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STATE BAR OF TEXAS

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CHAIR'S MESSAGE

I hope the New Year is treating you well.

In my first Chair's Message, I explained how our members can get involved in the activities of the Section by participating in regulatory commenting projects. In this message, I will explain what the Section is doing in the area of CLE.

As you know by now, one goal of the Section is to provide world-class education to our members through accessible and relevant CLE. We currently provide such world-class education through the Federal Tax Institute, the Advanced Tax Law Course, the International Tax Conference, the Federal Tax Controversy Program, and the Annual Meeting of the State and Local Tax Committee and the Office of the Comptroller. These are all terrific programs. In an effort, however, to increase delivery of and access to Section-sponsored CLE, the CLE Committee (primarily through the efforts of Bill Elliott and Tina Green) has been working on the roll-out of a new CLE initiative: curriculum based, web-delivered CLE.

Each of the Section's 12 substantive committees (Corporate Tax, Employee Benefits, Energy and Natural Resources, Estate and Inheritance Tax, General Tax, International Tax, Partnership and Real Estate Tax, Property Tax, State and Local Tax, Tax Controversy, Tax-Exempt Finance, and Tax-Exempt Organizations) has been assigned the responsibility for producing one basic and one advanced webcast in its area of tax law for every 12-month period. The webcasts are generally scheduled to run on the first and third Thursday of each month. The webcast on the first Thursday of the month will be a basic practice skills webcast. The webcast on the third Thursday of the month will be an advanced practice skills webcast.

With the roll-out of this new CLE initiative, we hope that, in time, the Section's library of webcasts will become an important tool in teaching both basic and advanced principles of tax law. We also hope that the library will become one of the first places you look to when tackling a new and unfamiliar tax project. You will be receiving additional information about our webcasts soon.

Have a prosperous and productive New Year.

Gene Wolf, Chair

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2006-2007 CALENDAR

July	
August	
14	Deadline for submitting articles for the October 2006 issue of the *Texas Tax Lawyer*
September	
15	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 (214) 969-2800
28-29	24th Advanced Tax Law Course – Dallas
October	
19 – 21	ABA Section of Taxation 2006 Joint Fall CLE Meeting – Denver, Colorado
November	
3	10:30 a.m. – 12:30 p.m. Council Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 (214) 969-2800
9-10	24th Advanced Tax Law Course – Houston (Video)
December	
11	Deadline for submitting articles for the February 2007 issue of the Texas Tax Lawyer
January	
18 – 20	ABA Section of Taxation 2007 Midyear Meeting – Hollywood, Florida
26	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 (214) 969-2800
February	

March	
12	Deadline for submitting articles for the May 2007 issue of the *Texas Tax Lawyer*
April	
20	10:30 a.m. – 12:30 p.m. Council Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 (214) 969-2800
May	
10	Deadline for SBOT Annual Meeting “early bird” registration and hotel reservations
10 – 12	ABA Section of Taxation 2007 May Meeting – Washington, DC
June	
7-8	23rd Annual Texas Federal Tax Institute – San Antonio
21-22	State Bar of Texas Annual Meeting – San Antonio
22	Members’ Meeting of the Section of Taxation of the State Bar of Texas – San Antonio
July	**Future Dates - Tentative**
July 26	Orientation for SBOT Section chairs/vice-chairs, treasurers and Committee chairs/vice-chair

ANNUAL MEETING EVENTS
STATE BAR OF TEXAS TAX SECTION

JUNE 22, 2007

SAN ANTONIO, TEXAS

PRELIMINARY PROGRAM:

9:00 a.m. – 10:00 a.m. Texas Franchise Tax Update: Navigating the New Margin Tax Calculation -
Jerry Oxford, Texas Comptroller of Public Accounts, Franchise Tax Section, Tax Policy and
Christi Modrik, Martens & Associates

10:00 a.m. – 10:15 a.m. Morning Break

10:15 a.m. – 11:15 a.m. Estate Tax: Litigating When the Best Plans Go Awry –
Honorable Juan Vasquez, United States Tax Court,
T. Richard Sealy, Associate Area Counsel, SB/SE,
Internal Revenue Service, and others

11:15 a.m. – 11:45 a.m. Tax Section Annual Meeting

11:45 a.m. – 12:00 p.m. Break

12:00 p.m. – 1:30 p.m. Celebrating Our Legends: Luncheon Question and Answers
with the Honorable Juan Vasquez, United States Tax Court,
Stanley Blend, Oppenheimer & Blend, and others

Sponsored by State Bar of Texas Tax Section

3.5 Hours Texas Bar CLE Credits (Requested)

SAVE THE DATE *** ***JUNE 22, 2007*** *** ***MARK YOUR CALENDARS***

IT IS THAT TIME AGAIN . . .

