The Texas Tax Lawyer

Spring 2010
Vol. 37, No. 3
www.texastaxsection.org

State Bar of Texas
2010
Created in 1939

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CHAIR'S MESSAGE

Dear Tax Section Members:

This fiscal year is coming to a close in June, but not before two last major Tax Section events: the 26th Annual Texas Federal Tax Institute and the 2010 Tax Section Annual Membership and CLE Meeting.

As in past years, the 26th Annual Texas Federal Tax Institute will be held at the Hyatt Regency Hill Country Resort in San Antonio. The 2010 Institute will be held on June 10 and 11 and is the premier federal tax conference held between the two coasts. The Institute covers the latest updates and developments on the hottest topics in federal tax law, and will feature several of the nation's highest regarded experts on tax and tax policy issues, including four government speakers from Washington, D.C. For more details and to register for this year's Institute, please see https://www.clesolutions.com/LinkClick.aspx?fileticket=wx3rg3CJrXE%3d&tabid=63.

The Tax Section's 2010 Annual Membership and CLE Meeting will be held on June 25 in Dallas and will feature two hours of CLE and a Lunch with Legends program in addition to the annual meeting of the Tax Section membership. The CLE programs will begin with a 9:00 a.m. panel discussing the IRS' new schedule for uncertain tax positions and related privilege and work product issues. A 10:00 a.m. panel will follow discussing the potential benefits and pitfalls of Roth IRA conversions. After a break and the Tax Section's annual membership meeting, the Tax Section will provide lunch for all attendees and Bill Elliott will moderate our Lunch with the Legends panel of Richard Freling, Ron Mankoff, and Buford Berry from Noon to 1:30 p.m.

The 2010 Annual Membership and CLE Meeting, including the Lunch with the Legends, will be held at the Dallas office of Thompson & Knight L.L.P., located in One Arts Plaza at 1722 Routh Street, Suite 1500, Dallas, Texas 75201. **All Tax Section members are invited to attend and there is no charge for any of the programs or for the lunch**. **We do request, however, that those who plan to attend please RSVP by emailing me at tyree.collier@tklaw.com so that we can make sure there is seating and food for all attendees**.

Two other events are also planned for the Summer of 2010: the State and Local Tax Committee's annual meeting with the Comptroller, which is scheduled for July 23 in Austin, and the annual Advanced Tax Law Course, which is scheduled for August 25-27 in Dallas. Please mark your calendar and plan to attend one or both of these excellent programs.

Finally, I want conclude by thanking the many members who have made this such a successful year for the Section. Elizabeth Copeland has done another great job in leading our Pro Bono Committee and expanding yet again our highly successful Tax Court Pro Bono program. Andrius Kontrimas has made significant improvements to The Texas Tax Lawyer and also organized and led this year's popular 12th Annual International Tax Symposium. Dan Baucum has put in another year of hard work in leading our Committee on Government Submissions. Ron Adzgery has been an excellent leader of our CLE Committee. Larry Jones was a fine leader of our planning committee for this year's Advanced Tax Law Course. Matthew Tepper did a great job organizing and leading the Property Tax Committee's annual CLE and meeting program, and introduced a pre-meeting happy hour for that event this year. Abbey Garber again led our highly appreciated law student outreach program. Matthew Larsen was joined by other members of the State and Local Committee in another successful year with margin tax comments and more.

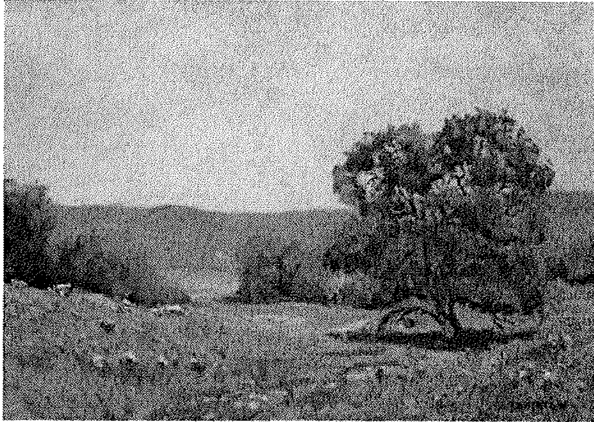
Many others contributed to government submission projects, to our three outstanding issues of The Texas Tax Lawyer, to our CLE Committee, by volunteering for our Pro Bono Committee projects, and in many other ways. Thanks to all of you who have made our Section the success that it has been. And last, but certainly not least, thanks to my three fellow officers, Patrick O'Daniel, Mary McNulty, and Tina Green, who have made this year so enjoyable for me.

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

Thanks, I look forward to finishing out this year with a bang and to many great years to come.

Tyree Collier, Chair

26TH ANNUAL TEXAS FEDERAL TAX INSTITUTE



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MUCH UNCERTAINTY ABOUT UNCERTAIN TAX POSITIONS

By: *Robert D. Probasco*[1]

Internal Revenue Service (the "Service" or "IRS") Commissioner Douglas Shulman stunned his audience at the January 26th annual meeting of the New York State Bar Association Tax Section with the disclosure of a new proposal, spelled out in Announcement 2010-9[2] (the "Announcement") released the same day. The Service plans to require certain large businesses to report "uncertain tax positions" on a new schedule filed with their annual tax returns.

Shulman explained the proposal as intended to increase efficiency: "Today, we spend up to 25 percent of our time in a large corporate audit searching for issues rather than having a straightforward discussion with the taxpayer about the issues." The Service believes that the new disclosure requirement will "help us prioritize selection of issues and taxpayers for examination." Rather than relying on auditors to identify items that might be in error, the proposal will require taxpayers to affirmatively point out the weak points in their returns, those that are most susceptible to challenge. As a result, the Service will be able to collect more taxes with fewer resources.

The Service subsequently issued Announcement 2010-30[3] on April 19, 2010, with a draft of the proposed Schedule UTP, Uncertain Tax Positions Statement, and related instructions. The draft schedule and instructions clarify some of the mechanical aspects of the new requirement but still leave many open issues and questions.

The Background – Financial Statement Reserves

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 ("FIN 48").[4] FIN 48 establishes a two-stage process of determining whether the taxpayer must establish a tax reserve. In the first step, the taxpayer must reserve 100% of the tax position unless it is more likely than not, based on the technical merits, that the position reported on the return would be sustained if the taxpayer litigated the issue to the court of last resort.[5] This determination is based on application of relevant legal authorities to the facts and circumstances and presumes that the Service audits the return and has full knowledge of all relevant information.[6] If the Service's past administrative practices and precedents, in its dealings with the taxpayer or similar enterprises, are widely understood, those are considered as well.[7] Thus, even if a tax position is technically incorrect, the taxpayer would not have to reserve 100% of it if the Service's practice is to allow it when and if examined.[8]

If a tax position is more likely than not correct, the second step in the FIN 48 process is the determination of how much, if any, of the tax benefits must be reserved in the taxpayer's financial statements. The taxpayer must reserve any amount of the total tax benefit in excess of the largest amount that is greater than 50% likely of being realized upon ultimate settlement with the Service.[9] Unless the probability is greater than 50% that the Service would concede the entire amount at issue, a reserve would be required for the financial statements. The second step in the FIN 48 process takes into account the likelihood that the taxpayer will settle rather than litigate. That

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determination is based on the amount the taxpayer would ultimately accept in a settlement with the Service, and therefore may well be less than 100% of the tax benefit even though it is more likely than not that the taxpayer would prevail in full by litigating.[10]

Thus, the taxpayer generally must establish a reserve in its financial statements for part or all of the tax benefit from the position unless it is more likely than not that the Service would *fully concede* the issue prior to litigation. Although Appeals normally will not demand concessions based on "nuisance" value, it is unlikely that the Service will fully concede the issue unless it assesses the probability that the taxpayer would prevail in litigation as at least 80%. (This is consistent with our understanding of the "should" degree of confidence at which accounting firms typically do not require a reserve for financial reporting purposes.) With some exceptions, therefore, the taxpayer has to establish a reserve in its GAAP financial statements for the position unless it is more likely than not that the Service would conclude it had no reasonable basis (roughly less than a 20% chance of success) for contesting the position taken on the return.

FIN 48's requirements apply only to items that are material with respect to the financial statements. The definition of a tax position also depends on the level of detail at which individual items are aggregated into a "tax position." FIN 48 addresses the level of aggregation through a concept described as "unit of account" and defined as follows:

> The appropriate unit of account for determining what constitutes an individual tax position . . . is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account to be used . . . shall consider the manner in which the enterprise prepares and supports its income tax return and the approach the enterprise anticipates the taxing authority will take during an examination.[11]

The taxpayer's financial statements do not show the amount of reserve by individual tax position, only an aggregate amount. Taxpayers routinely prepare supporting documentation for the tax reserves that show such detail. These "tax accrual workpapers" normally contain not only a description of the relevant facts but also identification of potential Service arguments, legal analysis, and assessment of the risks and most likely settlement amount. The tax accrual workpapers could provide the Service not only with a list of the most vulnerable positions to audit but also negotiating leverage from knowing the taxpayer's evaluation of the strength of its case.

The Service has a "policy of restraint," however, that limits the circumstances under which it will request the taxpayer's tax accrual workpapers. Currently, the Service's policy[12] is to request tax accrual workpapers:

- If the tax return claims any tax benefit from a listed transaction that was properly disclosed, only the tax accrual workpapers pertaining to that listed transaction.
- If the tax return claims any tax benefit from a listed transaction that was not properly disclosed, or benefits from multiple investments in a listed transaction (whether disclosed or not), all tax accrual workpapers.
- In unusual circumstances when additional facts are required for a specific identified issue but could not be obtained from the taxpayer's other records or from available third parties.

When the Service does request tax accrual workpapers, the request may lead to fierce disputes and litigation when the taxpayer asserts privileges against disclosure.[13]

This is the background against which the Service issued the Announcement. Speaking at the March 5th meeting Federal Bar Association Section on Taxation Tax Law Conference, IRS Chief Counsel William Wilkins explained that the proposed disclosures were not an outgrowth of a recent favorable court decision concerning the application of privileges to requests for tax accrual workpapers. Instead, he characterized it as a natural result of the accounting rules regarding companies' tax reserves, such as FIN 48. The information now being sought is available. Because the Service doesn't consider the information to be privileged, there is no reason not to ask for it.

The Proposal

What Positions Would Be Reported

The Announcement and the draft instructions for Schedule UTP define uncertain tax positions as:

- Positions for which the taxpayer or a related entity has recorded a reserve in its financial statements under FIN 48 or other generally accepted accounting standards;
- Positions for which a tax reserve is not required because the taxpayer expects to litigate (and win) the position; and
- Positions for which a tax reserve is not required because the taxpayer has determined that the Service has an administrative practice not to challenge the position.

The instructions for Schedule UTP indicate that it would be based on the same materiality and level of aggregation ("unit of account" in FIN 48) standards as used in the financial statements. Thus, the items reported should be the same as those recorded in the company's reserves for financial accounting.[14] For uncertain tax positions for which no reserve was recorded (because the taxpayer intends to litigate or determined the Service has an administrative practice not to challenge the position), the Service apparently intends taxpayers to apply the same materiality and level of aggregation standards.

Who Would Be Required to Report

The business taxpayers subject to the requirement are those with total assets in excess of $10 million, with one or more positions of the type required to be reported on the new schedule. It includes taxpayers who prepare financial statements themselves, or are in included in the financial statements of a related entity, if the financial statements determine United States federal income tax reserves under FIN 48 or other accounting standards. For now, the requirement is limited to corporations that file Forms 1120, 1120 F, 1120 L, or 1120 PC.

Timing and Transition Rules

Taxpayers would be required to file Schedule UTP starting with 2010 tax returns filed in 2011. The schedule has different sections to list uncertain tax positions for the current year and for prior years and the instructions include timing and transition rules.

- Uncertain tax positions taken in tax years beginning before December 15, 2009 need not be reported regardless of whether or when a reserve was recorded.[15]
- If the taxpayer makes the decision to record a reserve at least 60 days before filing a tax return, the uncertain tax position must be reported on that tax return. It will be reported on Schedule UTP either in Part I (if the position was taken in that year's tax return) or Part II (if the position was taken in an earlier year's tax return).
- If the taxpayer makes the decision to record a reserve less than 60 days before filing a tax return, the taxpayer has the option to report it on Schedule UTP either on that tax return or the return for the next tax year.
- A taxpayer takes an uncertain tax position in each year for which there would be an adjustment to a line item on that return if the position is not sustained. Thus, some uncertain tax positions will be taken in multiple years. The taxpayer is required to report the uncertain tax position once and only once for each year in which it takes the position.

What Would Be Reported

Taxpayers would report, for each uncertain tax position:

- The primary Internal Revenue Code sections relating to the tax position, to a maximum of three.
- Indication whether the uncertain tax position relates to a timing difference, and whether the difference is temporary or permanent.
- The EIN of a pass-through entity, if the corporation's tax position relates to a tax position of the pass-through entity.
- Indication whether the tax position is one for which no reserve is recorded because of the Service's administrative practices.
- The maximum tax adjustment, or a ranking of those items that are valuation or transfer pricing tax positions.
- A concise description of the tax position, including:
    - A statement that the positions involves an item of income, gain, loss, deduction, or credit against tax.
    - A statement whether the position involves a determination of the value of any property or right or a computation of basis.
    - The rationale for the position.
    - The reasons for determining the position is uncertain.

Maximum Tax Adjustment

One of the primary concerns of tax practitioners has been the computation of the maximum tax adjustment (MTA). It was not clear exactly how that should be determined to provide the most

useful information to the Service without providing risk assessment information. The Announcement, for example, requested input on whether the amount reported should be only for the tax period for which the return is filed or for all tax periods to which the position relates, and whether the determination should take into account net operating losses or excess credits. In addition, while the MTA might be determined in some instances simply from the effect of totally disallowing a deduction or loss, in other situations the maximum adjustment might be indeterminate. This might occur, for example, with many valuation or transfer pricing issues. If the taxpayer values something too high, the MTA might be based on changing the value of $0. If the taxpayer obtains a tax benefit from valuing something too low, however, there may be no logical or clear answer to the maximum value on which the MTA might be based.

The Service has resolved most of these issues, for now, in the draft Schedule UTP and instructions. The MTA is determined on an annual basis. For tax positions other than valuation or transfer pricing tax positions, the MTA is: (1) the total amount of an item of credit; and/or (2) the total amount of items of income, gain, loss, or deduction multiplied by an effective tax rate of 35%. Interest and penalties are not included, and items may not be offset other than by other items relating to the same tax position.

For valuation and transfer pricing tax positions, the Service provided another approach. Taxpayers are not required to report a specific amount as with other positions. Instead, the taxpayer reports the relative ranking of all valuation positions and the relative ranking of all transfer pricing positions. The taxpayer has a choice of basing the ranking on either: (a) the amount recorded as a reserve in the financial statements; or (b) the estimated adjustment to tax liability, computed as described above, if the tax position is not sustained. The taxpayer need not disclose the method chosen or the relative amounts used to rank the positions.

Concerns and Open Issues

The Service requested comments on the proposal by June 1, 2010, and has stated that there may be further changes based on those comments or as the proposal evolves. There are several open issues or areas of concern to many taxpayers and tax practitioners. Some of the most significant are as follows.

Practical Effect

Tax positions are uncertain for a number of reasons. As Commissioner Shulman recognized in recent comments to the Tax Executives Institute Midyear Conference, these reasons may include ambiguity in the law and a lack of public guidance on issues. An uncertain tax position may, and often will, simply reflect the taxpayer's honest effort to apply the tax law correctly rather than an aggressive interpretation of the law in the face of contrary guidance or caselaw. Often, the correct resolution will be no adjustment at all. It is clear from public pronouncements that top management at the Service understands this and does not intend that Exam automatically propose adjustments for all listed positions. However, there is reason for concern whether management's expectations will translate into reality.

Under FIN 48, the taxpayer generally must establish a reserve in its financial statements for part or all of the tax benefit from the position unless it is more likely than not that the Service would *fully concede* the issue prior to litigation. Service personnel will know, simply from the fact that a position is listed on the schedule, that the taxpayer determined it probably would have to concede at least a partial adjustment if the Service challenges the position. These positions will appear to be easy sources of additional tax collections, based on the taxpayers' own assessments. Also, Congress, the Executive Branch, the media, and the general public may not have the same understanding as the Service that an uncertain tax position is often completely proper, and they could react negatively to a perception that uncertain tax positions are not always challenged. It seems unlikely that Exam and Appeals would develop issues and analyze positions in the same manner as before, in the face of the changed circumstances and foreseeable pressures. There is a significant potential for overly aggressive use of the additional information provided, in a manner inconsistent with management's expectations, that could strain the Service's resources for handling taxpayer protests and litigation. Communicating management's expectations regarding use of the additional information alone may not be enough to avoid this potential disruption. Significant efforts to provide extensive training, align incentives, and monitor performance will be critical to the successful implementation of this program.

