALCULATED BY TAKING TAXABLE INCOME ADJUSTING SUCH INCOME FOR CERTAIN PREFERENCES TO DETERMINE AMTI AND MULTIPLYING AMTI TIMES 20%.

---

[1] Ryan Gardner practices tax, nonqualified executive compensation and corporate law in the Houston office of Locke Lord Bissell & Liddell LLP. Mr. Gardner has been a Certified Public Accountant since 1992 and a Tax Attorney since 2001. His practice encompasses all areas of federal income taxation, as well as state, local, and international taxation. Mr. Gardner represents clients in numerous industries, including energy, oil and gas, real estate, health care, private equity and financial sectors.

Registration of Foreign Series LLC

Ryan T. Gardner
Locke Lord Bissell & Liddell LLP

Registration of Foreign Series LLC

Ryan T. Gardner
Locke Lord Bissell & Liddell LLP

Following are various provisions from or relating to the new Texas Series LLC Statute:

Section 9.005. Supplemental Information Required in Application for Registration of Foreign Limited Liability Company.

(a) This Section apples only to a foreign limited liability company governed by a company agreement that establishes or provides for the establishment of a designated series or members, managers, membership interests, or assets that has any of the characteristics described in Subsection (b);

(b) A foreign limited liability company must state in its application for registration as a foreign limited liability company whether:

(1) the series has:

(A) separate rights, powers or duties with respect to specified property or obligations of the foreign limited liability company; or

(B) separate profits and losses associated with specified property or obligations of the foreign limited liability company;

(2) any debts, liabilities, obligations and expenses incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only, and not against the assets of the company generally or the assets of any other series; and

(3) any debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the company generally or any other series shall be enforceable against the assets of that series.

Subchapter M Series Limited Liability Company:

Section 101.601. Series of Members, Managers, Membership Interests or Assets.

(a) A **company agreement** may establish or provide for the establishment of one or more designated series of members, managers, membership interests, or assets that:

(1) has separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits or losses associated with specified property or obligations; or

(2) has a separate business purpose or investment objective.

(b) A series established in accordance with Subsection (a), may carry on any business, purpose, or activity, whether or not for profit, that is not prohibited by Section 2.003.

Section 101.602. Enforcement of Obligations and Expenses of Series Against Assets.

(a) Notwithstanding any other provision of this chapter or any other law, but subject to Subsection (b) and any other provision of this subchapter:

(1) the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only, and shall not be enforceable against the assets of the limited liability company generally or any other series; and

(2) none of the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the limited liability company generally or any other series shall be enforceable against the assets of a particular series.

(b) Subsection (a) applies only if:

(1) the r**ecords maintained for that particular series** account for the assets associated with that series separately from the other assets of the company or any other series;

(2) the **company agreement** contains a statement to the effect of the limitations provided in Subsection (a); and

(3) the **company's certificate of formation** contains a notice of the limitations provided in Subsection (a).

Section 101.603. Assets of Series.

(a) **Assets associated with a series may be held** directly or indirectly, including being held in the name of the series, in the name of the limited liability company, through a nominee, or otherwise.

(b) If the **records of a series are maintained in a manner so that the assets of the series can be reasonably identified** by specific listing, category, type, quantity, or computational or allocational formula or procedure, including a percentage or share of any assets, or by any other method in which the identity of the assets can be objectively determined, the records are considered to satisfy the requirements of Section 101.602(b)(1).

Section 101.604. Notice of Limitation on Liabilities of Series.

Notice of limitation on liabilities of a series required by Section 101.602 that is contained in a certificate of formation filed with the secretary of state satisfies the requirements of Section 101.602(b)(3), regardless of whether:

(1) the limited liability company has established any series under this subchapter when the notice is contained in the certificate of formation; and

(2) the notice makes a reference to a specific series of the limited liability company.

Section 101.605. General Power of Series.

A series established under this subchapter has **the power and capacity**, in the series' own name, to:

(1) sue and be sued;

(2) contract;

(3) hold title to assets of the series, including real property, personal property, and intangible property; and

(4) grant liens and security interests in assets of the series.

Section 101.606. Liability of Member or Manager for Obligations; Duties.

(a) Except as and to the extent the company agreement specifically provides otherwise, **a member or manager associated with a series or a member or manager of the company is not liable** for a debt, obligation, or liability of a series, including a debt, obligation, or liability under a judgment, decree, or court order.