VITA NEEDS YOUR HELP

The Volunteer Income Tax Assistance (VITA) program is sponsored by the IRS and various community organizations. VITA is designed to help low income working families claim special tax credits, such as the Earned Income Tax Credit (EITC) and the Child Tax Credit, by offering free tax return preparation at designated sites around the community.

The EITC is the largest cash assistance program for the working poor. And still, about 25% of eligible taxpayers fail to claim the credit because either they are not aware of the credit or it is too complex. Your efforts could help the working poor claim the EITC and lift them out of poverty. Last year, one Dallas location completed approximately 52 returns, resulting in $108,339 in refunds—$47,143 of which was the EITC.

Beginning in February, volunteers will meet with clients at various locations to help prepare basic tax returns. Volunteer schedules are very flexible.

All volunteers must take a short test before preparing any tax returns. In a change from last year, all volunteers must now complete certification *prior* to assisting with tax return preparation. You can access the online test at http://www.irs.gov/app/vita/index.jsp. Don't forget to print out your certification sheet when you have completed the intermediate test/module and bring it with you.

Dallas location (Saturdays 10:00am – 3:00pm):

Women's Southwest Federal Credit Union

4301 Bryan, Suite 120 F

Dallas, Texas 75024

If you are interested in volunteering or would like to hear more about VITA, or for other locations, please contact Janet Jardin, Chair of the Pro Bono Committee, at janet.jardin@tklaw.com or 214.969.1535.

TAX CALENDAR 2007

Individuals and Texas Business Entities

STATE BAR OF TEXAS
Solo and Small Firm Committee
SECTION OF TAXATION

CODES: Where to file forms and payments (Texas).

BANK Any authorized depository bank. Federal Tax Deposit (FTD) Coupons must accompany the payment. The payment must be made in sufficient time to be credited to the bank's tax account by 2:00 PM on the due date.

CAD Appraisal District, Information & Assistance Division, **locate county appraisal district website for address and telephone, or refer to telephone listing for your county.**

COLL Collector for the particular taxing authority.

COMP Comptroller of Public Accounts, Capitol Station, Austin, TX 78714-0100; Phone: 800-252-5555.

INS Texas Department of Insurance, Tax Administration (MC 108-2A) P.O. Box 149104, Austin, TX 78714-9104; Phone: 800-252-3439.

IRS Internal Revenue Service Center, Austin, TX 73301. Use pre-printed address with payment voucher if provided with return.

IRS-ES Internal Revenue Service Center, P.O. Box 970001, St. Louis, MO 63197-0001. Use pre-printed address with payment voucher if provided with return.

IRS-FD Internal Revenue Service Center, P.O. Box 970002, St. Louis, MO 63197-0002. Use pre-printed address if provided with return.

IRS-PHIL Internal Revenue Service Center, Philadelphia, PA 19255.

SSA Social Security Administration, Data Operations Center, Wilkes-Barre, PA 18769; Phone: 800-772-1213.

TWC Texas Workforce Commission, P.O. Box 149037, Austin TX 78714-9037; Local Phone: 713-661-3100 or 512-463-2222.

JANUARY 15, 2007

IRS-ES Final installment for 2006 individual estimated income taxes (Form 1040-ES). See 3/1/07 for an exception for farmers and fishermen, and 1/31/07 for a file and pay exception for other individuals.

IRS-FD Final installment of 2006 fiduciary estimated tax (Form 1041-ES). See 1/31/07 for an exception.

JANUARY 20, 2007

COMP Texas state, city and MTA sales and use tax returns and payment of tax in full for the quarter and year ended December 31, 2006 (Note 3).

JANUARY 31, 2007

Partnerships must provide Form 8308 to transferor and transferee in any exchange of a partnership interest that involved unrealized receivables or substantially appreciated inventory items.

Employer due date to furnish employees with 2006 (Form W-2) wage and withholding statement. Form 1099 due date for payers of interest or dividends of $10 or more, distributions in liquidation, other items, and compensation of $600 or more, and for amounts withheld on certain gambling winnings (Form W-2G) to be furnished by payer to recipients.

Business recipients of more than $600 of interest on any mortgage must furnish Form 1098 to payer.

IRS Employer's quarterly federal tax return (Form 941 or 943) for quarter ended December 31, 2006, (Note 2) and annual tax return (Form 945) for the year then ended. Employees' Form W2s due to employees.

IRS Federal unemployment tax returns (Form 940) and final deposit for 2006 (BANK). If timely deposits of federal unemployment tax have been made, including the fourth quarter deposit, the return may be filed as late as February 9, 2007.

TWC Texas Unemployment Quarterly Report (Forms C-3 and C-4) for the quarter ended December 31, 2006.