It will also be necessary to quickly and efficiently identify and resolve common issues. Exam may have enough published guidance and other authority to resolve many of the uncertain tax positions but other positions may be uncertain because of the lack of such authority. A thoughtful review and evaluation of the latter may require extensive coordination at National Office. As with other issues identified in the field, such coordination will help avoid wasteful duplication of effort and promote consistency. Depending on the volume of disclosures, however, the amount of time and effort required may well increase significantly.

It is not clear whether the Service has the administrative capacity to use the additional information appropriately. Given the potential difficulties and disruption from implementation of this new requirement, some practitioners have recommended that the Service give serious consideration to delaying implementation until it can conduct a pilot program to test how the process translates from theory to practice.

Privilege and Waiver

The proposed disclosure requirement appears to be intended as a *de facto* compromise in requesting sensitive information from taxpayers. Schedule UTP requires less information that is available in tax accrual workpapers. However, the proposal still creates serious concerns regarding privilege and waiver. The Service concludes that the information sought is not protected by privilege but many taxpayers and tax practitioners disagree. In particular, there could be serious questions about whether the work-product doctrine applies to the information requested. That privilege illustrates some specific objectionable aspects of the proposal.[16]

The Supreme Court first articulated the work-product doctrine in *Hickman v. Taylor*,[17] and the Advisory Committee incorporated it into the Federal Rules of Civil Procedure in 1970.[18] It generally protects from discovery "documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative."[19] Although that protection

may be overcome on a showing of substantial need, courts are directed to "protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative."[20] In *Upjohn Co. v. United States*,[21] the Supreme Court recognized that the protection is much stronger with respect to such opinion work-product[22] and some courts have held that the protection is nearly absolute.[23]

Schedule UTP primarily focuses on factual information about tax positions, rather than opinion work product often contained in tax accrual workpapers, such as the analysis of possible arguments and an overall assessment of the relative strength of the position and the hazards of litigation. However, there are aspects of the information requested that arguably constitute opinion work product.

First, the inclusion of a tax position on the schedule does not disclose the taxpayer's *exact* risk assessment, but it does demonstrate that the taxpayer assesses the risk as high enough that the Service probably would not fully concede the issue. This is a limited disclosure but arguably it is still opinion work product. Second, and more important, the proposal requests "a concise general statement of the reasons for determining that the position is an uncertain position." Similarly, the draft instructions include, as part of the concise description in Part III of the schedule, "the reasons for determining the position is uncertain." It is difficult to interpret this as asking for anything other than the taxpayer's assessment of the relative weaknesses of that position, since that assessment drives the decision to record a reserve for an uncertain tax position. All three examples given in the draft instructions are consistent with this interpretation that the Service is requesting the taxpayer's "conclusions, opinions, or legal theories," that is, opinion work product.

Taxpayers have legitimate concerns about the disclosure of opinion work product as well as the possibility that the Service could later argue that the disclosures constitute broad subject matter waivers of any privilege. The possibility of waiver is particularly troublesome as the waiver, if it is such, would result automatically from the required disclosures. This could essentially eliminate the privilege altogether for any such uncertain tax positions. In the context of requests for tax accrual workpapers, taxpayer concerns over privilege and waiver often lead to costly and time-consuming litigation to resolve the dispute. Although the proposed disclosures are less intrusive than a request for tax accrual workpapers, they are also being directed at a much larger population of taxpayers. As the proposal is structured, there is a significant possibility of dramatic increases in government resources required to litigate privilege disputes.

There are several possible changes to the proposal that could alleviate most taxpayers' concerns. First, the Service might confirm that the government will not take the position that the disclosures constitute a broad subject matter waiver of any privileges to which the taxpayer is entitled and that the disclosure requirements do not alter the otherwise applicable law relating to such privileges. This may be the Service's intent but taxpayers would be reassured by a formal commitment.

Second, a change to the Service's policy of restraint regarding tax accrual workpapers would be appropriate. In various public statements, Service personnel have stated that the Service would not, as a result of the new program, modify the policy of restraint to request additional tax accrual workpapers in circumstances other than those now authorized. That is, the Service will not

request tax accrual workpapers based solely on the disclosures on Schedule UTP. This is welcome news but it would be appropriate for the Service to further restrict the circumstances in which tax accrual workpapers are requested. Specifically, the Service should explicitly modify the policy of restraint to prohibit such workpaper requests of any taxpayer that complies with the new disclosure requirement. Although the Service may need additional facts about some of the uncertain tax positions, those can easily be obtained through normal channels in the course of the audit once the position has been identified. The only other information in the tax accrual workpapers would be the taxpayer's analysis and risk assessment. Under ordinary circumstances, there is no legitimate purpose for the Service to have that information.

Third, the Service should eliminate from the information to be disclosed the "concise general statement of the reasons for determining that the position is an uncertain tax position" or "reasons for determining the position is uncertain." If the reasons are factual in nature and unknown to the Service, such a request may be appropriate, but the information likely can be obtained as easily through normal channels during the audit rather than on the proposed schedule. If the reasons are legal in nature, they arguably fall within the realm of opinion work product. In addition, in the experience of most taxpayers and tax practitioners, once the Service has the relevant facts it has no difficulty identifying the arguments that could be used to challenge a tax position. This information adds minimal value to the Service while raising significant privilege concerns for the taxpayer and therefore should not be requested.

Some taxpayers and tax practitioners are making such recommendations to the Service. Whether the proposal will be modified accordingly remains to be seen.

Penalties

The Announcement stated that the Service "is also evaluating additional options for penalties or sanctions to be imposed when a taxpayer fails to make adequate disclosure of the required information regarding its uncertain tax positions. One option being considered is to seek legislation imposing a penalty for failure to file the schedule or to make adequate disclosure." It is still unclear whether the Service will seek a new penalty, rather than relying on existing penalties, and how any new penalty might be designed.

Other Disclosure Requirements

The draft instructions state that taxpayers need not file Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, for any tax positions disclosed on Schedule UTP.[24] The Service has not, as yet, addressed whether Schedule UTP might also replace other disclosure requirements, such as Form 8082, Notice of Inconsistent Treatment, or Form 8886, Reportable Transaction Disclosure Statement, or Schedule M-3. More importantly, the Service has not yet addressed whether listing an item on Schedule UTP will be considered adequate disclosure for purposes of various penalties or statute of limitations provisions, including:

- Accuracy-related penalties, Section 6662(d)(2)(B)(ii)(I)
- Reasonable cause exception for reportable transaction understatements, Section 6664(d)(2)(A)

- Extension of statute of limitations for undisclosed listed transaction, Section 6501(c)(10)
- Extension of statute of limitations for substantial omission of income, Section 6501(e)(1)(A)(ii)
- Extension of statute of limitations for substantial omission of income, Section 6229(c)(2)[25]

The purpose of most such provisions is to encourage sufficient disclosure for the Service to decide whether to examine an item. Clearly, listing an item on Schedule UTP will frequently, if not always, prompt the Service to consider additional investigation and provide the Service with fair warning of questionable items on the return. Listing a tax position on Schedule UTP should be considered "adequate disclosure" for the above and similar provisions seems entirely appropriate.

Conclusion

The effect of the proposed requirement remains unclear. The Service is still awaiting comments and considering changes. Even when the requirement is finalized, some experience with it will be necessary to determine how taxpayers implement it and how the Service uses the new information. At this point, though, it appears likely to be the most significant transformation in years of the tax reporting process and the relationship between the Service and taxpayers.

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[1] Mr. Probasco practices law with Thompson & Knight, LLP in Dallas, Texas.
[2] 2010-7 I.R.B. 408. The Service subsequently issued Announcement 2010-17, 2010-13 I.R.B. 515, to extend the deadline for comments and request input on three additional questions.
[3] 2010-19 I.R.B. ___.
[4] As a result of the FASB codification project, the relevant portions of FIN 48 are now contained in FASB ASC 740-10.
[5] FIN 48 ¶¶ 6, A2.
[6] *Id*. ¶ 7.
[7] *Id*. ¶ 7.b.
[8] Examples are at *id*. ¶¶ A12-A15, including a policy under which assets that cost less than $2,000 are deducted immediately rather than being capitalized.
[9] *Id*. ¶ 8.
[10] If the taxpayer determines that it will not accept anything less than a full concession by the Service, and will litigate if necessary, it may avoid the need to establish a tax reserve for that position for financial reporting. However, as discussed below, such positions would still be reported under the Service's new proposal.
[11] *Id*. ¶ 5.
[12] Announcement 2002-63, 2002-2 C.B. 72; I.R.M. 4.10.20 (Jul. 12, 2004).
[13] *See, e.g., United States v. Textron*, 553 F.3d 87 (1st Cir. 2009), *petition for cert. filed*, 78 U.S. Law Weekly (Dec. 24, 2009) (No. 09-750).
[14] In public pronouncements, Service management has denied any intention to second-guess taxpayers' decisions regarding the reserves in their financial statements.
[15] This also applies to tax years beginning on or after December 15, 2009, if the tax year ends before January 1, 2010.

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[16] Although the following discussion focuses on the work-product doctrine, taxpayers and tax practitioners have similar concerns about other privileges.
[17] 329 U.S. 495 (1947).
[18] This provision governs discovery proceedings in federal court, but the work-product doctrine is not limited to that context. Courts have also analyzed it in IRS summons enforcement actions.
[19] Fed. R. Civ. P. 2b(b)(3)(A).
[20] Fed. R. Civ. P. 26(b)(3)(B).
[21] 449 U.S. 383 (1981).
[22] *Id*. at 401-2. "[W]e think a far stronger showing of necessity and unavailability by other means . . . would be necessary to compel disclosure" of such opinion work-product.
[23] *See In re Grand Jury Subpoena*, 220 F.R.D. 130, 145 (D. Mass. 2004) and cases cited therein.
[24] These forms are used for items or positions not otherwise adequately disclosed, in order to avoid accuracy-related penalties.
[25] Although this section does not specifically mention adequate disclosure as an exception to the extension of the statute of limitations, the Service has interpreted it in that manner. *See* FSA 199925016 and cases collected in *CC&F Western Operations Limited Partnership v. Comm'r*, 273 F.3d 402 (1st Cir. 2001).

REVIEWING EXECUTIVE EMPLOYMENT AGREEMENTS: THE IMPACT OF SECTION 409A

By: *Linda A. Wilkins*[1]

INTRODUCTION

Providing advice to highly paid "C-level" executives requires many skills: expertise in income, gift and estate tax planning, in business succession planning (for closely held business owners), and an understanding of the types of equity and other long-term incentive awards that are commonly used in their industries. Financial planners may also review an executive's proposed employment agreement with a new employer. The executive may seek advice on whether the terms of his agreement are favorable to him from a tax standpoint, and whether the agreement reflects "best practices" or "industry-standard practices."

This article will describe the terms that are commonly used in employment agreements, and explore the key terms of the agreements that may trigger issues under Section 409A of the Internal Revenue Code of 1986, as amended (the "Code").[2] Because the excise tax penalties under Section 409A are imposed upon the executive and not his employer, the executive must obtain tax advice or he is acting at his peril.

There are two types of agreements in common use by public companies: the employment agreement (either fixed term, renewable term or "at will") and the change of control employment agreement. Either type of agreement is typically used only for executive officers. The change of control agreement is a more limited agreement, with a limited purpose. The change of control agreement is an employment agreement that is triggered and becomes effective only at the time of a change of control. It protects the executive in the event of involuntary termination (or constructive termination) following a change of control, and thus is a "double trigger" agreement. This means that no benefits are triggered because of the change of control alone.

Employment agreements may be negotiated either during the recruiting process, or, in the case of a start-up, immediately prior to an initial public offering. In a public company, the compensation committee of the board of directors (comprised of outside directors) typically reviews executive employment agreements and makes a recommendation to the board as a whole. During this process, the compensation committee will often rely upon the company's in-house and outside counsel and compensation consultants to advise them on terms that are "typical for the industry." Comparisons of peer companies' practices is often utilized as part of the due diligence process by the committee. Often the executive retains independent counsel and financial advisors. Even though legal counsel are involved in the drafting and negotiation of the agreements, the major "business points" of the agreement will typically be resolved directly between the principals (the executive and the board).

It is important to understand the dynamics at work in the process of deciding whether an executive will have an employment agreement, and if so, what the terms of the agreement will

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be. The mature company may consider it important to have an agreement only if there is a potential or contemplated change of control transaction. A change of control agreement, described below, provides protection that is more limited than an employment agreement. It assumes that the executives do not have any reason to require employment agreements so long as the "status quo" prevails. However, a change of control agreement is triggered by, and provides protection from adverse employment actions following a change of control.

Competition for executives (particularly CEOs and CFOs) is fierce. Retention can be difficult, particularly in the light of uncertainty arising from a pending sale of a business or restructuring efforts. Companies in certain industries (technology and business services) are more likely to have employment agreements with key executives in order to be competitive. In other industries they are less common, such as retailing and manufacturing.

KEY PROVISIONS OF EMPLOYMENT AND CHANGE OF CONTROL AGREEMENTS

Term of the Agreement. Employment agreements may be for a fixed term, or for a fixed term plus rolling renewal periods (i.e., 3 years, with automatic one-year renewals at the end of the term unless notice of non-renewal is given at least 90 days prior to the end of the year). From the company's perspective, a fixed term agreement is not desirable, because it forces the parties back to negotiations; the rolling series of renewals (an "evergreen provision") solves this dilemma.

The change of control agreement only becomes "triggered" and enforceable upon the occurrence of a change of control or a "potential" change of control (such as the commencement of a tender offer, or the entry into a merger agreement that remains subject to stockholder approval). The change of control agreement will typically have a term of 12 to 36 months.

Reporting Responsibilities. The employment agreement for a CEO should provide that he reports to the board of directors. For other officers, their title will be given, and their duties will be those that typically relate to such office. They will report to the CEO. The CEO and board of directors may also assign additional responsibilities, so long as they are generally consistent with the office.

Full-Time Service. The employment agreement will typically require the executive to devote all of his time and energies to his position, with exceptions for investment and community activities that are consistent with prior practice. In representing the executive, it is important to consider adding a provision permitting the executive to serve on one or more boards of directors for for-profit companies, if this is desired.

Compensation. The employment agreement or change of control agreement will specify the base salary and bonus opportunity. Often it is provided that the base salary may be increased but may not be decreased during the term. The agreement may provide for a "signing" bonus or relocation and housing allowances. If these costs are considerable, some employers require that the employee sign a one-year promissory note agreeing to repay these allowances if the executive terminates his or her employment during the first year.

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Other "make whole" provisions or incentives may be included to compensate the recruit for lost bonus or unvested options or forfeited SERP benefits under plans maintained by his previous employer.

Often the employment agreement will provide for an award of stock options or other equity incentives to be made upon the initial date of employment. In some cases, the parties negotiate for the award to be made upon the signing of a letter of intent, when actual employment will commence at a later date. If the company contemplates awarding incentive stock options (ISOs), be very careful that your client understands that ISOs may only be granted to employees, so no "pre-employment" awards can be made. It is critically important for tax and accounting reasons that any stock option awards be made coincident with the intended "grant date."[3]

If the executive's employment agreement includes a provision regarding his equity award, the award agreement should be attached to the employment agreement as an exhibit.

Termination Events. The employment agreement will provide that the executive's employment may be terminated at any time for "Cause," and that the executive forfeits any unvested equity or other long-term incentive awards and receives no severance benefits following termination for "Cause." Termination for "Cause" may encompass these events:

(a) acts of fraud, embezzlement or misappropriation with respect to the business;

(b) conviction of a felony or a crime involving moral turpitude;

(c) violation of a non-disclosure or non-compete covenant;

(d) material breach of the employment agreement (after notice and opportunity to cure); and

(e) use of drugs or alcohol that substantially interferes with the performance of duties.

The agreement should also permit the executive to terminate employment for "Good Reason," upon certain events that constitute a constructive termination. In that event, the executive would receive severance benefits. Common definitions of "Good Reason" include:

(i) a material diminution in office, title, reporting requirements or responsibilities (after notice and opportunity to cure);

(ii) a material reduction in the executive's salary or bonus;

(iii) following a change of control, a relocation of the executive's office of more than 50 miles without his prior consent; and

(iv) a material breach of the agreement..