(b) The **company agreement may expand or restrict** any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person associated with a series has to:

(1) the series or the company;

(2) the member or manager associated with the series; or

(3) a member or manager of the company.

Section 101.607. Class or Group of Members or Managers.

(a) The **company agreement may**:

(1) establish classes or groups of one or more members or managers associated with a series each of which has certain express relative rights, powers, and duties, including voting rights; and

(2) provide for the manner of establishing additional classes or groups of one or more members or managers associated with a series each of which has certain express rights, powers, and duties, including providing for voting rights and rights, powers, and duties senior to existing classes and groups of members or managers associated with a series.

(b) The company agreement may provide for the taking of an action, including the amendment of the company agreement, without the vote or approval of any member or manager or class or group of members or managers, to create under the provisions of the company agreement a class or group of the series of membership interests that was not previously outstanding.

(c) The **company may provide** that:

(1) all or certain identified members or managers or a specified class or group of the members or managers associated with a series have the right to vote on any matter separately or with all or any class or group of the members or managers associated with the series;

(2) any member or class or group of members associated with a series has no voting rights; and

(3) voting by members or managers associated with a series is on a per capita, number, financial interest, class, group, or any other basis.

Section 101.608. Governing Authority.

(a) Notwithstanding any conflicting provision of the certificate of formation of a limited liability company, the governing authority of a series consists of the managers or members associated with the series as provided in the company agreement.

(b) If the company agreement does not provide for the governing authority of the series, the governing authority of the series consists of:

(1) the managers associated with the series, if the company's certificate of formation states that the company will have one or more managers; or

(2) the members associated with the series, if the company's certificate of formation states that the company will not have managers.

Section 101.609. Applicability of other Provisions of Chapter; Synonymous Terms.

(a) To the extent not inconsistent with this subchapter, this chapter applies to a series and its associated members and managers.

(b) For purposes of the application of any other provision of this chapter to a provision of this subchapter, and as the context requires:

(1) a reference to "limited liability company" or "company" means the "series";

(2) a reference to "member" means "members associated with the series"; and

(3) a reference to "manager" means "manager associated with the series."

Series 101.610. Effect of Certain Event on Manager or Member.

(a) An event that under this chapter or the company agreement causes a manager to cease to be a manager with respect to a series does not, in and of itself, cause the manager to cease to be a manager of the limited liability company or with respect to any other series of the company.

(b) An event that under this chapter or the company agreement causes a member to cease to be associated with a series does not, in and of itself, cause the member to cease to be associated with any other series or terminate the continued membership of a member in the limited liability company or require the winding up of the series, regardless of whether the member was the last remaining member associated with the series.

Section 101.611. Member Status with Respect to Distribution.

(a) Subject to Sections 101.613, 101.617, 101.618, 101.619, and 101.620, when a member associated with a series established under this subchapter is entitled to receive a distribution with respect to the series, the member, with respect to the distribution, has the same status as a credit of the series and is entitled to any remedy available to a credit of the series.

(b) Section 101.207 does not apply to a distribution with respect to the series.

Section 101.612. Record Date for Allocations and Distributions.

A company agreement may establish or provide for the establishment of a record date for allocations and distributions with respect to a series.

Section 101.613. Distributions.

(a) A limited liability company may make a distribution with respect to a series.

(b) A limited liability company may not make a distribution with respect to a series to a member if, immediately after making the distribution, the total amount of the liabilities of the series, other than liabilities described in Subsection (c), exceeds the fair value of the assets associated with the series.

(c) For purposes of Subsection (b), the liabilities of the series do not include:

(1) a liability related to the member's membership interest; or

(2) except as provided by Subsection (e), a liability of the series for which the recourse of creditors is limited to specified property of the series.

(d) For purposes of Subsection (b), the assets associated with a series include the fair value of property of the series subject to a liability for which recourse of creditors is limited to specified property of the series only if the fair value of that property exceeds the liability.

(e) A member who receives a distribution from a series in violation of this section is not required to return the distribution to the series unless the member has knowledge of the violation.

(f) This section may not be construed to affect the obligation of a member to return a distribution to the series under the company agreement or other state or federal law.

(g) Section 101.206 does not apply to a distribution with respect to a series.

(h) For purposes of this section, "distribution" does not include an amount constituting reasonable compensation for present or past services or a reasonable payment made in the ordinary course of business under a bona fide retirement plan or other benefits program.

Section 101.614. Authority to Wind Up and Terminate Series.