COLL County, HISD and other 2006 property taxes due.

IRS Individuals may file their 2006 income tax returns (Form 1040) and pay tax due in lieu of payment of the final estimate at January 15, 2007.

IRS Trusts, calendar-year estates and certain residuary trusts may file their 2006 income tax returns (Form 1041) and pay tax due in lieu of payment of the final estimate at January 15, 2007.

Trustees or issuers of IRAs and SEPs must provide participants with a statement of the account's value.

FEBRUARY 15, 2007

Last day for filing Form W-4 by employees who wish to claim exemption from withholding of income tax for 2007.

FEBRUARY 28, 2007

IRS Annual information returns of dividends or interest of $10 or more, distributions in liquidation and other payments of $600 or more (Forms 1096, 1099, 1098).

SSA File copies of 2006 Wage and Tax statements complete with transmittals (Forms W-2, W-2P and W-3), or by March 31 if filed electronically.

INS Annual report of insured applicable to unauthorized or non-admitted insurer required of all non-corporate persons or business entities with insurance on Texas risks (corporations file by June 15).

IRS Farmers and fishermen may file their income tax return (Form 1040) and pay tax due in lieu of payment of the final estimate at January 15, 2007.

MARCH 1, 2007

Last day for complex trusts to distribute income for 2006 deduction.

IRS Last day to file Form 1041-T.

MARCH 15, 2007

Last day for payment of charitable contributions authorized by the board of directors in 2006 for deductions on calendar year 2006 tax return by accrual basis taxpayers.

BANK Full payment of calendar year 2006 corporation income tax.

IRS Due date for calendar-year corporate 2006 income tax return Forms 1120, 1120-A, 1120S,

and 1120S K-1s, or file Form 7004 for six-month extension.

IRS Last day to elect S Corporation status for 2007 (Form 2553).

IRS-PHIL Return and deposit (BANK) of tax withheld from non-resident aliens, foreign partnerships, etc. (Forms 1042 and 1042S).

IRS Last date for a calendar-year corporation to file an amended income tax return (1120X) for the calendar year 2003.

APRIL 1, 2007

IRS Final day for individuals who turned 70? in 2006 to take first retirement plan distribution. Due date for electronically filed Forms 1099, 1098 and W-2G.

APRIL 15, 2007

Final day to establish or fund 2006 IRA.

Final day for accrual basis, calendar-year employer to make 2006 contributions to employees' trust and make 2006 IRA contributions to individual accounts.

IRS Last day for individuals to file amended income tax returns for calendar year 2003, and for calendar-year partnership to file amended return for 2003.

IRS Individual 2006 income tax returns due and returns of 2005 decedents (Form 1040, 1040A, 1040EZ).

Form 4868 due for six-month extension. Form 5471 due for foreign corporations filed with Form 1040.

IRS Calendar-year fiduciary 2006 income tax return (Forms 1041 and 1041A) due. File Form 8736 for 3-month extension for trusts or Form 2758 for 90-day extension for estates.

IRS Calendar-year partnerships 2006 income tax return Form 1065, K-1 or Form 7004 six-month extension.

IRS Split-interest trust 2006 information return (Form 5227). Form 2758 for estate extension of time to file.

IRS Gift tax return (Form 709) for taxable gifts made during 2006. Form 4868 for six-month extension.

IRS-ES First installment of 2007 individual estimated income taxes (Form 1040-ES) due.

IRS-FD First installment of 2007 fiduciary estimated tax (Form 1041-ES).

BANK First installment of 2007 calendar-year corporation estimated income taxes (Form 8109).

CAD Property tax rendition form due or exercise two week extension.

APRIL 20, 2007

COMP Texas state, city and MTA sales and use tax returns including payment of tax in full for the quarter ended March 31, 2007. (Note 1).

APRIL 30, 2007

CAD Final day to file extended property tax rendition form.

APRIL 30, 2007

IRS Employer's quarterly federal tax return (Form 941 or 943) for the quarter ended March 31, 2007. (Note 2).

TWC Texas Unemployment Quarterly Reports (Forms C-3 and C-4) for the quarter ended March 31, 2007.

MAY 15, 2007

IRS Information returns for 2006 for calendar-year exempt organizations (Form 990, 990-PF, 990-T, etc.). Corporations filing for six month extension of Form 990 use Form 7004; other entities use Form 2758 for 90-day extension.

COMP Texas franchise tax return and Texas public information annual report for year ended in 2006, or Extension to November 15, 2007 (Note 3).

Calendar-year private foundation (Form 990-PF) and calendar-year organizations with unrelated business income (Form 990-T). Fiscal year by 15th day of 5th month following the close of tax year.

JUNE 1, 2007

Annual statement to IRS regarding 2006 account balances for IRAs and SEPs (Form 5498).