A change of control agreement typically prohibits any change in an executive's title, authority and duties. The "Good Reason" definition is likely to be more comprehensive following a change of control. The change of control agreement protects the executive from any material change[4] in working conditions or reporting relationships from those that predated the change of control. If any material changes are made, the executive will have "Good Reason" to

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terminate and receive severance benefits. A "Good Reason" termination is treated as an involuntary or constructive termination of employment by the employer.

During a "window" period following a change of control, such as a period of 30 days commencing 12 months following the change of control, an executive will often have an opportunity to terminate employment voluntarily and still receive a complete severance package. This provides an incentive for the executive to continue his employment for a transition period following the change of control. It also provides an incentive for the acquiring company to negotiate a new employment agreement promptly following the change of control.

It is important that all agreements contain a carefully crafted definition of a change of control. This definition, as well as other key definitions, should conform to those set forth in the final Treasury Regulations under Section 409A of the Code.[5]

Separation Pay. A key term in every employment agreement is separation pay. If the executive's employment is terminated during the term of the agreement without "Cause" (or if the executive terminates with "Good Reason"), then severance benefits will typically be paid in a lump sum, based on a multiple of current salary and bonus. The bonus factored into the severance benefit may be an average of the prior three years' bonuses, or may be based solely on the most recent year's bonus. In a change of control agreement, the severance formula may be enhanced (ie., 36 months rather than 12 or 24 months of compensation), and in addition, all unvested options and other equity incentives would fully vest.

Continued company-provided medical and dental benefits are typically extended for the number of months equal to the severance period. The continuation of group health benefits should be coordinated with the executive's COBRA statutory continuation rights. Typically, an executive can only be provided with continued group health coverage under COBRA, and for the maximum 18-month COBRA continuation period. Any additional company-provided coverage (absent the insurance carrier's express written consent) can be handled through reimbursement of the former executive's premiums for individual coverage.[6] This coverage should cease if the former executive becomes covered by a new employer's group health plan.

Separation Pay under Section 409A of the Code. The Treasury Regulations under Section 409A of the Code provide that deferred compensation may include separation pay.[7] This is significant for two reasons. First, if separation pay is subject to Section 409A rules as deferred compensation, then it must be payable on fixed dates and cannot be accelerated, or the amounts will be subject to the Section 409A excise tax and other penalties. Second, if the separation pay is subject to Section 409A, then key employees of public companies cannot commence receipt of the separation pay until six months following termination of employment.

If separation pay is triggered only upon an "involuntary" termination event, then a portion (up to $450,000) may be paid to a key employee in a public company without regard to the six-month delay rule.[8] Generally, an "involuntary" termination is defined to include a termination by the company without cause, or a "Good Reason" termination where "Good Reason" is defined as required by the regulations under Section 409A of the Code.[9] This definition must be limited to material negative changes in the service relationship, duties, conditions or compensation. The regulations provide a "safe harbor" definition which may be

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used with assurance that it qualifies as an "involuntary termination" event. The safe harbor definition includes a material reduction in base salary (but not a material reduction in bonus) and certain other events, if the employee must provide timely notice of the event to the employer and the employer has a right to cure the event.

In practice, from the executive's standpoint, it will be best, if he is a key employee in a public company, to have a "non-safe harbor" definition of "Good Reason," accepting the mandatory six-month delay in receipt of separation pay satisfying the Section 409A requirements. It is common for agreements to provide that interest will accrue and be paid upon the deferred amounts during the six-month delay. It may also be desirable to provide in the agreement that the company must deposit the amounts deferred to a rabbi trust for the benefit of the executive, particularly if the separation is incident to a change of control of the company.

Releases of Claims. The agreement will likely require that, as a condition of receipt of severance pay following an involuntary termination without cause, the executive must deliver a comprehensive release of claims. There is a potential "trap" in drafting this provision that could trigger adverse consequences under Section 409A. The agreement may provide that the severance pay is paid only following receipt of the signed release. This causes the timing of the payment to become uncertain, and subject to possible voluntary deferral. In drafting the release provision, it is recommended that the executive be required to deliver the release no later than a fixed period of time (ie., sixty days) following his or her termination of employment and that the severance payment date be a fixed date shortly thereafter (with the payment forfeited if the release has not been received by that date).

Restrictive Covenants. The agreement will likely contain non-compete and other restrictive covenants. Companies will often require that all employees sign a "trade secrets" agreement, acknowledging that all inventions belong to and are the property of the employer. It also confirms the employee's common law duty not to disclose or utilize the company's proprietary information. These non-disclosure covenants are the key building block upon which the non-compete covenant is "appended." Therefore, if it is desirable to obtain a non-compete covenant in the employment agreement, it should be drafted as a component of, and as "ancillary to" the confidentiality and non-disclosure covenants.[10]

Dispute Resolution Provisions. The employer may include an arbitration clause, committing the employee to resolving any employment disputes through mandatory arbitration. Many employers routinely require consent to arbitration. Thus far, the courts have enforced mandatory arbitration provisions. The "pros and cons" of mandatory arbitration terms are beyond the scope of this article, but it is common in this context.

Excise Tax "Gross-Up" Provisions. It has become common practice for executives to be protected from liability for the Section 280G "golden parachute" (20%) excise tax by a "gross-up" bonus. This excise tax under Section 4999 of the Code may be triggered upon a change of control if the severance and other benefits exceed a multiple of the executive's average compensation over the prior five years. These bonuses can become very substantial for highly paid executives, because the bonus is taxable income, in addition to being a "parachute payment," and so the bonus must be grossed-up for both ordinary income tax and the 20% excise tax.

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It is likely that executives will, in the future, be protected from violations of Section 409A in their deferred compensation arrangements by "gross-up" provisions in their employment agreements. These terms are likely to become typical because, although the executive bears the excise tax under Section 409A, the executive does not draft the deferred compensation arrangements and is not the party in control of assuring that its terms comply with Section 409A. Some commentators have noted that, if an employer is particularly "displeased" with a departing executive, it could trigger his or her excise tax liability by accelerating a deferred compensation payment without his or her consent! The executive's only protection in that event would be a "gross-up" provision.

Summary. The drafting and negotiation of executive employment agreements is now more complex and the stakes are higher in that adverse taxes may be owed by the executive if attention is not paid to the Section 409A ramifications of all payment terms. Parties representing both the employer and the executive should assure that these issues are addressed.

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[1] Ms. Wilkins practices law with the Law Offices of Linda A. Wilkins.
[2] This article will not provide an overview of the provisions of Section 409A of the Code.
[3] Section 409A treats any stock option awarded at a discount from the market price of the shares as of the date of grant as deferred compensation, with significant adverse consequences for the design of the stock option.
[4] A "material" reduction in job duties should specifically include the scenario where an executive continues to have the same job title, but he becomes an officer of a subsidiary company and does not perform this role for the parent company.
[5] Treas. Reg. §1.409A-3(i)(5).
[6] There are timing requirements for the reimbursement of these expenses under the Section 409A regulations. See Treas. Reg. §1.409A-1(b)(9)(v)(B). If the reimbursements do not meet these requirements, the arrangement violates Section 409A and would result in the imposition of excise taxes upon the former executive.
[7] If the timing of separation pay following termination falls within the "short-term deferral" exception, then Section 409A would not apply. However, separation pay may be considered payable upon a "voluntary" termination event and therefore fully vested if the pay is triggered by a "Good Reason" that is more broad than the permitted definition under Section 409A. In that case, separation pay will always be considered deferred compensation subject to Section 409A and cannot be structured to meet the short-term deferral rule.
[8] Treas. Reg. §1.409A-1(b)(9)(iii).
[9] Treas. Reg. §1.409A-1(n)(2).
[10] A discussion of the enforceability of non-compete covenants, a challenging area, is beyond the scope of this article.

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A PRIMER ON THE FATCA WITHHOLDING PROVISIONS

By: *Judith M. Blissard*[1]

With the passage of the Hiring Incentives to Restore Employment Act (the "HIRE Act")[2] on March 18, 2010, the government expanded the arsenal of weapons it can use in its efforts to improve the reporting of U.S.-owned foreign accounts. The HIRE Act includes the provisions of the legislation referred to as the Foreign Account Tax Compliance Act or "FATCA." This legislation imposes expansive withholding and reporting requirements on both foreign financial institutions (a term which is broadly defined) and other non-financial foreign entities, imposes new rules related to dividend equivalent transactions, and limits the viability of the use of bearer bonds in foreign markets. The FATCA legislation adds a new Chapter 4 to the Code,[3] which provides for withholding taxes aimed at enforcing the new reporting requirements for specified foreign accounts owned by specified United States persons or by United States owned foreign entities.[4] Although the FATCA withholding provisions, which are now contained in new Sections 1471 through 1474 of the Code, generally have a delayed effective date, the provisions have attracted significant attention since they may affect agreements that are entered into, and instruments that are acquired, prior to the effective date.

The breadth of the FATCA reporting and withholding rules will ultimately depend on the scope of various definitions in the statutes, as well as yet to be prescribed exceptions to those definitions. The Associate Chief Counsel (International) of the Internal Revenue Service (the "IRS") has indicated in public statements that the main purpose of the legislation is to encourage reporting of offshore financial and other passive investments and thus to reconfirm public confidence in the voluntary compliance system.[5] In that regard, the legislation will be considered a success if it leads to increased reporting of information to the IRS rather than increased withholding.[6]

General Framework of the Statute

As described below, the framework of the FATCA rules is embodied in new Chapter 4 of the Code and, in particular, the various definitions contained in those provisions. The rules are intended to apply in addition to the rules contained in Chapter 3.[7] The FATCA withholding tax is imposed under Sections 1471(a) and 1472(a), which require withholding at a rate of 30 percent on a *"withholdable payment"* paid to either a *"foreign financial institution"* or *"non-financial foreign entity"* unless certain requirements are met. Thus, the basic analysis of the rules is bifurcated depending on whether the recipient of U.S. source payments is a foreign financial institution or another type of foreign entity.

Foreign Financial Institution - Under the FATCA rules, a *foreign financial institution* generally will be subject to the 30 percent withholding tax unless it has entered into an agreement with the IRS under which it has agreed to (i) obtain sufficient information regarding its account holders to determine if any of its *"financial accounts"* are *"United States accounts,"* (ii) comply with prescribed verification and due diligence procedures, (iii) comply with annual reporting requirements with respect to *"specified United States persons,"*[8] and (iv) deduct and withhold a tax equal to 30 percent of any *"passthru payment"* made to "recalcitrant" account

holders, other financial institutions that have not entered into an agreement with the IRS, or foreign financial institutions that have elected to be withheld upon rather than to withhold on payments they make to recalcitrant account holders or foreign financial institutions that have not entered into an agreement with the IRS.[9] Foreign financial institutions may make certain elections including (a) an election to have the withholding tax apply with respect to any payments made to the institution that are allocable to "recalcitrant" account holders or foreign financial institutions that do not provide information that will allow the financial institution to comply with the relevant requirements, (ii) an election to have a withholding agent withhold on payments so that the foreign financial institution does not have to act as a withholding agent with respect to payments it makes to other foreign financial institutions, and (iii) an election to be subject to the reporting requirements applicable to financial institutions that are United States persons.[10]

Non-Financial Foreign Entity – A *non-financial foreign entity* will be subject to 30 percent withholding unless the entity or other non-financial foreign entity which is the beneficial owner of the payment provides the withholding agent with either a certification that the beneficial owner does not have any *"substantial United States owners"* or the name, address and TIN of each substantial United States owner of the beneficial owner.[11] Payments beneficially owned by certain recipients that may present a lower risk of U.S. tax evasion (such as publicly traded corporations or members of the publicly traded corporation's affiliated group, international organizations, foreign governments or political subdivisions thereof, and any foreign central bank of issue) are not subject to withholding.[12] In determining whether an entity is a United States owned foreign entity and whether a person is a substantial owner of such an entity, only *specified United States persons* are considered.

Definitions Critical to Application of the Withholding Rules

As a threshold matter, potential application of the rules to a specific taxpayer depends on the scope of certain key definitions.

- A "*foreign financial institution*" generally includes any foreign entity that is a financial institution – that is, an entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) as a substantial portion of its business, holds financial assets for the account of others, or (iii) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities.[13] The Technical Explanation clarifies that under the foregoing definition, the term financial institution may include investment vehicles such as hedge funds and private equity funds.[14]

- A "*non-financial foreign entity*" is defined as any foreign entity which is not a financial institution (as defined in Section 1471).[15]

- The payment must be a "*withholdable payment*," which generally encompasses any U.S.-source payment of fixed or determinable annual or periodical income (FDAP), as well as the gross proceeds from the sale or other disposition of any property of a type that can

produce U.S. source interest or dividends, provided the income is not effectively connected with a U.S. trade or business.[16] The term also includes dividend equivalent payments (*e.g.,* arising from a securities lending transaction or sale-repurchase transaction).[17]

- A *"passthru payment"* means any *withholdable payment* or other payment to the extent attributable to a withholdable payment.[18]

- A *"financial account"* means any depository account or custodial account maintained by a financial institution and any equity or debt interest (other than a regularly traded interest) in the financial institution.[19]

- A *"United States account"* means any financial account which is held by one or more specified United States persons or United States owned foreign entities (any foreign entity that has one or more substantial United States owners).[20]

- A *"specified United States person"* means any United States person other than certain categories of persons that are either not subject to tax or presumably are considered a low risk for failure to report. These categories include publicly traded corporations and members of their affiliated groups, tax-exempt entities, and individual retirement accounts, banks, REITs and RICs.[21]

- A *"substantial United States owner"* generally means a United States person that owns, directly or indirectly, more than 10 percent of the stock of a corporation (by vote or value) or more than 10 percent of the capital or profits interest of a partnership.[22] However, in the case of a financial institution that is engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities or other types of interests in those items (*e.g.,* a hedge fund or private equity fund), a substantial United States owner is a United States person that owns any interest in that entity without regard to percentage.[23]

- A *"withholding agent"* is defined as all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any withholdable payment.[24]

Effective Date and Applicability to Current Transactions

The FATCA rules generally apply to payments made after December 31, 2012; however, no withholding is required with respect to any payment made under any "obligation" outstanding on the date that is two years after the date of enactment or from the gross proceeds from any disposition of such an obligation. Thus, interest on notes that are issued into the market prior to that date will not be subject to withholding, even if the notes mature after December 31, 2012. In the case of notes that are deemed to be newly issued as a result of a modification, the Technical Explanation indicates that the IRS may provide guidance on the application of the material modification rules of section 1001 in determining whether an obligation is outstanding on the date two years after enactment.[25]

Prior to the enactment of FATCA, comments were provided to the Senate Finance Committee and the House Ways and Means Committee requesting clarification of the meaning of the term "obligation" and recommending that the term include all contractual obligations (including debt and other contractual obligations such as licenses or annuities) but exclude equity securities.[26] Until such guidance is issued, it may be reasonable to assume that all traditional debt instruments, such as notes or bonds, that are issued prior to the end of the two-year period will not be subject to the withholding regime, but that distributions made with respect to equity investments after December 31, 2012 will be subject to the withholding regime, even if the equity instruments were outstanding on the two-year anniversary date. In addition, it is also reasonable to assume that interest payments made with respect to borrowings after March 18, 2012 under contractual arrangements (such as credit agreements) existing on or prior to that date, will be subject to the FATCA regime; practitioners should take this possibility into account in entering into or amending such contractual arrangements.

Open Questions / Areas in Which Guidance May Be Issued

The statutory language forms only the bare framework of the legislation, and many details and procedures will be articulated in subsequent guidance. The IRS has indicated that the biggest issue that must be addressed through published guidance is specifically defining the term "foreign financial institution" for purposes of the statute, including determining the appropriate exceptions to that definition.[27] Those exceptions presumably will involve institutions that are considered at low risk for non-compliance in reporting or sharing information on U.S. accounts. Another area in which early guidance will be needed is determining the proper scope of the term "United States account" and the type of due diligence that will be required of a foreign financial institution to determine whether it has such accounts. The Technical Explanation indicates that the existing know-your-customer, anti-money laundering, anti-corruption, and other regulatory requirements may form the basis for crafting due diligence and verification procedures in jurisdictions where those requirements provide reasonable assurance that the foreign financial institution is in compliance with the requirements of FATCA.[28] In addition, the IRS will need to issue guidance to address the following questions:

- What documentation must withholding agents obtain to certify that a foreign financial institution or non-financial foreign entity has satisfied the relevant requirements and thus is not subject to withholding? Under Section 1474(c)(2), the disclosure of a list of financial institutions that have entered into Section 1471(b) agreements with the IRS is permitted and is not treated as return information for purposes of Section 6103. Practitioners and their clients already are attempting to craft language to be included in financing agreements that will provide generally for a form or documentation requirement.

- Will the reporting and due diligence requirements apply to existing accounts held by foreign financial institutions or only to new accounts?