Except to the extent otherwise provided in the company agreement and subject to Sections 101.617, 101.618, 101.619, and 101.620, a series and its business and affairs may be wound up and terminated without causing the winding up of the limited liability company.

Section 101.615. Termination of Series.

(a) Except as otherwise provided by Sections 101.617, 101.618, 101.619, and 101.620, the series terminates on the completion of the winding up of the business and affairs of the series in accordance with Sections 101.617, 101.618, 101.619, and 101.620.

(b) The limited liability company shall provide notice of the termination of a series in the manner provided in the company agreement for notice of termination, if any.

(c) The termination of the series does not affect the limitation on liabilities of the series provided by Section 101.602.

Section 101.616. Event Requiring Winding Up.

Subject to Sections 101.617, 101.618, 101.619, and 101.620, the business and affairs of a series are required to be wound up:

(1) if the winding up of the limited liability company is required under Section 101.552(a) or Chapter 11; or

(2) on the earlier of:

(A) the time specified for winding up the series in the company agreement;

(B) the occurrence of an event specified with respect to the series in the company agreement;

(C) the occurrence of a majority vote of all of the members associated with the series approving the winding up of the series or, if there is more than one class or group of members associated with the series, a majority vote of the members of each class or group of members associated with the series approving up of the series;

(D) if the series has no members, the occurrence of a majority vote of all of the managers associated with the series approving the winding up of the series or, if there is more than one class or group of managers associated with the series, a majority vote of the managers of each class or group of managers associated with the series approving the winding up of the series; or

(E) a determination by a court in accordance with section 101.621.

Section 101.617. Procedures for Winding Up and Termination of Series.

(a) The following provisions apply to a series and the associated members and managers of the series:

(1) Subchapters A, G, H, and I, Chapter 11; and

(2) Subchapter B, Chapter 11, other than Sections 11.051, 11.056, 11.057, 11.058, and 11.059.

(b) For purposes of the application of Chapter 11 to a series and as the context requires:

(1) A reference to "domestic entity," "filing entity," or "entity" means the "series";

(2) A reference to an "owner" means a "member associated with a series";

(3) A reference to the "governing authority" or a "governing person" means the "governing authority associated with the series" or a "governing person associated with the series"; and

(4) A reference to "business," "property," "obligations," or "liabilities" means the "business associated with the series," "property associated with the series," "obligations associated with the series," or "liabilities associated with the series."

(c) After the occurrence of an event requiring winding up of a series under Section 101.616, unless a revocation as provided by Section 101.618 or a cancellation as provided by Section 101.619 occurs, the winding up of the series must be carried out by:

(1) the governing authority of the series or one or more persons, including a governing person, designated by:

(A) the governing authority of the series;

(B) the members associated with the series; or

(C) the company agreement; or

(2) a person appointed by the court to carry out the winding up of the series under Section 11.054, 11.405, 11.409, or 11.410.

(d) An action taken in accordance with this section does not affect the limitation on liability of members and managers provided by Section 101.606.

Section 101.618. Revocation of Voluntary Winding Up.

Before the termination of the series takes effect, a voluntary decision to wind up the series under Section 101.616(2)(C) or (D) may be revoked by:

(1) a majority vote of all of the members associated with the series approving the revocation or, if there is more than one class or group of members associated with the series a majority vote of the members of each class or group of members associated with the series approving the revocation; or

(2) if the series has no members, a majority vote of all the managers associated with the series approving the revocation or, if there is more than one class or group of managers associated with the series, a majority vote of the managers of each class or group of managers associated with the series approving the revocation.

Section 101.619. Cancellation of Event Requiring Winding Up.

(a) Unless the cancellation is prohibited by the company agreement, an event requiring winding up of the series under Section 101.616(1) or (2) may be canceled by the consent of all of the members of the series before the termination of the series taken effect.

(b) In connection with the cancellation, the members most amend the company agreement to:

(1) eliminate or extend the time specified for the series if the event requiring winding up of the series occurred under Section 101.616(1); or

(2) eliminate or review the event specified with respect to the series if the event requiring winding up of the series occurred under Section 101.616(2).

Section 101.620. Continuation of Business.

The series may continue its business following the revocation under Section 101.618 or the cancellation under Section 101.619.

Section 101.621. Winding up by Court Order.

A district court in the county in which the registered office or principal place of business in this state of a domestic limited liability company is located, on application by or for a member associated with the series, has jurisdiction to order the winding up and termination of a series if the court determines that it not reasonably practicable to carry on the business of the series in conformity with the company agreement.