JUNE 15, 2007

BANK Second installment of 2007 calendar-year corporation estimated income taxes.

INS Texas corporation annual report of non-admitted insurer for 2006.

IRS-ES Second installment of 2007 individual estimated income taxes (Form 1040-ES).

IRS-FD Second installment of 2007 fiduciary estimated tax (Form 1041-ES).

IRS-PHIL 2006 tax returns of U.S. citizens and permanent residents out of the country on April 15, 2007 (Form 1040), non-resident aliens not subject to withholding on wages (Form 1040NR). Foreign corporations and partnerships without a U.S. office (Forms 1120F and 1065, respectively), and domestic corporations whose records are abroad (Form 1120, et al).

JUNE 30, 2007

Final day for U.S. individuals, corporations, etc., with financial interests in a foreign country to report 2006 foreign bank, securities and other financial assets (Form 90-22.1); Department of the Treasury, P.O. Box 32621, Detroit, MI 48232-2621, or hand delivered to any local IRS office.

IRS Final day for calendar-year taxpayers to apply for a change in accounting method for 2006 (Form 3115); Commissioner of Internal Revenue, Washington, D.C. 20224.

JULY 15, 2007

IRS Calendar-year trust 2006 income tax return (Forms 1041 & 1041A) extended by Form 8736. Form 8800 application for additional three-month extension.

JULY 20, 2007

COMP Texas state, city and MTA sales tax and use tax returns including payment of tax in full for the quarter ended June 30, 2007 (Note 3).

JULY 31, 2007

IRS Employee's 2006 trust information return (Form 5500 series), as applicable.

IRS Employer's quarterly federal tax return (Form 941 or 943) for the quarter ended June 30, 2007 (Note 2).

TWC Texas Unemployment Quarterly Reports (Forms C-3 and C-4) for the quarter ended June 30, 2007.

SEPTEMBER 15, 2007

BANK Third installment of 2007 calendar-year corporation estimated income taxes.

IRS-ES Third installment of 2007 individual estimated income taxes (Form 1040-ES).

IRS-FD Third installment of 2007 fiduciary estimated tax (Form 1041-ES).

IRS Last day for calendar-year corporate 2006 income tax return (Form 1120, 1120-A, 1120S, 1120S K-1s, etc.) extended by Form 7004.

OCTOBER 15, 2007

IRS Last day for individual 2006 income tax returns (Form 1040) extended by Form 4868.

IRS Last day for gift tax return (Form 709) extended by Form 4868.

IRS Last day for calendar-year trust and estate 2006 income tax return (Form 1041 and 1041A) extended by Form 8736 and Form 8800.

IRS Last day for split interest trust 2006 information return (Form 5227) extended by Form 2758.

IRS Last day calendar-year partnership 2006 income tax return (Form 1065, K-1's) extended by Form 7004.

OCTOBER 20, 2007

COMP Texas state, city and MTA sales and use tax returns including payment of tax in full for the quarter ended September 30, 2007 (Note 1).

NOVEMBER 15, 2007

COMP Last day to file extended Texas corporation franchise returns for year ended in 2006.

NOVEMBER 30, 2007

IRS Employer's quarterly federal tax return (Form 941 or 943) for quarter ended September 30, 2007 (Note 2).

TWC Texas Unemployment Quarterly Reports (Form C-3 and C-4) for the quarter ended September 30, 2007.

IRS Last day for information returns for 2007 for exempt organizations (Form 990, 990-PF, 990-T, etc.) extended by Form 2758.

DECEMBER 15, 2007

BANK Final installment of 2007 calendar-year corporation estimated income taxes.

DECEMBER 23, 2007

Final business day in 2007 to complete securities transactions for a 2007 gain.

DECEMBER 31, 2007

Final day for any calendar-year taxpayer to complete distributions, payments or other financial transactions with closely related parties, including but not limited to: estates, simple corporations. Last day to establish Keogh Plan for 2006 contributions. Last day to spend money from Flexible Spending Accounts. Last day to place assets "in-service" for 2006 depreciation.

2007 Federal Legal Holidays:

1/1/07 New Years Day	9/3/07 Labor Day
2/15/07 M.L. King Day	10/8/07 Columbus Day
2/19/07 Washington Birthday	11/12/07 Veterans Day
5/28/07 Memorial Day	11/22/07 Thanksgiving Day

NOTE 1: Sales and use tax returns are due on or before the 20th day of the month subsequent to the reporting period (month, quarter, year). A prepayment discount may be earned by reporting and prepaying sales taxes to the state on or before the 15th day of the second month for quarterly filers. Please see the Caution section for further information.