- How will the withholding requirements of Sections 1471 and 1472 coordinate with other existing withholding requirements? As described above, the Technical Explanation

indicates that Sections 1471 and 1472 will build on, and must be applied prior to the application of, the withholding rules in Chapter 3.

- What procedures will be prescribed with respect to the requirements to claim a refund and the administration of credits and refunds?

As indicated above, many questions remain to be answered regarding how the rules will be applied and how effective the rules will be in achieving the desired objective of obtaining information on foreign accounts held by United States persons. Although the rules have a delayed effective date, the time to react and prepare for their application is relatively short given the complexities of the functions that are performed by financial institutions and foreign investment vehicles. Moreover, it is unclear whether certain foreign financial institutions will opt out of participating in the U.S. securities markets or will hold only the accounts of United States persons that hold only securities of non-U.S. companies and receive payments only of non-U.S. source income. It is also unclear whether, or to what extent, the requirement to disclose the accounts of all United States persons owning interests in entities such as foreign hedge funds and private equity funds will affect the structure or operation of such entities. In short, although the basic framework of FATCA exists, the extent to which the regime will change existing procedures and practices will be determined based upon guidance issued by the IRS, and practices that develop in response, in the upcoming months.

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[2] Pub. L. No. 111-147, 124 Stat. 71 (2010).

[3] References to the "Code" or "Section" are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

[4] *See* Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate* (JCX-4-10), p. 39, February 23, 2010 (the "Technical Explanation").

[5] Stewart, "IRS Taking a 'Process-Oriented' Approach to FATCA, Official Says," *Tax Notes Int'l*, May 3, 1010, p. 388 (statements of Steven Musher, IRS Associate Chief Counsel (International)).

[6] *Id.*

[7] *See* Technical Explanation, p. 42 (foreign financial institutions that have entered into QI agreements under Section 1441 and the regulations are required to meet the requirements of Section 1471 in addition to any other requirements imposed under the QI or similar agreement) and p. 46 (it is expected that the Secretary will provide for the coordination of withholding rules under FATCA and other withholding provisions of the Code).

[8] I.R.C. § 1471(c)(1). The information required to be reported includes (i) the account number, (ii) the name, address and TIN of each account holder, or in the case of an account held by a foreign entity, the name, address and TIN of each substantial United States owner, (iii) the account balance or value, and (iv) the gross receipts and gross withdrawals and payments from the account.

[9] I.R.C. § 1471(b)(1); *see also* Technical Explanation, p. 40 (stating that the provision for withholding on payments to an account holder that does not provide the required information is not intended as an alternative to withholding; also stating that the IRS may require under the terms of an agreement with a foreign financial institution that, in the case of new accounts, the foreign financial institution not withhold as an alternative to collecting the required information).

[10] *See* I.R.C. §§ 1471(b)(3) and (c)(2); *see also* Technical Explanation, pp. 41-42.

[11] I.R.C. § 1472(b)(1).

[12] *See* Technical Explanation, p. 46.

[13] I.R.C. § 1471(d)(4) and (5).

[14] Technical Explanation, p. 44.

[15] I.R.C. §1472(d).

[16] I.R.C. S 1473(1). Under a special rule, interest paid by foreign branches of domestic banks also may be treated as U.S. source income subject to withholding. I.R.C. § 1473(1)(C).

[17] *See* Technical Explanation, pp. 44-45.

[18] I.R.C. § 1471(d)(7).

[19] I.R.C. § 1471(d)(2).

[20] I.R.C. § 1471(d)(1)(A). The term generally does not include any depositary account maintained at a foreign financial institution if the owner is a natural person and the aggregate value of the accounts held in the financial institution does not exceed $50,000. I.R.C. § 1471(d)(1)(B).

[21] I.R.C. § 1473(3); *see also* Technical Explanation, p. 45.

[22] I.R.C. § 1473(2)(A).

[23] I.R.C. § 1473(2)(B).

[24] I.R.C. § 1473(4). As is the case with other withholding requirements, a withholding agent that fails to withhold is liable for the tax. I.R.C. § 1474(a).

[25] Technical Explanation, p. 49.

[26] NYSBA Tax Section's Comments on Foreign Account Tax Compliance Legislation submitted to Sen. Max Baucus, Chair of the Senate Finance Committee and Rep. Charles Rangel, Chair of the House Ways and Means Committee, on January 11, 2010.

[27] Tax Notes Today, April 29, 2010 "IRS, Treasury Aim for Release of FATCA Guidance in Stages, Official Says" (statements of Steven Musher, IRS Associate Chief Counsel (International)).

[28] Technical Explanation, p. 40.

CURRENT DEVELOPMENTS IN TEXAS FRANCHISE TAX

By: *Alyson Outenreath*[1]

A. 81st Legislative Session Update

- **H.B. 469.** Established certain incentives for carbon dioxide sequestration. Incentives are limited to three projects implemented in connection with the construction of a new facility and requires approval from the Texas Railroad Commission. The effective date of the legislation is September 1, 2009; however, the Texas Comptroller may not begin granting credits until after September 1, 2013.

- **H.B. 1474.** Exempted bingo units from the Texas franchise tax. Eligible entities must submit an application for exemption on Texas Comptroller Form AP-204. The legislation is effective October 1, 2009.

- **H.B. 4765.** Increased the no tax due threshold from $300,000 to $1,000,000 effective for Texas franchise tax reports originally due in 2010 and 2011 (based on 2009 and 2010 revenues, respectively). Thereafter, the threshold amount will decrease to $600,000 for Texas franchise tax reports originally due on or after January 1, 2012 (based on 2011 revenues and thereafter).

- **H.B. 4611.** Allows lending institutions to report gross proceeds from sales of loans or securities for apportionment purposes, if such sales are treated as "securities available for sale" or "trading securities" for FAS 115 purposes. The legislation is effective for Texas franchise tax reports originally due on or after January 1, 2010.

- **S.B. 636.** Created an exclusion from total revenue for payments made to persons providing services, labor or materials in connection with destination management services, as such term is defined in Section 151.0565.[2] The exclusion is effective for Texas franchise tax reports originally due on or after January 1, 2010. The exclusion generally will not apply to travel agents or travel agencies.

- **S.B. 1442.** Revised the Texas Business Organizations Code to require all entities that are taxable entities for Texas franchise tax purposes to provide a tax clearance letter prior to dissolution, reinstatement, etc. The effective date of the legislation is September 1, 2009.

B. New Rule Regarding Initial Franchise Tax Reports. The Texas Comptroller recently changed the previous, and oftentimes complicated, rule regarding the due date for an entity's first Texas franchise tax report. The new rule applies to taxable entities that are first subject to the Texas franchise tax on or after October 4, 2009. Such taxable entities will no longer be required to file an "initial" Texas franchise report, the filing of which oftentimes involved complicated

computations regarding not only determining when the due date was for the initial report, but also the period on which Texas franchise tax was to be computed for such report. In lieu of the complicated initial reports, taxable entities now will be required to file only annual reports, the first of which will be due on May 15 (or if not a business day, the next following business day) in the year following the first date the entity becomes subject to the Texas franchise tax. Below are two examples.

Example 1:

A Texas LLC was formed on March 1, 2010. The LLC has a December 31 accounting year end. The LLC's first Texas franchise tax report is due May 16, 2011 and tax will be computed based on the period March 1, 2010 through December 31, 2010.

Example 2:

A Delaware limited partnership with a February 28 accounting year end opened a Texas office on March 15, 2010. Prior to March 15, 2010, the Delaware limited partnership engaged in no Texas activities, and accordingly, did not have nexus with Texas for Texas franchise tax purposes. The limited partnership's first Texas franchise tax report will be due on May 16, 2011. Since the limited partnership will not have an accounting year end during 2010 that is after its Texas franchise tax beginning date, the limited partnership will file a No Tax Due Report for its first annual report due on May 16, 2011. The limited partnership's 2012 Texas franchise tax report will report tax due based on the period March 15, 2010 through February 28, 2011.

C. Texas Comptroller FAQ Guidance

- **Cancellation of Debt Income (Oct. 2, 2009).** Section 1231 of the American Recovery and Reinvestment Act of 2009, effective January 1, 2009, provides for deferred recognition of cancellation of debt (**"COD"**) income. Pursuant to Section 171.0001(9), total revenue, which is generally the tax base for Texas franchise tax purposes, is calculated based upon the Internal Revenue Code of 1986 in effect for the federal tax year beginning on January 1, 2007, and not including any changes made by federal law after that date, or any Treasury Regulations adopted under the Internal Revenue Code applicable to such period. Because the federal election for deferral of COD income was effective January 1, 2009, such federal election must be disregarded for Texas franchise tax purposes. Accordingly, such amounts must be adjusted with respect to the federal income items that carry over when computing total revenue for purposes of the Texas franchise tax report.

- **Internal Revenue Code Section 179 Expense Deduction and COGS (Jan. 25, 2010).** The Internal Revenue Code Section 179 expense deduction is allowed for Texas franchise tax purposes only if the subject taxable entity elects to use the cost of goods sold (**"COGS"**) deduction to compute its margin for Texas franchise tax purposes. Pursuant to the provisions of Section 171.1012, only

taxable entities that sell real or tangible personal property in the ordinary course of business are eligible to elect the COGS deduction for Texas franchise tax purposes. Allowable within the Texas franchise tax COGS deduction are depreciation and Internal Revenue Code Section 179 expense deductions that are related specifically to equipment used in the production of goods. The limit for the Internal Revenue Code Section 179 expense that is allowed to be included in COGS for Texas franchise tax purposes for the 2009 Texas franchise tax report is $115,000, and $120,000 for the 2010 Texas franchise tax report. As discussed above, the Internal Revenue Code that applies for Texas franchise tax purposes is the Internal Revenue Code in effect for the federal tax year beginning on January 1, 2007, not including any changes made by federal law after such date. Accordingly, the increase to the Internal Revenue Code Section 179 amount to $125,000 by the Small Business & Work Opportunity Act, which was signed into federal law on May 25, 2007, is not applicable for Texas franchise tax purposes.

- **Compensation Deduction When W-2 Wages and a Federal K-1 Are Issued to the Same Individual (Feb. 16, 2010).** The Texas Comptroller provided in FAQ guidance that, if a taxable entity issues both a W-2 and K-1 to the same individual, then the wage limitation per 12-month period on which margin is based for purposes of computing the compensation deduction under Section 171.1013 applies to the sum of such individual's W-2 and K-1. The wage limitation for purposes of the compensation deduction under Section 171.1013 is $320,000 for Texas franchise tax reports due in 2010 and 2011.

- **Compensation Deduction for Accounting Periods Less Than 12 Months (Feb. 16, 2010).** The Texas Comptroller provided in FAQ guidance that, in the event the accounting period for purposes of a Texas franchise tax report is less than 12 months, such taxable entity is not allowed to deduct the full amount of the wage limitation in wages per person. Rather, if the subject accounting period is less than 12 months, the wage limitation must be prorated over the length of the accounting period. For example, if a 2011 Texas franchise tax report is based on the accounting period January 1, 2010 through June 30, 2010, the deduction limitation for wages and cash compensation is not $320,000 per person, but rather is limited to $160,000 per person.

- **Compensation Deduction and Certain Benefit Plans and Health Care Costs (Feb. 16, 2010).** By FAQ, the Texas Comptroller provided guidance on the question of whether a partnership can include in the Section 171.1013 compensation deduction for Texas franchise tax purposes the costs of tax qualified defined contribution and defined benefit retirement plans as well as health care costs (**"benefit costs"**) that are deductible for federal income tax purposes on the individual partners' returns under the following two scenarios:

  - ***Scenario One – the benefit costs are reported on IRS Form 1065, Schedule K, line 13.d and on Schedule K-1, line 13, and the benefit costs are not deducted as guaranteed payments***. Under Scenario One, the

Texas Comptroller stated that the benefit costs may be included in the compensation deduction of the partnership for Texas franchise tax purposes without regard to the wage limitation of the compensation deduction.

- ***Scenario Two – the benefit costs are deducted on IRS Form 1065 as guaranteed payments.*** Under Scenario Two, the benefit costs may be included in the compensation deduction of the partnership for Texas franchise tax purposes without regard to the wage limitation of the compensation deduction if and only if the amount deducted as a guaranteed payment is adjusted as may be necessary to prevent a double deduction of benefit costs.

D. *Steven and Robbie McCarroll v. My Sentinel, L.L.C.*, No. 14-08-01171-CV, 2009 WL 4667403, (Tex. App.— Houston Dec. 20, 2009) (mem.Op.). In *Steven and Robbie McCarroll v. My Sentinel, L.L.C.*, My Sentinel, L.L.C. (**"My Sentinel"**) sued Steven and Robbie McCarroll, among other directors and officers of 4M Security Systems, Inc. (**"4M"**), to collect on a judgment previously obtained against 4M. More specifically, on February 13, 2004, the Texas corporate charter of 4M became forfeited due to the failure of 4M to pay certain Texas franchise taxes or file the requisite Texas franchise tax reports. After revocation of 4M's charter, Steven and Robbie McCarroll, acting as officers and directors of 4M, entered into an agreement with My Sentinel to sell to My Sentinel certain security system monitoring accounts associated with Luby's Cafeteria locations in Texas. My Sentinel then later accused 4M of breaching such agreement and filed suit against My Sentinel in Utah. On May 25, 2007, the Third Judicial District Court of Salt Lake County, Utah granted default judgment in favor of My Sentinel and awarded My Sentinel actual damages, recovery of attorney fees, courts costs and post-judgment interest. Thereafter, My Sentinel domesticated the Utah judgment in Texas with the 10th District Court in Galveston, Texas. My Sentinel then filed the subject action seeking to impose personal liability of the damage award directly on Steven and Robbie McCarroll, as officers and directors of 4M, under Section 171.255. The Texas trial court found in favor of My Sentinel. On appeal, the McCarrolls contended that the trial court was in error because (i) the doctrine of res judicata barred the lawsuit; and (ii) the debt in question was not created or incurred in Texas. The Texas appellate court declined to hold in favor of the McCarrolls with respect to either argument. Summarized below is the Texas appellate court's analysis regarding issue (ii).

The McCarrolls contended that, for personal liability to result, Section 171.255 requires that the debt in question be incurred or created in Texas, and the debt in question here was incurred or created in Utah when the Utah court granted the initial judgment against 4M prior to such judgment being domesticated in Texas. In making their argument, the McCarrolls acknowledged that a debt is deemed created or incurred for purposes of Section 171.255 at the time of the event or events that gave rise to the subject debt. On this issue, the court stated that, based on prior precedent, in the breach of contract context, the relevant for purposes of Section 171.255 event is when the contract in question was executed, not when the breach occurred. The McCarrolls further did not dispute that the underlying debt sought to be enforced against them was based on an alleged breach of contract. In contrast, the McCarrolls sought to argue that the reduction of the debt to a monetary judgment by the Utah court created an intervening event that

made the location of the trial court issuing the judgment the relevant location for purposes of Section 171.255, which here was Utah.

The Texas appellate court disagreed. The court stated that the issuance of the Utah judgment did not give rise to or create the debt in question. Rather, it only established My Sentinel's legal right to collect the existing debt. The court stated that the debt in question was the debt on the contract, which was created or incurred in Texas. The court further stated that the McCarroll's contention that the issuance of the judgment constituted an intervening event for purposes of Section 171.255 ignores the fact that the relevant events under Section 171.255, for which a director or officer can be held liable, are those a director or officer can be said to have consented to or approved of, as apposed to involuntary events like the issuance of a court judgment. Under such analysis, the Texas appellate court affirmed the decision in favor of My Sentinel.

E. Tex. Comp. Dec. 48,507 (June 15, 2009). The taxpayer (**"Taxpayer"**) in Tex. Comp. Dec. 48,507 operated a company engaged in rail transportation in the northeastern part of Texas. Taxpayer's tracks are located entirely in Texas. In its Texas franchise tax reports for report years 2003 and 2004, Taxpayer apportioned its taxable capital by reporting all of its receipts from rail transportation as Texas receipts.[3] Taxpayer contended in Tex. Comp. Dec. 48,507 that the original Texas franchise tax reports filed for the 2003 and 2004 report years were filed in error with respect to such sourcing of the rail transportation activities. Taxpayer agreed that its receipts from transporting freight received from a Texas point of origin to a final destination in Texas constituted Texas receipts. However, Taxpayer contended in Tex. Comp. Dec. 48,507 that receipts from transporting freight in interstate commerce should not be included in Texas receipts. For example, Taxpayer picked up freight railcars from customers in Texas and transported them to interchange points, all of which were located in Texas. At the interchange points the railcars were transferred from Taxpayer's locomotive to the locomotives of other rail carriers and transported to final destinations outside of Texas. Conversely, other rail carriers brought freight railcars from outside Texas to the interchange points, where the railcars were transferred to Taxpayer's locomotives for transportation to final destinations in Texas.