NOTE 2: If timely deposits in full payment of tax due were made, the due date for Forms 940, 941 and 943 is 10 days after the applicable due date to file the return.

NOTE 3: The initial Texas Franchise Tax Return is due within 90 days after the initial period ends. (The initial period ends on the day before the first anniversary of the charter date for a Texas corporation, and the earlier of the date it began business in Texas or the date of its certificate of authority for a foreign corporation). New Texas margin tax accounting year effective 1/1/07.

NOTE 4: Annual information returns:

- Form 1099-Div-report payment of $10 or more, taxes withheld, and liquidation distributions.
- Form 1099-Int-report payment of $10 or more. Interest paid in the course of a trade of business is reportable when the amount totals $600 or more for any person.
- Form 1099-Misc-$10 in gross royalty payments, of $600 for rents or services, in course of a trade or business, was paid.
- Form 1096-Annual summary and Transmittal of U.S. Information Returns.

CAUTION:

- The extension discussed merely extends the filing date of the return. Filing an extension does not, however, extend the payment of tax.
- In many cases the information contained on Annual Information Returns (See Note 4) must be reported to the IRS by means of magnetic media.
- Sales and Use tax returns must be filed together with the tax due. If the retailer has a tax liability of less than $500 for a calendar month, or $1,500 for a calendar quarter, he qualifies for quarterly filing and payment of the tax; if the liability is less that $1,000 (of state taxes at the rate of .0625, not including local tax) for a calendar year, the retailer may request authorization to file and pay annually. Note only the due dates for a retailer filing quarterly are listed.
- Due dates are subject to change. **Due dates are extended to the next business day if the due date falls on a weekend or holiday. The due dates listed on the file sheet apply to the 2007 calendar year and are not adjusted to the next business day for dates falling on weekends and holidays.**

Solo/Small Firms Committee of State Bar Tax Section E. Rhett Buck, CPA, JD 12/18/06

TAX SECTION OF THE STATE BAR OF TEXAS STATE AND LOCAL TAX COMMITTEE DRAFT COMMENTS TO HOUSE BILL 3[1]

COMMENTS CONCERNING HOUSE BILL 3, 79th LEGISLATURE, 3RD C.S. (2006)

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the State Bar of Texas or the Section of Taxation.

These comments were prepared by individual members of the Committee on State and Local Taxation (the "Committee"). Principal responsibility was exercised by Matthew Larsen and by David Colmenero, Committee Vice Chair. Substantive contributions were made by Ira Lipstet, Dan Micchiche, Charlotte Noel, Cynthia Ohlenforst, Alyson Outenreath, Glen Rosenbaum, Mark Weiss, and David White, Committee Vice Chair. The Comments were reviewed by and substantive contributions were made by Geoffrey Polma, Committee Chair. They were also reviewed by Patrick O' Daniel of the Section's Committee on Government Submissions.

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

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Date: January 23, 2007

1. EXECUTIVE SUMMARY

The following comments are submitted in response to a request for comments from Lieutenant Governor David Dewhurst by letter dated November 17, 2006. The comments were requested in anticipation of the 2007 Texas Regular Legislative Session.

Following is a summary of our comments:

A. Taxable Entities

1. Business Trust Definition: We recommend that the term "business trust" be defined globally as "a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b)" to ensure consistency whenever the term is used.

2. General Partnerships With Natural Person Partners: We recommend that language be implemented to prevent general partnerships wholly-owned by, or trusts wholly benefiting, natural persons from becoming taxable solely as a result of the death of a partner or beneficiary.

3. Entities With Requirements in Addition to Passive Entity Qualification: We recommend the repeal or clarification of certain provisions providing that passive entities are nontaxable if they meet certain requirements in addition to meeting the passive entity requirements.

4. Passive Entities: Qualifying Entities: We recommend that the definition of a passive entity encompass not only state law partnerships and trusts, but also entities treated as partnerships, trusts, or disregarded entities for federal income tax purposes.

5. Passive Entities: 90 Percent Income Test: In order to address potential ambiguities, we recommend certain adjustments to the "90-percent-of-gross-income" test used for determining whether an entity qualifies as a nontaxable passive entity.

6. Passive Entities: Definition of "Securities": We recommend that for purposes of the "90-percent-of-gross-income" test used for determining whether an entity qualifies as a nontaxable passive entity, the term "securities" be given the same meaning given to the term in Section 581-4 of The Securities Act, Vernon's Civil Statues Article 581-4.

7. Passive Entities: Dividend and Partnership Income: We recommend the application of federal income tax principles in determining whether amounts are "dividends" or "distributive shares of income" for purposes of the "90-percent-of-gross-income" test used for determining whether an entity qualifies as a nontaxable passive entity.

8. Passive Entities: 10% Active Trade or Business Test: Because it is unclear how at least 10% of an entity's income could be from an active trade or business if at least 90% of the entity's income is passive, we recommend that the "active trade or business" component of the test used for determining whether an entity qualifies as a nontaxable trade or business either (i) be clarified, or (ii) be repealed.

9. Exemption of 401(a) Trusts: We recommend an exemption for trusts exempt from federal income tax under section 401(a) of the Internal Revenue Code.

B. Tax Rates

1. Reference to Privilege Period: We recommend that language calculating the tax rate as a fixed percentage "per year of privilege period" be revised.

2. Sale of Excess Telecommunications Capacity: We recommend that the legislature consider whether an entity should be prevented from taking advantage of the 0.5% tax rate available to retailers and wholesalers if the entity resells its excess telecommunications capacity.

C. Total Revenue

1. Guaranteed Payments: We recommend that the definition of total revenue for an entity treated as a partnership for federal income tax purposes be amended to prevent guaranteed payments to partners from being taxed twice.

2. Exclusions: We recommend certain clarifying revisions to the exclusions from total revenue for various types of flow-through funds.

D. Compensation Deduction

1. Definition of Wages and Cash Compensation: If consistent with Legislative intent, we recommend that the compensation deduction available for amounts paid to officers, directors, owners, partners and employees be extended to include compensation paid to independent contractors. In addition, even if the compensation deduction is not expanded to include payments to independent contractors, we recommend that the definition of wage and cash compensation be amended to include certain payments reported on IRS Form 1099-MISC.

2. Net Distributive Share of Income: We recommend that the compensation deduction that is available to entities that elect to deduct compensation and that are treated as partnerships and S corporations for federal income tax purposes with respect to the distributive share of income to certain partners and shareholders also be made available to entities that are disregarded for federal income tax purposes. We also recommend that the amount deductible as compensation be extended to include the net distributive share of income to a partner that is a professional corporation or professional association. In addition, we recommend that the Legislature amend Section 171.1013 to clarify that the distributive share of income to partners and shareholders that is otherwise deductible may be deducted regardless of whether the income is actually distributed.

3. Employer Share of Employment Taxes: We recommend that the Tax Code be amended to clarify whether en employer's share of social security and medicare payments are deductible as compensation.

4. Management Companies: We recommend that the Legislature define the term "active trade or business" for purposes of determining whether an entity is acting as a "management company" within the definition of Section 171.0001(11).

E. Cost of Goods Sold

1. Services Relating to Real Property: Language in the Tax Code suggests that the Legislature intended to permit persons providing construction, improvement, remodeling, repair or real property maintenance services to claim a cost of goods sold deduction. We have proposed certain revisions to the Tax Code to clarify this intent.

2. Capital Intensive Service Providers: If consistent with Legislative intent, we recommend that the Legislature consider amending the Tax Code to permit a cost of sales deduction that would allow capital-intensive service providers to claim the same deductions available to persons selling goods under the current cost of goods sold deduction.

3. Contract Manufacturers: Because contract manufacturers incur the same type of costs that other manufacturers incur, we recommend that the Legislature consider allowing contract manufacturers to claim a cost of goods sold deduction.

4. Rental and Leasing Companies: We have proposed a revision to the Tax Code that removes reference to the gross receipts tax imposed under Section 152.026 of the Tax Code in connection with the cost of goods sold deduction that is available for motor vehicle rental and leasing companies. The reference to Section 152.026 makes it unlikely that a leased vehicle would ever qualify for a cost of goods sold deduction, which seems inconsistent with the plain language in the Tax Code. It also results in disparate treatment between domestic and interstate motor vehicles which could call into question its constitutionality.

5. Employment Taxes: We recommend an amendment to the Tax Code to clarify that the cost of goods sold deduction amount includes an employer's share of employment taxes.

6. Transactions Between Members of An Affiliated Group: We recommend an amendment to the Tax Code to state that a payment between members of an affiliated group that are not members of a combined group and that is later determined not to have been made on an arms-length basis may nevertheless be deducted to the extent that an arm's length price can be established for that transaction.

7. Direct and Necessary Costs: There are several references in the Tax Code permitting a deduction for certain "direct" costs of producing goods. In addition, depreciation, depletion and amortization costs to the extent "associated with and necessary for the production of goods" qualify as costs of goods sold. We recommend that the Legislature consider amending the Tax Code to clarify the proximity that must exist between the costs at issue and the goods produced.

8. Definition of Sale: We recommend that the Legislature define the term "sold" for purposes of the cost of goods sold deduction.

9. Inventories: We have proposed an amendment to Section 171.1012(g) relating to the cost of goods sold deduction to clarify that taxpayers are required to maintain inventories in computing their cost of goods sold deduction amount.