During the report years in question, Section 171.1032(a)(2) provided that gross receipts from business done in Texas included receipts from each service performed in Texas.[4] The ALJ noted that, since transportation of freight is a service, and the transportation was performed by means of railcars, tracks, and personnel located within Texas, the statute would not appear to support Taxpayer's sourcing position that such services generated non-Texas source income. However, the Comptroller Rules for the report years at issue contained a specific provision regarding transportation companies. Comptroller Rule 3.549(b)(45) in effect for the periods at issue provided:

> Transportation companies must report Texas receipts from transportation services by:
>
> > (A) including receipts derived from the transportation of goods or passengers in intrastate commerce; or

(B) multiplying total transportation receipts by total mileage in transporting goods and passengers picked up and delivered within Texas (in intrastate commerce) divided by total mileage everywhere.[5]

Taxpayer's Texas franchise tax reports for the period at issue used the first method based on receipts. Taxpayer proposed to exclude from Texas receipts the receipts from transporting freight in Texas when the transportation was a segment of an interstate journey on the grounds that such transportation is not intrastate commerce as specified in Comptroller Rule 3.549(b)(45). In contrast, the Comptroller argued that such receipts were from intrastate commerce because Taxpayer tracks were located in Texas and the transportation occurred within Texas.

Because the conclusion in Tex. Comp. Dec. 48,507 rested, in a large part, on how the term intrastate commerce was historically understood and applied, the ALJ discussed several prior precedents. After considering such precedents, the ALJ concluded that receipts from intrastate commerce under Comptroller Rule 3.549(b)(45) means receipts from transporting goods from a Texas point of origin to a delivery point that is also in Texas, and that receipts from transporting goods in a segment of interstate commerce are not intrastate commerce, even when the transportation occurs in Texas. Accordingly, the Taxpayer's claim for refund was granted.

F. Tex. Comp. Ltr. Rul. 200901463L (Jan. 15, 2009). In Tex. Comp. Ltr. Rul. 200901463L, the Comptroller outlined the circumstances under which a taxable entity can qualify for the Texas franchise tax exemption under Section 171.056. Section 171.056 provides: "A corporation engaged solely in the business of manufacturing, selling, or installing solar energy devices, as defined by Section 171.107 of this code, is exempted from the franchise tax." Section 171.107(a), in turn, provides that a "solar energy device" means ". . . [A] system or series of mechanisms designed primarily to provide heating or cooling or to provide electrical or mechanical power by collecting and transferring solar-generated energy. The term includes a mechanical or chemical device that has the ability to store solar-generated energy for use in heating or cooling or in the production of power."

Tex. Comp. Ltr. Rul. 200901463L indicates that the Texas Comptroller has long interpreted the exemption provided for in Section 171.056 to extent to wind energy devices. The Texas Comptroller further stated in Comp. Ltr. Rul. 200901463L:

- A device that qualifies under Section 107.107 includes (i) the entire device that collects the solar or wind-generated energy and converts that energy into a form of heating, cooling, electrical or mechanical power; or (ii) mechanical equipment or chemicals that store the energy for future use.
- A entity that is solely engaged in the business of manufacturing, selling or installing qualifying solar (wind) energy devices, as defined in Section 171.107, or certain component parts of such devices (discussed below), may qualify for the Texas franchise tax exemption under Section 171.056. Important to note is that the term "solely engaged" applies to all of the subject entity's activities, not merely activities conducted in Texas.
- A taxable entity solely engaged in the business of manufacturing, selling or installing component parts of a qualifying solar energy device may qualify for the

Texas franchise tax exemption under Section 171.056 if each component part meets the following criteria and if the entity provides detailed supporting documentation:

1. The component part is essential to the operation of a solar (wind) energy device that qualifies under Section 171.107;
2. The component part cannot be an item that could be used for any purpose other than a component part that is essential to the operation of a solar (wind) energy device that qualifies under Section 171.107; and
3. The entity manufacturing, selling or installing the component part can only sell the component part to , or install it for, a person or entity that will be incorporating the item into solar (wind) energy devices that qualify under Section 171.107.

G. <u>Tex. Comp. Ltr. Rul. 200908505L (Aug. 10, 2009)</u>. In Tex. Comp. Ltr. Rul. 200908505L, the Texas Comptroller outlined the criteria, effective July 16, 2009, to be used in determining whether a nonprofit homeowner's association (**"HOA"**) qualifies for the exemption from Texas franchise tax provided for under Section 171.082. The Texas Comptroller stated that an HOA must satisfy the following three requirements in order to qualify for a franchise tax exemption under Section 171.082:

1. The entity must be organized and operated primarily to obtain, manage, construct and maintain the property in or of a residential condominium or residential real estate development;
2. 51% of the property in the development must be for residential use (the other 49% can be used for other purposes, including commercial use); and
3. The individual homeowners must collectively have 51% voting control and effective control of the HOA, and that voting control, however acquired, cannot be held by: (i) a single individual or family; (ii) one or more developers, declarants, banks, investors, or other similar parties. With respect to the term "effective control," the Texas Comptroller stated in Tex. Comp. Ltr. Rul. 200908505L that such term means "the Declarant, nor any other party, can have the power to override the homeowners' 51% voting control in the HOA, in matters that affect the residential condominium or residential real estate development."

H. <u>Tex. Comp. Ltr. Rul. 200909441L (Sept. 3, 2009)</u>. In Tex. Comp. Ltr. Rul. 200909441L, the Texas Comptroller confirmed that certain insurance entities are excluded from the Texas franchise tax while other insurers are not. Insurance organizations that are not subject to Texas franchise tax include those that are either subject to the gross insurance premium receipts tax as admitted/licensed/authorized insurers, health maintenance organizations or title insurance agents under Title 3 of the Texas Insurance Code, or those that pay for a tax year the "unauthorized insurance" premium tax under Section 226. Organizations that are not exempt from Texas franchise tax include surplus lines insurers that are eligible to write insurance in Texas through licensed surplus lines agents.

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[2] Unless otherwise specified, all Section references are to the Texas Tax Code.

[3] Although such report years pre-date the Texas franchise tax as amended by H.B. 3, many of the sourcing rules that applied prior to H.B. 3 continue to apply under the Texas franchise tax as amended by H.B. 3. Accordingly, Tex. Comp. Dec. 48,507 should continue to have precedential effect. *See* Tex. Tax Code 171.103, Comp. Rule 3.591(d)(32).

[4] *See* Section 171.103 for the corresponding provision under current law prior Section 171.1032(a)(2).

[5] *See* Comp. Rule 3.591(d)(32) for the corresponding provision under current law.

HOT TOPICS AND DEVELOPMENTS IMPACTING NONPROFIT ORGANIZATIONS

By: *Bruce E. Bernstien* [1]

INTRODUCTION

The Treasury Department, Internal Revenue Service (IRS) and Congress continued its heavy focus on nonprofit organizations during 2009 and through this time in 2010. This attention to the nonprofit industry will continue as indicated by the Treasury Department and IRS in their 2009-2010 Priority Guidance Plan initially released on November 24, 2009 and updated on March 16, 2010. Below is a summary of tax developments impacting nonprofit organizations and a listing of the items in the 2009-2010 Priority Guidance Plan.

TAX DEVELOPMENTS FROM CONGRESS, TREASURY AND THE IRS

SENATOR CHARLES GRASSLEY (R-IOWA) CONSIDERING LEGISLATION ON TAX-EXEMPT HOSPITALS

In early 2009, it was reported that Senator Grassley and his tax staff were taking another look at a 2007 discussion draft prepared by committee staff that contained possible nonprofit hospital reforms, including a requirement that a Section 501(c)(3) hospital dedicate at least 5 percent of its operating expenses or revenue to charity care (see discussion below regarding new requirements for tax-exempt hospitals included in the Patient Protection and Affordable Care Act)

LOIS LERNER, DIRECTOR OF THE IRS EXEMPT ORGANIZATIONS DIVISION, ON FEBRUARY 12, 2009 PROVIDES A STATEMENT ON THE IRS REPORT ON NONPROFIT HOSPITALS

The report resulted from an IRS study of nonprofit hospitals begun in 2006. The study was conducted so that the IRS and other stakeholders could better understand nonprofit hospitals and their community benefit and executive compensation practices, based on questionnaires sent by the IRS to 500 nonprofit hospitals. The IRS also examined 20 nonprofit hospitals regarding their executive compensation practices. Ms. Lerner's comments on the community benefit standard focused on the level of community benefit expenditures (the average was 9% of revenues and the median was 6% of revenues). Uncompensated care represented 56% of all community benefit reported. Ms. Lerner's comments on compensation focused on the fact that almost all hospitals in the study used comparability data and independent personnel when setting the compensation of its executives.

IRS ISSUES ITS 2009 "DIRTY DOZEN LIST OF TAX SCAMS (IR-2009-41, APRIL 13, 2009), INCLUDING THE MISUSE OF CHARITABLE ORGANIZATIONS

One of the twelve tax scams is entitled "Abuse of Charitable Organizations and Deductions." The tax scam was described as follows:

> The IRS continues to observe the misuse of tax-exempt organizations. Abuse includes arrangements to improperly shield income or assets from taxation and attempts by donors to maintain control over donated assets or income from donated property. The IRS also continues to investigate various schemes involving the donation of non-cash assets, including easements on property, closely held corporate stock and real property. Often the donations are highly overvalued or the organization receiving the donation promises that the donor can purchase the items back at a later date at a price the donor sets. The Pension Protection Act of 2008 imposed increased penalties for inaccurate appraisals and new definitions of qualified appraisers for taxpayers claiming charitable contributions.

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB) TAKES STEPS TO ISSUE FASB INTERPRETATION NO. 38, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES (FIN 48)

The FASB on April 15, 2009 voted to proceed with drafting proposed guidance to assist tax-exempt nonprofit entities with the application of FIN 48. The proposed FASB Staff Position (FSP FIN 48-d) was released on May 18, 2009 and had a Comment Deadline of June 17, 2009. The Board decided not to address whether a tax is an income tax because that determination went beyond the scope of this project. That issue of whether a tax is or is not an income tax is the subject of Statement 109.

Management must determine whether the entity is in fact a tax-exempt not-for-profit entity in the jurisdictions in which it files a return or would otherwise be subject to income taxes. They also must consider whether the entity has nexus in jurisdictions in which it has income. The entity should review its status as a not-for profit by:

- Verifying the application and approval of tax-exempt status (Federal and State)

- Verifying current legal organizational documents

- Analyzing current activities
  - Are the activities consistent with the exemption application?
  - Private benefit or inurement?
  - More than an insubstantial lobbying?
  - Political campaign intervention?
  - More than 15-20% of income classified as Unrelated Business Income

- Assessing whether it has any tax positions associated with unrelated business income subject to income taxes

E-POSTCARD FINAL REGULATIONS PUBLISHED – FILING BY CERTAIN SMALL TAX-EXEMPT ORGANZIATIONS OF THE ANNUAL ELECTRONIC NOTICE – T.D. 9454

The Final Regulations affect tax-exempt organizations whose annual gross receipts are not normally in excess of $25,000. The regulations were effective on July 23, 2009 and are applicable to annual periods beginning after 2006.

The requirements for these small tax-exempt organizations are per Section 6033(a)(1) which was added by Section 1223(a) of the Pension Protection Act of 2006 (Public Law 109-208, 120 Stat. 1090.) There is no "de minimus" exception to the required filing and it must be filed electronically. However, an organization will not be required to file the electronic notification if it files a Form 990 – Return of Organization Exempt From Income Tax or a Form 990-EZ – Short Form Return of Organization Exempt From Income Tax. The annual electronic notification must include the following:

- The legal name of the organization

- Any name under which such organization operates or does business

- The organization's mailing address

- The organization's web site address (if any)

- The organization's taxpayer identification number

- The name and address of a principal officer

- Evidence of the continuing basis for organization's exemption from the filing requirements under Section 6033(a)(1).

IRS UPDATES GUIDANCE FOR SUPPORTING ORGANIZATIONS SEEKING RECLASSIFICATION – ANNOUNCEMENT 2009-62

The Pension Protection Act of 2006 (P.L. 109-280) put into law certain restrictions impacting Section 509(a)(3) Supporting Organizations. One provision that permits taxpayers age 70 ½ or older to make tax-free distributions from their IRAs to a charity does not apply to distributions to a Section 509(a)(3) supporting organization. Another provision stated that distributions from private foundations to some Section 509(a)(3) supporting organizations are not qualifying distributions and could be taxable expenditures for the private foundation.

Because of those Pension Act restrictions, some Section 509(a)(3) organizations may want to be reclassified under Section 509(a)(1) or 509(a)(2). Under Announcement 2009-62, a request for reclassification must be submitted in writing and include one of the following:

- A copy of the organization's Form 990 (Parts I through XI) or Form 990-EZ (Parts I through VI) plus the completed Schedule A – Public Charity Status and Public Support that was filed with the IRS for the tax year preceding the tax year in which the request is made; OR

- A copy of the organization's Schedule A support information for the previous five years.

IRS RELEASES PROPOSED REGULATIONS IMPACTING SECTION 509(a)(3) TYPE III SUPPORTING ORGANIZATIONS

The IRS released Proposed Regulations under Section 509(a)(3) that would impose a 5 percent payout requirement on Type III supporting organizations that are <u>not</u> functionally integrated into the operations of their supported organizations. These regulations resulted from changes made to the requirements made by the Pension Protection Act of 2006 to be a Type III supporting organization. The organizations operate in connection with one or more supported organizations.

Functional integration is present if the supporting organization is significantly involved in the operations of its supported organizations. The payout requirements on the supporting organization to the supported organization are similar to payout requirements of private foundations. The amount required to be paid would be 5 percent of the fair market value of the nonexempt use assets of the supporting organization.

IRS RELEASES EXAMINATION MATERIALS REGARDING TAX EXEMPT ORGANIZATION GOVERNANCE

The IRS has developed a check sheet to be used by IRS Exempt Organizations agents to capture data about the governance practices and the related internal controls of organizations under examination. The data collected will be included in a long-term study to gain a better understanding of the intersection between governance practices and tax compliance.

The check sheet is entitled "Governance Project – Guide Sheet for Completing the Project Check Sheet." It contains 28 items for the agent to complete while examining the organization. The questions focus on conflict of interest policies, procedures for setting executive compensation, mission statements, meetings of the Board, document retention and destruction policies, contemporaneous documentation of meetings of the Board and other governance practices.

The IRS will use the data collected from these check sheets to determine if there is a relationship between governance practices and compliance by organizations.

TAX-EXEMPT ORGANIZATIONS MUST FILE ONE OF THE FORM 990 SERIES OF RETURNS TO PRESERVE TAX-EXEMPT STATUS

Most tax-exempt organizations, other than churches, must file an annual Form 990 Series Return with the IRS. It is important to timely file a return because an organization that does not file a required Form 990, 990-EZ, 990-PF or 990-N (e-postcard) for three consecutive years will automatically lose its Federal tax-exempt status. Non-filers will be subject to automatic revocation for the first time beginning in 2010.

The IRS issued IR-2010-10 on January 21, 2010 to remind tax-exempt organizations to file their annual information return on time. The Pension Protection Act of 2006 enacted the rule that revocation of tax exempt status will result from three consecutive years of not filing the required Form 990 Series return. This requirement has been in effect since the beginning of 2007.

If an organization loses its exemption, it will have to reapply with the IRS to regain its tax-exempt status. Any income received between the revocation date and renewed date may be taxable. The organization would then be required to file a Form 1120 – U.S. Corporation Income Tax Return or a Form 1041 – U.S. Income Tax Return for Estates and Trusts. Additionally, the organization cannot receive tax-deductible charitable contributions and will not be listed in Publication 78 – Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code.

The automatic revocation is effective as of the filing due date of the third year. The organization may request two three-month extensions of time to file these annual returns. However, for those organizations required to file the Form 990-N, an extension of time cannot be filed. The IRS will send a letter to an organization that has not filed a required annual return or notice for three consecutive years, informing them that the exempt status has been automatically revoked for failure to file.

An organization whose tax-exempt status is revoked can apply for reinstatement by filing a Form 1023 (501(c)(3) organization) or Form 1024 (other 501(c) organizations) and paying the required user fee. If the tax-exempt status is reinstated, the effective date of its reinstatement will be the date the organization filed its application. However, an organization may request to have its tax-exempt status reinstated as of the effective date it was automatically revoked.

To request that the effective date of reinstatement of tax-exempt status be the date of revocation, the organization must attach a letter to its application for exemption requesting that the date of revocation is the effective date of reinstatement. The IRS will only grant that request if the organization had reasonable cause for not filing an annual return or notice for three consecutive years and approves the exemption application.