F. Apportionment

1. Location of Payor Rule: We recommend codifying the current "location of payor" rule that exists under the Comptroller's administrative rules for sourcing certain receipts from dividends, interest and limited liability company distributions and extending that rule to make it applicable to partnership distributions as well.

G. Reporting

1. Combined Groups: Attribution Rules: To eliminate ambiguity, we recommend providing a definition of the term "indirect" for purposes of defining a "controlling interest" in the context of the "affiliated group" definition.

2. Combined Groups: Joint and Several Liability: Because it is unclear whether or to what extent each member of a combined group is responsible for the entire group's franchise tax liability, we recommend that each member of a combined group be liable for the group's tax liability only to the extent of that member's percentage contribution to the group's total Texas receipts.

3. Combined Groups: Deduction Elections: We recommend that the Legislature consider further whether in the combined group context the election between a cost of goods sold deduction and a compensation deduction should be made on a group level or on an individual member level.

4. Tiered Partnerships: We recommend that the language of the tiered partnership rules be modified to correct what appear to be transposed references to "upper tier" and "lower tier" entities.

H. Temporary Credit

1. Net Operating Losses: The computation of, and procedures for claiming, the "temporary credit" against the margin tax for certain losses incurred in prior periods is unclear, and we recommend various changes to clarify the computation of the credit and the process for claiming it.

I. Transition Provisions (HB3, Section 22)

1. Accounting Period for 2008 Returns: We recommend clarification of the transition rules to address more clearly what accounting periods are to be used to compute franchise tax in the 2008 returns of entities subject to franchise tax prior to the effective date of the Act.

2. Special Exit Tax Applicable For 2007 Dissolutions and Conversions: We recommend several clarifications to the transition rules specifying the tax obligations of withdrawing or terminating entities, i.e., entities that are subject to the franchise tax prior to the effective date of the Act but that are not subject to the franchise tax after the effective date of the Act.

3. Terminating, Merging, Consolidating or Dividing Partnerships: We recommend clarification of the transition rules applicable to successor partnerships to confirm that the tax will not apply to partnerships that are predecessors of partnerships which are exempt or not subject to margin tax after the effective date of the Act.

4. Combined Reports: We recommend further clarification and transition rules to assist taxpayers subject to combined group reporting in moving from the current single-entity reporting required for the current franchise tax to the combined reports required by the margin tax.

BACKGROUND

The Texas Legislature amended the Texas Tax Code in 2006 with the enactment of House Bill 3 to substantially revise the existing Texas franchise tax. In general, the new law substantially expands the entities that are subject to the Texas franchise tax, replaces the current tax base, which consists of taxable earned surplus and taxable capital, with a new "taxable margin" tax base, and substantially revises the existing reporting rules. Several other provisions are also included. The Texas Comptroller has not yet issued regulations construing these new franchise tax rules.

III. COMMENTS

We commend the Texas Legislature for the substantial amount of quality work that it has put forth in implementing these new Texas franchise tax provisions. We also appreciate the opportunity to comment on these new franchise tax provisions and hope that the Legislature will find the comments below helpful.

A. Taxable Entities (Sections 171.0002, 171.0003, 171.0004 and 171.001)

1. Business Trust Definition

a. Language at Issue

Section 171.0002 includes a "business trust" among its list of specifically enumerated taxable entities. Section 171.0003(1) provides that a business trust may not qualify as a passive entity.

b. Recommendation

We recommend that the term "business trust" be defined as "a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b)."

c. Explanation

Although certain entities organized under the laws of states other than Texas are commonly referred to as "business trusts," the term "business trust" is not defined under current franchise tax law or by House Bill 3 ("HB3"). Various HB3 provisions do, however, specifically reference "a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b)." See, e.g., Section 171.0002(c)(1) (precluding trusts so defined from qualifying as non-taxable grantor trusts) and Section 171.0002(7) (precluding trusts so defined from qualifying as non-taxable passive trusts). The use of the federal income tax regulatory definition in connection with some business trust provisions and not others may create an inference that "business trust" has a meaning other than the federal income tax regulatory meaning when used in provisions not specifically citing the federal income tax regulatory definition.

2. General Partnerships With Natural Person Partners

a. Language at Issue

Section 171.0002(b)(2) provides that a "taxable entity" for franchise tax purposes does not include a general partnership "the direct ownership of which is entirely composed of natural persons . . . ." Section 171.0002(c)(1) likewise states that a taxable entity does not include a grantor trust, "all of the grantors and beneficiaries of which are natural persons or charitable entities . . . ."

b. Recommendations

We recommend that the term "natural persons" in each of these provisions be replaced with the term "natural persons or estates of natural persons."