IRS ISSUES, ITS 2010 "DIRTY DOZEN" LIST OF TAX SCAMS, INCLUDING THE MISUSE OF CHARITABLE ORGANIATIONS

The IRS continues to observe the misuse of tax-exempt organizations. Abuse includes arrangements to improperly shield income or assets from taxation and attempts by donors to maintain control over donated assets or income from donated property. The IRS also continues to investigate various schemes involving the donation of non-cash assets including situations where several organizations claim the full value for both the receipt and distribution of the same non-cash contribution. Often these donations are highly overvalued or the organization receiving the donations promises that the donor can repurchase the items at a price set by the donor. The Pension Protection Act of 2006 imposed increased penalties for inaccurate appraisals and set new definitions of qualified appraisals and qualified appraisers for taxpayers claiming charitable contributions.

IRS TO HONOR MEDICAL RESIDENT FICA REFUND CLAIMS (IR-2010-25, MARCH 2, 2010)

The Internal Revenue Service has made an administrative determination to accept the position that medical residents are excepted from FICA taxes based on the student exception for tax periods ending before April 1, 2005, when new IRS regulations went into effect.

The IRS will, within 90 days, begin contacting hospitals, universities and medical residents who filed FICA (Social Security and Medicare tax) refund claims for these periods with more information and procedures. Employers and individuals with pending claims do not need to take any action at this time.

Employers (typically hospitals and medical schools) and individual taxpayers (medical residents) began filing FICA refund claims in the 1990's based on their position that medical residents are students eligible for the FICA tax exception under Internal Revenue Code section 3121(b)(10). This is referred to as the *student exception* and may apply to a school, college or university. The employer's FICA refund claims were for both the employer share and the employee share of the FICA tax. In some cases, individual medical residents filed their own claim for the employee share of the FICA tax. The IRS held the claims in suspense because there was a dispute as to whether the student FICA exception applied. The IRS has made an administrative determination to accept the position that medical residents are excepted from FICA taxes for tax periods ending before April 1, 2005, when new IRS regulations went into effect.

Institutions that employed medical residents and individual medical residents are eligible to receive refunds if they are covered by timely filed FICA refund claims. Institutions can be covered under FICA refund claims they filed themselves. Individual medical residents can be covered under FICA refund claims they filed themselves or under claims filed by the institutions that employed them. These refund claims are subject to the same requirements that apply to all FICA refund claims including verification by the IRS of the amount of the claim and payment of interest.

Can a FICA refund claim be filed for periods before April 1, 2005? No, The period of limitations for filing a claim for tax periods before April 1, 2005 has expired.

What is the significance of April 1, 2005? On April 1, 2005, new regulations regarding the student FICA exception became effective. One part of these regulations states that an employee who works 40 hours or more (full-time employees) for a school, college or university is not eligible for the student exception. This part of the regulations excludes medical residents from the student exception.

2009-2010 PRIORITY GUIDANCE PLAN ISSUED IN A JOINT STATEMENT BY THE U.S. DEPARTMENT OF TREASURY AND THE IRS – ITEMS IMPACTING TAX-EXEMPT ORGANIZATIONS

On November 24, 2009, the 2009-2010 Priority Guidance Plan listing 315 projects for the plan year beginning July 1, 2009 and ending June 30, 2010 was released. In a Joint Statement that accompanied the release of the 2009-2010 Priority Guidance Plan, it was indicated that they would update the plan periodically to reflect additional guidance that they intend to publish during the plan year. Updating the plan also provides flexibility throughout the plan year to consider comments received from taxpayers and tax practitioners relating to additional projects and to respond to developments arising during the plan year.

The following is a list of the projects impacting tax-exempt organizations:

- Guidance on §403(b) plan terminations.
- Revenue procedure on §403(b) prototype program.
- Guidance on procedures for ruling requests under §414(e) for church plans.
- Guidance on distributions from §457(b) plans for unforeseeable emergencies.
- Announcement providing a remedial amendment period for §403(b) plans.
    - PUBLISHED 12/28/09 in IRB 2009-57 as ANN. 2009-89 (RELEASED 12/10/09).
- Guidance under §457(f) on ineligible plans.
- Guidance under §457A.
- Revenue procedure to provide terms for hosts of Cyber Assistant software (which is used to generate Forms 1023 eligible for a reduced user fee).
- Proposed regulations under §§509 and 4943 regarding the new requirements for supporting organizations, as added by the Pension Protection Act of 2006.

- PUBLISHED 09/24/09 in FR as NPRM REG-155929-06.

- Final regulations under §§509 and 4943 regarding the new requirements for supporting organizations, as added by the Pension Protection Act of 2006. Proposed regulations were published on September 4, 2009.

- Announcement superseding Announcement 2006-93 to request a change in public charity classification.

    - PUBLISHED 08/17/09 in IRB 2009-33 as ANN. 2009-62 (RELEASED 08/10/09).

- Notice under §4943, as amended by the Pension Protection Act of 2006, on excess business holdings rules.

- Guidance under §4944 on program-related investments.

- Final regulations under §§4965, 6011, and 6033 on excise taxes on prohibited tax shelter transactions and related disclosure requirements. Proposed regulations were published on August 20, 2007.

- Proposed regulations regarding the new excise taxes on donor advised funds, as added by the Pension Protection Act of 2006.

- Regulations under §6033 on group returns.

- Proposed regulations to update regulations under §6104(c) relating to disclosures to state charity agencies for changes made by the Pension Protection Act of 2006.

- Proposed regulations under §7611 relating to church tax inquiries and examinations.

    - PUBLISHED 08/05/09 in FR as NPRM REG-112756-09.

- Final regulations under §7611 relating to church tax inquiries and examinations. Proposed regulations were published on August 5, 2009.

- Guidance updating grantor and contributor reliance criteria under §§170 and 509.

- Guidance regarding certain annual information return requirements under §6033.

PROVISIONS AFFECTING TAX-EXEMPT ORGANIZATIONS UNDER THE HEALTH CARE REFORM ACTS (PATIENT PROTECTION AND AFFORDABLE CARE ACT; HEALTH CARE AND EDUCATION AFFORDABILITY RECONCILIATION ACT OF 2010) – "THE ACT"

The Act authorizes $6 billion in federal funds for the establishment of the Consumer Operated and Oriented Plan (the "COOP program") to foster the creation of qualified nonprofit health

insurance issuers that will offer qualified health plans in individual and small group markets. The federal funds are to be distributed as loans to assist with start-up costs and grants to assist in meeting state solvency requirements. An entity receiving a loan or grant under the COOP program must enter into an agreement with HHS requiring the recipient to meet the requirements for being treated as a qualified nonprofit health insurance issuer.

An organization that receives a grant or loan under the COOP program and that is in compliance with requirements of the ACT and the terms of any program grant or loan agreement qualifies as eligible to apply for exemption from federal income tax under new section 501(c)(29) of the Code. Such organizations also are subject to certain organizational and operational requirements applicable to certain Section 501(c) organizations, including prohibitions on private inurement and political activities, limitations on lobbying activities, taxation of excess benefit transactions, and tax on unrelated business taxable income, and return-filing requirements.

The Act imposes four new requirements that a hospital must satisfy to be tax-exempt: (1) the periodic preparation of a community health needs assessment; (2) maintenance of a qualified financial assistance policy; (3) limitations on charges to individuals eligible for assistance; and (4) avoidance of certain billing and collections activities.

The new requirements apply to organizations that operate a facility required by a state to be licensed, registered, or otherwise recognized as a hospital, and are determined to have hospital care as its primary function or purpose for exemption. If an organization operates more than one hospital, every hospital facility in the organization must adhere to the provisions of the Act separately to qualify for its tax-exempt status.

Community health needs assessment – To preserve its tax-exempt status under section 501(c)(3) the organization must conduct a community health needs assessment at least once during any three-year period (specifically, the current taxable year or the two immediately preceding years), as well as have an implementation strategy, which is available to the public, to meet the needs identified through the assessment.

Financial assistance policy requirements – Each hospital must adopt, implement, and publicize a written financial assistance policy that includes a description of the criteria for assistance (free or discounted), the basis for calculating amounts charged to patients, the method for applying assistance, the actions an organization may take to collect outstanding debts, methods to widely publicize the financial assistance policy, and a requirement that the organization provide nondiscriminatory emergency care regardless of the ability to qualify under the written financial policy.

Charges – Hospitals are limited as to how much they can bill patients who qualify for financial assistance. The prescribed rules on fees require that the amounts charged for emergency or other necessary procedures performed on those patients be no more than the lowest amounts generally billed to insured individuals.

Collections – With respect to billing and collection, a hospital cannot engage in extraordinary means of collection until reasonably exploring the eligibility for assistance under the financial assistance program (guidance may be released relating to what constitutes reasonable efforts).

Effective date – Generally, the requirements apply to taxable years beginning after the enactment date, however, the community health needs assessment requirement applies to taxable years beginning two years after the date of enactment.

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FAMILY ISSUES AFFECTING
PRIVATE FOUNDATIONS

By: *Ronald S. Webster*[1]

A. Introduction.

Private foundations are tax exempt organizations that are typically founded, funded and controlled by one family. There is no requirement under federal tax laws or state nonprofit laws to have outside, independent directors. Thus, a founding family may control the governance of the foundation and, if desired, require that future directors be limited to descendents of the founders. Because few families are perfect, and private foundations are often dominated by one family, the normal disagreements, conflicts and changes in relationships that occur within families can affect the management and operations of the family's foundation. A complicating factor can be that as foundations age, more siblings, descendants, cousins and spouses can become involved with the governance of the foundation. These additional family members can lead to increased conflict among the family as directors of the family foundation. The purpose of this outline is to highlight and explore how the governance of a private foundation can be affected by family dynamics.

It is important to remember that private foundations and their "disqualified persons" are subject to the strict (and complicated) penalty taxes of Sections 4940-4946 of the Internal Revenue Code of 1986, as amended (the "Code"). Further, directors (including family directors) are "fiduciaries" with fiduciary duties under state law, and which are subject to enforcement by the Attorney General's office. Thus, when addressing family issues within the context of a private foundation, both the problems and the proposed solutions must be evaluated under federal tax laws and state fiduciary duty laws.

B. Family Issues Affecting the Governance of a Private Foundation.

There are specific family issues that can affect the governance of a private foundation, as illustrated below:

1. "Dad, I need a paycheck."

Compensation paid by a foundation to family members can be problematic under both the self-dealing prohibitions of Section 4941 of the Code and state fiduciary duty laws. While reasonable compensation can be paid by a foundation to family members, such family members must actually provide necessary services to the foundation. There is no "entitlement doctrine" under private foundation law. Arguments such as "the job market is lousy," "I have nothing to do," or "my expenses have increased since I am not living at home" have no relevance to the determination of what is reasonable compensation. Further, salary surveys do not tell the whole story. The advisor to a family foundation must also consider qualifications, time devoted to the position, and actual contributions to the management of the foundation. The bottom line is that proper education of the family during the formation of the foundation is critical to managing expectations of family members relative to compensation.

2. "It's still my money."

The process of creating a foundation is oftentimes fairly seamless for the founder. When an entity is formed with the founder's name, a bank/brokerage account is usually established with the institution where the family has its accounts, cash or securities are electronically transferred from one family account to "another" family account, and the founder still controls the funds. However, because of the continuing family involvement over funds within the foundation, sometimes the founder may not fully appreciate the significance of the word "Foundation" after his or her family name. The foundation funds are irrevocably dedicated to charitable purposes. From the advisor's perspective, most problems that arise from this misconception relate to how foundation funds are invested (types of investments, level of diversification, and identity of managers), but problems can also involve the foundation providing improper benefits to family members. In addition to excise taxes and fiduciary duties, specific investment laws can be impacted by this attitude.

3. "It's our money that created the foundation, therefore we want a dictatorship not a democracy."

Most parents do not want to be out-voted by their children who might occupy a majority of the director positions. To alleviate this issue, many family foundations have parents as "members" who elect or remove directors. Such foundations may also provide special quorum and/or voting requirements to ensure parental control during the founders lifetimes. However, it is important to encourage the participation by descendents in the governance of the foundation, and emphasizing parental control can discourage meaningful involvement of the future generations.

4. "Mom and Dad, we (the children) want more involvement in how grants are awarded."

It is relatively easy to allow broader involvement in the grant process without giving up overall control of the foundation. As an example, the bylaws can provide that the annual distributable amount is to be allocated among the directors, and that each director has authority to spend his or her allocated amount. Allocation methods can be flexible or fixed, and can involve all or partial amounts of the distributable amount. It is strongly recommended that a percentage of the distributable amount be awarded by entire board. Finally, grant guidelines should specify parameters for individual-approved grants (no personal benefits, no tuition payments, etc.) so as to preclude self-dealing or other excise tax issues.

5. "Mom and Dad, we want our children (your grandchildren) to begin learning how the foundation operates since one day they will be directors."

This is a good reason to have an advisory committee. Participation in an advisory committee allows the grandchildren to meet regularly on a long-term basis to provide advice and/or support to the foundation, and gain valuable experience for their future role as directors. The committee provides third generation external input into internal processes performed by the

earlier generations. However, the expectations about the roles of the committee in providing advice and support need to be clear, consistent, and well communicated or the grandchildren, finding themselves in a ceremonial role, lacking the information and the opportunity to make a contribution to the program, could become disgruntled.

6. "We want a divorce."

If a husband and wife are co-founders of a foundation, a divorce usually means that they no longer wish to continue serving on the same board (this is an understatement!). The resolution of a divorce at the foundation level often depends on the marital property characterization of the property used to fund the foundation. If community property was used, then the spouses may consider splitting the foundation into two foundations – with each spouse controlling a separate foundation. A division of the foundation can be accomplished under Code Section 507 fairly easily with no additional tax burdens, and usually without an IRS ruling. See, e.g. PLR 199938039. A donor advised fund at a community foundation may also be used to accomplish a split. If the separate property of one spouse was used to fund the foundation, then usually the divorce settlement agreement will provide for a resignation. Divorce can be very difficult for adult children who remain on the board of the foundation co-founded by their parents. Attorneys: beware of conflicts issues!

7. "Now that our parents are deceased, we can no longer get along with [our siblings] [our cousins] [our children]."

Disagreements between family lines are more prevalent once the founding parents are no longer alive or exercising control over the foundation. Of course, one option is to split the foundation into 2 or more separate foundations, with each family group controlling their separate foundation. As stated above, this can be accomplished under Code Section 507 fairly easily from a tax standpoint. An alternative to consider, especially if a split would be viewed as disrespectful to the parents' legacy, is to keep one foundation but divide payout responsibilities and governance along family lines. In essence, it may be possible to preserve family peace and keep one entity by allowing each family line to have some autonomy over grants and governance.

8. "Let the foundation share in all expenses of managing our personal and business interests."

Office sharing arrangements among personal/business/foundation interests are becoming more common. However, great care must be exercised to avoid inadvertent self-dealing under Section 4941 of the Code. For example – paying for space or office supplies can create problems depending upon how such arrangements are structured. Also, the foundation must be careful in allocating payments for services rendered as there is a tendency to split expenses pro rata, without regard to actual time spent.

9. <u>“We don’t want our children's spouses to ever be directors!”</u>

Many foundations want to keep the board “in the family” and define “family” in such a way that precludes spouses, step-families, in-laws and others. There are several avenues that a foundation can take to keep the board “in the family.” Charitable trusts can be made non-amendable, but are more difficult to work with and may have certain legal disadvantages. Nonprofit corporations are more flexible, but are amendable under state law. However, bylaws can stipulate director requirements (<u>e.g.</u> no spouses) <u>and</u> the Certificate of Formation can make amendments very difficult to pass in order to protect donor’s intent. At some point in the future when the parents are gone, the children or grandchildren directors may attempt to override the directives of the founders with respect to diversification of the board by bringing non-familial perspectives and talents to the board.

10. <u>“Our children are too young to be appointed to the board now, but we want them to be appointed automatically when they reach age 25.”</u>

There is a trade-off between not allowing directors to use their discretion and judgment to elect members of the board, versus assuring the future election of family members. Age or family name alone is not always the only criteria to consider for board appointment. A foundation should consider a hybrid approach (“will be eligible for board election at age 25”) and proceed with elections at the time of eligibility based on objective qualifications set forth by the board.

11. <u>“We want our foundation to terminate at [the last of us to die] [ten years after the last of us to die] [when none of our children are serving on the board].”</u>

It is becoming more common for the founders or current directors to consider a controlled termination of their foundation at some designated time in the future. What if future directors disagree? Again, the differences between charitable trusts and nonprofit corporations must be considered. As part of the dissolution process, the bylaws of a non-profit corporation can provide for specific grantees to benefit from terminating distributions. Bylaws can also give directors existing at time of dissolution discretion to wind-up affairs, allowing leeway for decisions like whether to pay severance to employees, etc.

12. <u>“You’re our family’s attorney.”</u>

For attorneys, potential conflicts of interests abound where the attorney represents an entire family (individuals, trusts, family limited partnerships, and/or family foundation). A united family today may be a divided family in the future. Especially in the estate planning context, the family attorney should carefully consider who he or she is willing to represent (parents, children and/or family foundation?). Careful drafting of the engagement letter can be critical if future disputes arise.

13. "We don't have family who are able to manage the family foundation."

When either there are no descendants, or no descendants who are able or interested in managing a foundation, the founders should consider engaging a corporate fiduciary. Corporate fiduciaries can be the sole or co-trustee of a charitable trust, or be engaged as an agent for a nonprofit corporation. A corporate fiduciary can remove the emotional issues from foundation decisions, contribute significant assistance to the performance of management responsibilities, and provide continuity to assure the family's intent is carried out.

C. Conclusion.

The governance of a private foundation can be profoundly affected by family dynamics. With thoughtful and creative planning, the various family issues can be managed so that the foundation's governance can survive family disputes and continue its charitable activities uninterrupted. With conscientious guidance, a foundation can leave a legacy of giving that will make all family members proud!

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WHO CARES ABOUT CONTRACTOR VS. EMPLOYEE STATUS? 10 ZONES OF DANGER

By: *Robert W. Wood*[1]

Who is an independent contractor and who is an employee? We know it matters, and we know disputes over this fundamental divide occur. But do we know how, where and when they occur? Usually not. Most of us may know there are liabilities lurking in independent contractor versus employee controversies. But our awareness of the specific types of liabilities and the potential exposure varies widely, from ignorance to near paranoia.

Some of us naively assume things are always what you call them. Surely slapping an "independent contractor" label on a worker's name badge resolves the question! The more sophisticated among us know a nice moniker isn't enough. We seek to have an independent contractor treated as such in both word and deed. If we are very careful, that should bring a measure of certainty and protection from liability.

Yet almost nothing is risk free. Even the most cautious and carefully constructed working relationships and written agreements can go awry. Wherever you or your clients fit along this spectrum, you know almost instinctively that there is a risk of recharacterization. For tax and other purposes, the IRS or others may come along and say that you owe something that you do not think you should owe.

To be able to more carefully fix where you fit along the spectrum of awareness, you should have a better sense of the various battlegrounds where the worker status debate can be waged. Here are ten things about worker status disputes you should know.

1. The IRS is Number One.

Most classically, the independent contractor versus employee distinction is raised by the IRS. This is so both for income tax withholding and for employment taxes. The latter, it must be remembered do not fall exclusively on the worker and in fact are shared by the employer.

Yet in terms of overall dollar exposure, the biggest dollars at stake generally concern income tax. Independent contractors are paid the gross amount of their pay with no tax withholding. If the putative independent contractor turns out to be an employee, then all of that pay was "wages," and that means you should have withheld! If an employer fails to withhold income tax on wages, the penalties are severe. This potential liability can be enormous in a multi-year independent contractor versus employee controversy.

2. State Income and Employment Tax.

The same concerns that can arise for federal income and employment taxes can also arise under state law. Not every state has an income tax, but most do, and their withholding systems generally parallel the federal one. Thus, for both state income taxes (where applicable) and state employment taxes, the contractor versus employee distinction remains important.

Sometimes the state tax agencies are tougher than the IRS. In California, for example, it's generally accepted by tax lawyers and accountants that it is harder to win a California employment and income tax matter than to beat the IRS in a similar case. Given exchange of information agreements between the IRS and the states (and among the several states themselves), one battleground usually turns into another.

3. ERISA and the Department of Labor.

The Employee Retirement and Income Security Act of 1974 has been amended many times and is among the more complex of federal laws. It governs pensions and employment benefits. If you are an employer, its name should send you quaking. Jointly administered by the IRS and the US Department of Labor ("DOL"), it mandates and regulates a vast system of enforcement and compliance.

And guess who it excludes from its coverage and nondiscrimination rules? Independent contractors. As a result, in ways you may not have anticipated, the IRS or DOL or both may scrutinize who you cover and how you cover them.

4. Workers' Compensation Liability.

Workers' compensation systems are designed to provide no-fault coverage to employees injured on the job. Workers' compensation laws are creatures of state law, and while there is variation, they are pretty consistent. They cover only employees and not independent contractors. That leads to inevitable coverage disputes.

An injured "independent contractor" worker may (or may not) realize that only employees are covered. But even claims that start out innocently can end up being time consuming and expensive. A claim that might involve only a few dollars can become the first domino in an expensive and protracted multi-disciplinary controversy.

5. Unemployment Insurance.

Like the workers' compensation system, most unemployment insurance is designed to provide a broad base of support where it is needed when workers lose their jobs. Unemployment benefits may not be much, but they help. That is why in the current economic doldrums, many state unemployment benefits systems are woefully under water.

Unemployment insurance applies only to employees who have been terminated or laid off, not to independent contractors. Even so, many putative independent contractors end up making claims for unemployment benefits. In doing so, they may actively be seeking reclassification as "employees."

However, they may simply not appreciate the distinction between the two classifications of workers. In either case, disputes often arise. As with workers' compensation claims, sometimes a seemingly small claim may turn out to be the proverbial straw that broke the camel's back.

6. State Labor and Employment Law.

Labor disputes represent another classic type of employment matter. One's workers may ask for more money or benefits, and this may occur whether the workers are employees or independent contractors. More often, one encounters investigations by state departments of labor or industrial relations.

Such agencies routinely receive complaints from workers which they are required to investigate. These investigations often lead to worker status disputes. In the absence of worker complaints, the agencies may target certain industries, looking for what they may consider to be rampant misclassification abuses in a particular industry or geographic area.

7. Union Organizers.

Understandably, union organizers want to expand their franchise and to gain a foothold in new organizations. After all, union members are the lifeblood of these organizations. To have power one must have strength, and in this context, strength requires numbers. More members pay more dues.

Yet when one thinks of labor law today, one increasingly thinks of employment and discrimination laws rather than of union organizations and traditional labor relations. Nevertheless, the independent contractor versus employee dichotomy is very much alive in the union context too. The vast system of laws governing organized labor covering strikes, walkouts, lockouts and more applies to employees, not to independent contractors. For that reason, disputes over worker status in this specific and traditional context can have high stakes.

8. Liability in Civil Suits.

Civil suits for tort liability might seem to be an unlikely place for worker status disputes to arise. In fact, however, such disputes are rampant, and for understandable reasons. If an independent contractor causes an auto accident, he may certainly be sued.

But if the driver is an employee on the job, the injured party may sue not only the driver but his employer too. The employee is an agent of his employer, and that makes the employer liable. But how does this drama play out given the vicissitudes of modern litigation?

Even if on paper and in fact it appears that the driver was an independent contractor, the injured party may sue the putative employer. The injured party may expect the employer to settle rather than to risk a large fight over the worker's status that may turn out badly. Worker status disputes in this context are occurring with increasing frequency.

9. "Other Litigation."

Almost defying categorization, the status of a worker as either an independent contractor or an employee can arise in surprising ways. Under the rubric of "other litigation," one might lump the many legal contexts in which this legal issue occurs. The matter can arise in intellectual property disputes, in suits concerning the liability of officers and directors, in disputes between companies tangentially involving the acts of authorized persons, etc.

The independent contractor versus employee question may be a small or a large point in the overall case. It may even be the linchpin that imparts—or that avoids—significant liability.

10. Suits by Your Own "Contractors."

Suits may be brought by workers themselves for benefits, expense reimbursement, nondiscriminatory treatment, wage and hour protections and more. Such suits can come in many forms and in many forums. Some suits are brought as individual cases by one or several workers. Others are styled as class actions.

The object of such suits varies too. A suit may be primarily about benefits, about expense reimbursement, about working conditions, or something very targeted, such as valuable stock options. It may even be about applicable minimum wage. Usually it is only "employees" who are entitled to sue and to the legal protections many statutes provide.

Nevertheless, workers increasingly bring legal action for damages notwithstanding their explicit status within the company as "independent contractors." In effect, they are saying that whatever their contracts and agreements may call them, they are being *treated* as employees. Accordingly, the lawsuit will assert, they should be entitled to the financial and legal advantages employee status accords.

Perhaps more than any other type of worker status dispute, this type may generate the most ire of all on the part of the defendant companies. Some companies with very clear written independent contractor agreements find it outrageous that their workers may seek to contradict (and in effect to abrogate) a contract that the worker himself signed. However, this is not too different from the attacks mounted by government agencies that assert that a putative independent contractor is really an employee.

Whoever is pursuing the dispute, it is ultimately about the facts and the law. It might well seem to a defendant company that some kind of estoppel principle would protect them. Yet that argument fails in this context. The law is clear that even by written agreement, the parties cannot make someone an "independent contractor" who is truly an employee under the law.

Such worker suits are becoming more and more common. Across America, company liability for cases of this sort is exploding.

Conclusion

Most of us focus on the legal and factual distinctions between independent contractors and employees, on the specifics that are likely to make a worker one thing or another. Occasionally, though, it is worthwhile stepping back to look at the landscape of worker status controversies and to consider the particular contexts in which these disputes arise. When you do, you may find it is frighteningly vast and diverse.

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

PART II: SUPPORTING ORGANIZATIONS SIMPLIFIED (KIND OF)

By: *Albert Lin*[1]

I. Introduction and Recap of Part I.

Considering the fact that entire treatises have been written about private foundations,[2] the general tax practitioner might appreciate a more simplified explanation of the "fantastically intricate and detailed"[3] rules that arise in this subset of tax-exempt laws. Much of the blame for the confusion surrounding supporting organizations rests with the shotgun-style statutory approach of the charitable and tax-exempt laws.

While none of the Internal Revenue Code of 1986, as amended ("Code") can be considered simple, the provisions outlining rules for private foundations are found not in Section 501(c)(3) (which might make sense) but in Section 509, Section 170, and throughout various penalty provisions in Section 4940 and subsequent sections. This can make proper statutory compliance an excruciating headache for tax lawyers (especially non-exempt tax specialists called upon for pro bono assistance). To add to the complexity, the new Section 4966 of the Code, added by the Pension Protection Act of 2006,[4] creates a new penalty provision for subcategories of charitable organizations within supporting organizations. The rules are so convoluted, advising the simplest of nonprofits (with admittedly tight budgets) properly is a challenge for the tax practitioner who desires to help clients efficiently.

Part II: Supporting Organizations Simplified is a continuation of Part I: Public Charities and Private Foundations - A Statutory Roadmap published last year.[5] Part I outlined the differences between a public charity and a private foundation, and described the Code's roundabout way of saying a private foundation is any Section 501(c)(3) organization that is NOT a private foundation. As discussed in Part I, a public charity is a tax-exempt Section 501(c)(3) organization which meets certain tests outlined in three subsections of Section 509, which will result in the organization NOT being a private foundation. Part I discussed the first two subsections (that is, Section 509(a)(1) and Section 509(a)(2)) which set forth requirements that qualify a tax-exempt organization for public charity status (by avoiding private foundation status). This Part II will focus on the third subsection, Section 509(a)(3), which covers supporting organizations (which also avoid private foundation status). Complete discussion of supporting organizations is not the intent here; rather, this Part II hopes to provide tax practitioners not familiar with these rules with some basics in assisting their clients.

II. It's Not a Private Foundation if it is Described in Section 509(a)(3)("Supporting Organizations"), *but* it Better Be a Type I, II, or Functionally Integrated Type III Supporting Organization.

Section 501(c)(3) organizations which cannot meet the various tests to avoid private foundation status as a public charity pursuant to Section 509(a)(1) and Section 509(a)(2), as discussed in the first Part to this two-Part Article,[6] may consider "supporting organization" classification under Section 509(a)(3) in the process of completing its Form 1023 (Application for Recognition of Tax Exemption).

Such classification is important if, for example, an existing public charity wants to "spin off" certain activities that are not necessarily charitable in and of themselves (such as administrative support functions solely for the public charity). Hence, Section 509(a)(3) organizations, called supporting organizations, may be considered when there are close ties with another organization or organizations that actually did meet Section 509(a)(1) or Section 509(a)(2) tests. Supporting organizations essentially "piggyback" the public charity status of other organizations.

Supporting organizations must meet three tests. In practice, the first two tests are relatively simple to apply. The third test, changed by PPA '06, created the term "Types" to clarify three Types of supporting organizations. PPA '06 also created two subcategories of the third Type. Such is the confounding way of typical tax legislation.

Meeting the three tests means that the organizational document (i.e., the Texas certificate of formation) must contain some technical provisions not typically seen by the average tax practitioner. The supporting organization analysis should be done before formation to avoid annoying amendments later on. Analysis is now more complicated with the PPA '06 revisions on the Types. The exact Type of supporting organization should be ascertained such that the first determination letter correctly names the Type (to avoid later IRS hassles to change or update the determination letter). The IRS determination letter will now state, for example, "We [the IRS] have determined that you are a Type 1 supporting organization under Section 509(a)(3))."

A. *Section 509(a)(3)(A) - Organizational and Operational Test for a Supporting Organization.*

The first test, set forth under Section 509(a)(3)(A), requires that a supporting organization be "*organized, and at all times thereafter . . . operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2)*[specifically, Sections 509(a)(1) and (a)(2)]."[7] The extensive Section 509 regulations expand upon this requirement in great detail. Stated simply, the certificate of formation needs to sufficiently describe *who* the supporting organization supports. This can be accomplished, by example, by stating in the certificate of formation that:

> "The organization is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the

purposes of _________________, a [tax-exempt organization recognized as a public charity under Section 501(c)(3) and Section 509(a)(1), 509(a)(2), etc.]."

One easy way to do this is simply name (i.e. fill in the blank) the specified organizations in a manner that satisfy the Section 509 regulations. Guide Sheets published by the IRS will walk the practitioner through the necessary language in organizing documents.[8] If there are one or more organizations that can be identified, *naming those* is best (and it is prudent, of course, to make sure they are actually organizations defined in Section 509(a)(1) and (a)(2)).

If the organization intends to benefit many existing or yet-to-be-created organizations, it is possible to refer to supported organizations without name, so long as such organizations are identified *by class or purpose*. For example, a church-affiliated Section 501(c)(3) organization can be a supporting organization under Section 509(a)(3)(A) where the articles of organization required it to care for the aged, which is a charitable class (because one of the church's purpose was to care for the aged via a home).[9] In this example, the supporting organization shall "carry out the purposes of such organization or organizations qualified under Section 501(c)(3) and which provide home and medical care for the aged." In addition, the certificate of formation may describe the existence of a *historic and continuing relationship* such that there is a substantial identity of interests between the two organizations.[10] In practice, the third test is rarely applied. It seems hard to argue a historic and continuing relationship where a new organization is being formed.[11]

The certificate of formation must also refrain from expressly empowering the organization to engage in activities not in furtherance of the specified purpose, or support or benefit any other organization not named by purpose or class.[12] Generally, once the practitioner gets past the part naming the exclusive beneficiary or class, any further expansions of power should be discouraged.

Supporting organizations under Section 509(a)(3) can also include those which support Section 501(c)(4), (5), or (6) organizations, so long as the Section 509(a)(2) public support tests[13] are met by the (c)(4), (5), or (6) organization as if such organization's purpose were charitable rather social welfare, labor, or business league or other purpose permitted by (c)(4), (5) or (6).[14] What all this means is that a supporting organization might be set up to conduct charitable activities under the watch of a (c)(4), (c)(5), or (c)(6) organization, *but* the supporting organization needs to be prepared to observe all limitations and restrictions applicable to charitable organizations and not otherwise applicable to the supported organization. Therefore, if this structure is considered, a certificate of formation cannot simply say that it is "organized and operated exclusively for" the benefit of the non-charitable exempt organization. *Instead, a stand-alone Section 501(c)(3) charitable, educational, etc. purposes clause is required for organizations seeking supporting organization status when supporting a non-charitable tax-exempt organization under Section 501(c)(4), (5), or (6).* Note, also, that where the supported organization is a (c)(4), (c)(5), or (c)(6) organization, the supporting organization will not be able to use the Section 509(a)(3)((A) organizational and operational test because it cannot name the (c)(4), (c)(5), or (c)(6) entity as a supported organization. Instead, it needs to rely solely under the Section 509(a)(3)(B), Type I or Type II category discussed in the Section 509(a)(3)(B) explanation below.

B. *Section 509(a)(3)(C) - Disqualified Person Prohibitions (Control Test).*

The second test, under Section 509(a)(3)(C), provides that disqualified persons[15] (other than foundation managers) must not control directly or indirectly, the supporting organization. Stated differently, substantial contributors to the supporting organization cannot make up a majority of a supporting organization. In application this particular test can be tedious despite simplicity in concept, with all indirect corporate and entity ownership included.

C. *Section 509(a)(3)(B)(Relationship Test).*

The most difficult and confusing components of supporting organization tests are found in the third test, outlined in Section 509(a)(3)(B). These tests were the subject of recent changes under PPA '06. Subsection (B) now names three Types of Section 509(a)(3) supporting organizations by imposing some not easily objective relationship tests. The relationship tests require satisfaction through provisions in bylaws and other governing documents outside the basic certificate of formation.

The tax practitioner creating a new supporting organization should attempt to identify the Type of supporting organization in the certificate of formation, particularly as the IRS will now specifically list the Type in the determination letter. For organizations dependent upon grants from a broad range of public charities and private foundations, having the correct Type shown in the letter will facilitate contributions. As discussed later, major private foundations will find it preferable to contribute to Type I, Type II, or "functionally integrated" Type III supporting organizations due to the new excise taxes potentially imposed on distributions not made to such organizations. Types I and II are easy to identify; the "functionally integrated" Type III is much harder to identify and establish, and the determination of whether a Type III is "functionally integrated" has drawn many a nonprofit CEO to the brink of insanity since formerly generous donors now require new substantiation as a condition to receiving the generous grants.

1. *Section 509(a)(3)(B)(i) - Type I Supporting Organizations (Parent/Subsidiary).*[16]

Type I supporting organizations are "operated, supervised, or controlled by one or more organizations" which are public charities by virtue of Section 509(a)(1) or 509(a)(2). The key terms are "operated, supervised, or <u>controlled by</u>." This parent/subsidiary Type I is easiest to identify. The Regulations provide that the terms operated, supervised, or controlled "presupposes a substantial degree of direction" over the supporting organization, and requires that a majority of the directors of the supporting organization be appointed or elected by the supported organization.[17] If a parent supported organization appoints or elects the majority of the subsidiary supporting organization's governing body, the supporting organization is clearly Type I.

2. *Section 509(a)(3)(B)(ii) - Type II Supporting Organizations (Brother/Sister).*[18]

Type II supporting organizations are "supervised or controlled in connection with one or more such organizations." Here, the key terms are "controlled in connection with." To be a Type II supporting organization, the control or management of a Type II must be vested in the same persons that control or manage the supported organization.[19] In other words, there are typically overlapping directorates in Type II supporting organizations. For example, a majority of the "brother" supported organization is also a majority of the "sister" supporting organization.

3. *Section 509(a)(3)(B)(iii) - Type III Supporting Organizations (Just Friends (But Very Close Friends)).*

The practitioner can usually identify and request Type I and II status without too much fuss; Type III is harder to identify and establish. Type III supporting organizations are "operated in connection with one or more such organizations" and as such, do not have as much direct oversight from the supported organizations. The key term is simply "operated in connection with." The statutory terms are admittedly nebulous. For this reason – the perception that Type III supporting organizations strayed too far from the purposes and direction of the supported organization – the IRS created specialized rules relating to Type III supporting organizations with PPA '06.

Type III supporting organizations must meet two tests. First, the Type III supporting organization must be "*responsive to the needs of*" (as opposed to controlled by) the supported organization. Second, the Type III supporting organization must be an "*integral part*" of the supported organization, by maintaining a significant involvement in the operations of the supported organization and such supported organizations are dependent upon the supporting organization for the type of support it provides. The integral part test now has additional relevance as it determines whether a Type III supporting organization will be classified as a "functionally integrated" or "non-functionally integrated" Type III supporting organization. The practitioner will want the formation documents and tax-exempt application to support functionally integrated Type III classification if possible due the disadvantages of non-functionally integrated" Type III classification. New proposed Treasury regulations, issued on September 24, 2009, have considerably added to compliance headaches in this area.

(i) The "responsiveness" test is met if at least one of the Type III supporting organization's officers, directors, or trustees are elected or appointed by the supported organization, or if the officers, directors, or trustees of the supporting organization maintain a close and continuous working relationship of the publicly supported organization.[20] In addition, by reason of the common leadership position, the persons on the supported organization have a "significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients of such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization."[21] So, the practitioner should try to ensure at least one common director or officer is in place, and such person or persons should be active and not simply a nominee director.

(ii) The "integral part" test can be met by satisfying one of two tests. New regulations break up the two "integral part" tests into tests that result in the Type III supporting organization being either "functionally integrated" or "non-functionally integrated."

(1) To be functionally integrated, a Type III supporting organization must meet yet two more subtests. First, the Type III supporting organization wishing to meet functionally integrated status must prove substantially all of its activities directly further the exempt purposes of the supported organization to which it is responsive.[22] Second, "the activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, *but for the involvement of the supporting organization*, would normally be engaged in by the publicly supported organizations themselves."[23] In other words, this "but for" test asks, "is the supporting organization conducting an activity that the supported organization would otherwise need to conduct itself?"

(2) If the above functionally integrated tests are not met, the Type III supporting organization can at least be a non-functionally integrated Type III supporting organization if it satisfies two other tests. The second test requires that the Type III supporting organization meet an annual distribution requirement and an "attentiveness" test. First, a non-functionally integrated Type III supporting organization must distribute annually roughly 5% of the fair market value of its non-exempt use assets to the organization or organizations it supports.[24] This is called the organization's "annual distributable amount." Second, of the annual distributable amount, at least one-third or more must be distributed to supported organizations that are "attentive" to the operations of the Type III supporting organization and to which the supporting organization is "responsive."[25] "Attentiveness" can be shown if the Type III supporting organization distributes an amount equal to 10% of the supported organization's total support, or, more generally, if the supported organization needs the Type III supporting organization's money to avoid interruption of an activity or function of the supported organization.[26]

There are excruciating rules continued in the proposed regulations, which outline what consists of "non-exempt use" assets and limitations where donor advised funds are considered. These rules will not be covered in this Article, nor will this Article cover the compliance and transitional rules. To recap, the point in this Article is that satisfaction of Section 509(a)(3) tests is desirable to avoid private foundation classification and the disadvantages thereof. If the satisfaction of Section 509(a)(3) is required, the practitioner must try to avoid non-functionally integrated Type III supporting organization status. The "bad" Type III supporting organizations are subject to restrictions that can affect fundraising from private foundations. In other words, private foundations (typically, exempt organizations set up by wealthy donors and controlled by such) will strongly disfavor contributions to a non-functionally integrated Type III supporting organization.

D. Why it is Bad to be a Non-Functionally Integrated Type III Supporting Organization.

The final component of this analysis looks to whether, once it is determined a Type III supporting organization exists, such Type III supporting organization is functionally integrated. Section 4943, in brief, provides that excise taxes on undistributed income of a private foundation can be imposed if a private foundation does not make sufficient "qualifying distributions." One of the key problems with private foundation status is the requirement to distribute a minimum amount of income as qualifying distributions.[27] Under Section 4943(f), qualifying distributions cannot be made to Type III supporting organizations unless they are functionally integrated. Grants from a private foundation to a bad Type III supporting organization will be classified as taxable expenditures under Section 4945 unless the hassle of expenditure responsibility is complied with. Excess business holding rules now apply to bad Type III supporting organizations as well as private foundations. For these reasons, most large private foundations now require proof that a grant applicant that is a supporting organization prove that it is not a non-functionally integrated Type III supporting organization. If the IRS determination letter does not specifically state the Type, potential donor organizations require a "reasoned opinion of counsel" that a particular supporting organization meets the tests under Section 509(a)(3) to be a particular Type.[28] The time and expense of doing such an opinion can be a sticky spot for tax practitioners and their clients.

III. **Certificate of Formation Language**.

Now that this Article has (somewhat) clarified what makes up a supporting organization, the tax practitioner should at least have a frame of reference in which to more knowledgeably draft formation documents for a tax-exempt organization. Common Texas corporate form resources delicately avoid suggesting any standard tax-compliant language. The author has noticed more than a few articles of incorporation/certificates of formation which include language that the Code requires for private foundations, above and beyond the standard purpose and dissolution clauses. The Code provisions that impact formation documents are worth revisiting.

For example, Section 508 of the Code (the Code section which references the tax-exempt application process) requires, as a condition for a private foundation to be tax-exempt, certain additional provisions in the articles of incorporation/certificate of formation. The provisions relate to the minimum distribution requirement (Section 4942), the self-dealing prohibition (Section 4941(d)), the excess business holdings prohibition (Section 4943(d)), the jeopardy investment provisions (Section 4944), and the taxes on taxable expenditures (Section 4945).[29] To comply with Section 508, this messy language was present in many now-antiquated articles of incorporation for private foundations, but certainly they are not required in any entity that desires to avoid private foundation status. The practitioner should make sure these private foundation-only rules are not in the certificate of formation for a public charity.

Even if private foundation status is desired, the Texas Business Organizations Code ("TBOC") thankfully provides the Section 508 language by operation of Texas law. Section 2.107 of the TBOC (entitled "Standard Provision for Certain Charitable Nonprofit Corporations; Power to Exclude") recites the exact provisions that the federal Code requires and therefore,

incorporates federal Code requirements by operation of state law. Hence, there is no need to insert the Section 508 language in the formation documents of a Texas nonprofit corporation.

What follows, then, is suggested minimum tax language for the "Purposes" and “Dissolution” clauses of a Section 501(c)(3) organization. Some of these provisions have been drawn from the IRS’s instructions to Form 1023,[30] other provisions are from the author’s own language used over years.

1. Tax Paragraph 1 to Purposes Clause. The Corporation is organized exclusively for charitable, educational, and scientific purposes under section 501(c)(3) of the Internal Revenue Code of 1986, as amended ("Code").

Note: If a more specific description is desired, a statement elaborating on the specific purpose of the corporation can be inserted, but state that the specific purpose is within the general purpose as stated above; i.e. “More specifically, but within such general purpose . . .”

2. Tax Paragraph 2 to Purposes Clause. No part of the net earnings, gains, or assets of the Corporation shall inure to the benefit of or be distributable to its directors, officers, other private individuals, or organizations organized or operated for a profit, except that the Corporation shall be authorized and empowered to pay reasonable compensation for services rendered.

3. Tax Paragraph 3 to Purposes Clause. No substantial part of the activities of the Corporation shall be the carrying on of propaganda or otherwise attempting to influence legislation, and the Corporation shall be empowered to make the election authorized under section 501(h) of the Code. The Corporation shall 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.

4. Tax Paragraph 4 to Purposes Clause. Notwithstanding any other provision herein, the Corporation shall not carry on any activities not permitted to be carried on (i) by an organization exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3) of such Code, or (ii) by an organization, contributions to which are deductible under sections 170(c)(2), 2055(a)(2), or 2522(a)(2) of the Code.

5. Tax Paragraph 1 to Dissolution Clause. Upon the dissolution of the Corporation, after payment or provision for payment of the Corporation’s liabilities has been made, the Corporation’s remaining assets shall not be transferred to private ownership, but shall be distributed exclusively to a Qualified Recipient or Recipients (as hereinafter defined).

Note: In supporting organizations, often the Corporation will desire assets to be distributed to the supported organization. Language should be included that ensures the supported organization is still qualified under Section 501(c)(3).

6. Tax Subparagraph to Paragraph 1 to Dissolution Clause. A "Qualified Recipient" shall mean either (i) an organization that is existing and qualified as exempt from federal income taxation under Section 501(a) of the Code as an organization described in Section 501(c)(3) of the Code and organized exclusively for the tax-exempt purposes as set forth in this Certificate (or such other tax-exempt purposes as may lawfully be conducted by an organization described in Section 501(c)(3) of the Code); (ii) a federal, State or local government, exclusively for such government's public purpose; or (iii) any entity which has been declared, by court order in a duly authorized court of competent jurisdiction, as an entity which shall best accomplish the general purposes for which the Corporation was organized.

IV. **Conclusion.**

With heightened interest in nonprofit organizations and frequent media coverage outlining abuses,[31] the tax practitioner will continue to confront issues relating to Code requirements on tax-exempt organizations. The rules surrounding and defining Section 501(c)(3) organizations are amazingly convoluted and, it is hoped, the overviews provided in Part I and II will provide assistance as Texas tax lawyers continue to be involved in the nonprofit arena.

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[2] See Bruce R. Hopkins & Jody Blazek, PRIVATE FOUNDATIONS: TAX LAW AND COMPLIANCE (John Wiley & Sons 1997) for an excellent - and 520 page - reference source for rules regarding and relevant to the private foundation world.

[3] Windsor Foundation v. U.S., 77-2 U.S.T.C. 9709 (E.D. Va. 1977).

[4] Pension Protection Act of 2006 (PL 109-280)("PPA '06").

[5] Albert Lin, *Public Charities, Private Foundations, and Supporting Organizations for the Non-Exempt Organizations Specialist*, TEXAS TAX LAWYER (May 2009).

[6] Id. p. 34 (discussing § 509(a)(1) and 509(a)(2) as ways an organization avoids private foundation status, which would otherwise subject it to excise taxes and charitable contribution limits not applicable to public charities).

[7] I.R.C. § 509(a)(3)(A). The regulations to this section are unfortunately lengthy and found at Treas. Reg. § 1.509(a)-4 (and which have proposed regulations pending now).

[8] IRC 509(a)(3) Supporting Organizations Guide Sheet Type I & Type II (March 13, 2008), available at <<www.irs.gov/pub/irs-tege/509a3_typeiandii_guidesheet.pdf>>; see also for Type III, available at <<http://www.irs.gov/pub/irs-tege/509a3_typeiii_guidesheet.pdf>>.

[9] Treas. Reg. § 1.509(a)-4(d)(2)(b)(iii), Ex. 1.

[10] Id. § 1.509(a)-4(d)(2)(b)(iv).

[11] See supra no. 8.

[12] Id. § 1.509(a)-4(c)(1)(iv).

[13] More than one-third of its supports must derived from gifts, grants, contributions, or membership dues from permitted sources, and not more than one-third of its support is derived from the sum of gross investment and unrelated business taxable income. See supra n. 5 at 33.

[14] "For purposes of paragraph (3)[which is § 509(a)(3) describing supporting organizations], an organization described in paragraph (2)[which is a § 509(a)(2) publicly supported organization] shall be deemed to include an organization described in section 501(c)(4), (5), or (6)[which are non-charitable types of exempt organizations] which would be described in paragraph (2) if it were an organization described in 501(c)(3)." I.R.C. § 509(a)(3)(brackets added in the off chance it might help). This provision apparently didn't justify its own subsection in § 509(a)(3); rather, it is simply the last paragraph following § 509(a)(4). An IRS CPE noted, tongue in cheek, that this "provision had the dubious honor of being placed at least twice in the Gobbledygook column of the defunct Washington Star (D.C.)." Ron Shoemaker and Bill Brockner, *Public Charity Status on the Razor's Edge: IRS 509(a)(3) and the Complexities of the Operating in Connection with the Integral Part Texas, and Miscellaneous IRC 509(a)(3) Issues*, 1997 IRS CPE TEXT, available at <<www.irs.gov/pub/irs-tege/eotopici97.pdf>>.

[15] See supra n. 5 at 34 for the definition of a "disqualified person."

[16] Just for kicks, Type I supporting organizations are also defined in new § 4966(d)(4)(B)(i), which uses identical language in the PPA '06 codification to the new 20% excise tax on certain nonqualifying distributions.

[17] Treas. Reg. § 1.509(a)-4(h)(1).

[18] Now also defined in Section 4966(d)(4)(B)(ii).

[19] Id. § 1.509(a)-4(h)(2).

[20] Prop. Reg. § 1.509(a)-4(i)(3)(ii).

[21] Id. § 1.509(a)-4(i)(3)(iii).

[22] Id. § 1.509(a)-4(i)(4)(i)(A)(1).

[23] Id. § 1.509(a)-4(i)(4)(i)(A)(2).

[24] Id. § 1.509(a)-4(i)(5)(ii).

[25] Id. § 1.509(a)-4(i)(5)(iii).

[26] Id.

[27] See infra n. 5 at 34.

[28] IRS Notice 2006-109.

[29] The IRS has described this language in Publication 557, available at <<http://www.irs.gov/pub/irs-pdf/p557.pdf>>.

[30] Id. at Appendix.

[31] See, e.g., Andrea Ball, Family Connections: The Death of a Nonprofit, Austin American Statesman (Apr. 12, 2010), available at <http://www.statesman.com/news/local/family-connections-to-close-amid-investigation-557252.html>.