Alternatively, we recommend that the Legislature consider amending Section 171.0002(b)(2) to permit any

non-taxable entity to own an interest in a general partnership together with natural persons without causing the general partnership to become a taxable entity. Likewise, we recommend that the Legislature consider amending Section 171.0002(c)(1) to permit a non-taxable entity to be either a grantor or beneficiary of a grantor trust without causing the grantor trust to become a taxable entity.

c. Explanations

The first proposed change above would prevent otherwise non-taxable partnerships and trusts from becoming taxable immediately upon the death of a partner, grantor or beneficiary. It is likely that the legislature did not intend that estates be treated differently from natural persons for purposes of these provisions. Section 171.0002(c)(2) makes clear that estates of natural persons are not treated as taxable entities.

The second proposed change addresses a similar potentially unintended consequence in HB3. As Section 171.0002(b)(2) is currently written, a general partnership with any partner that is not a natural person is a taxable entity even if the non-natural person partner is itself an excluded entity. For example, a general partnership with 10 partners all of which are natural persons would not be a taxable entity and would therefore be excluded from the franchise tax. However, if one of the 10 partners is instead a grantor trust, the partnership becomes a taxable entity notwithstanding that the grantor trust itself may be an excluded entity. It is not clear that this was the Legislature's intent as there does not appear to be any clear policy reason for classifying an otherwise non-taxable general partnership as a taxable entity simply because one of its partners is a non-natural person where the disqualifying partner is itself excluded from the franchise tax. If this was not the intent of the Legislature, we recommend amending Section 171.0002(b)(2) to correct this unintended consequence. The same applies to a grantor trust with any grantor or beneficiary that is neither a natural person nor a charitable entity, but which is itself excluded from the franchise tax.

3. Family Limited Partnerships and Other Entities With Requirements in Addition to Passive Entity Qualification

a. Language at Issue

Section 171.0002(c)(4) provides that a family limited partnership that is a passive entity and that meets certain ownership and other requirements is not a taxable entity. Section 171.0002(c)(5) provides that a limited partnership that is a passive entity and which meets certain organizational requirements is not a taxable entity. Section 171.0002(c)(6) provides that a general partnership that is a passive entity is not a taxable entity. Section 171.0002(c)(7) provides that a trust that is a passive entity and which meets various other requirements is not a taxable entity.

b. Recommendation

We recommend that Sections 171.0002(c)(4) through (7) be repealed or, in the alternative, that the legislature clarify under what circumstances the exclusions provided by these provisions differ from the passive entity provisions.

c. Explanation

Section 171.0002(b)(3) provides that "taxable entity" does not include "a passive entity as defined by Section 171.0003." Sections 171.0002(c)(4) through (7), however, provide separate exclusions from taxable entity treatment for entities that (i) are "passive entities" and (ii) meet additional requirements. Our understanding is that Sections 171.0002(c)(4) through (7) were enacted to ensure that entities with the specific characteristics referenced therein would not be taxable. However, as "passive entities," these entities would be nontaxable under Section 171.0002(b)(3) without regard to Sections 171.0002(c)(4) through (7). If Sections 171.0002(c)(4) through (7) remain as written, it might be argued that passive entities not meeting the additional requirements therein should be treated as taxable entities in order to attach significance to these provisions. Repealing the provisions would remove this implication. In the alternative, we recommend that the legislature clarify these provisions to specify circumstances under which the provisions would treat as nontaxable certain entities that would otherwise not qualify as passive entities.

4. Passive Entities: Qualifying Entities

a. Language at Issue

Section 171.0003 provides that an entity can qualify as a passive entity only if the entity "is a general or limited partnership or a trust, other than a business trust."

b. Recommendation

We recommend that Section 171.0003 be modified to provide than an entity can qualify as a passive entity only if the entity "is an entity treated for federal income tax purposes as a partnership, disregarded entity, or trust, other than a business trust."

c. Explanation

For most purposes, HB3 gives similar treatment to partnerships and limited liability companies taxed as either partnerships or disregarded entities for federal income tax purposes. With the exception of partnerships owned entirely by natural persons, each type of entity is subject to franchise tax directly under Section 171.0002. The franchise tax liability of a limited liability company taxed as a partnership for federal income tax purposes will generally be identical to the liability of a partnership taxed as such for federal income tax purposes, and the intent of HB3 is that the tax liability of a limited liability company taxed as a disregarded entity for federal income tax purposes will be "substantially equivalent" to that of a partnership. Section 171.1011(c)(3). Allowing a limited liability company taxed as a partnership for federal income tax purposes to qualify as a passive entity would be consistent with this approach, and would give taxpayers the same flexibility in choosing an entity form as is currently enjoyed for federal income tax purposes.

5. Passive Entities: 90 Percent Income Test

a. Language at Issue

Section 171.0003(a)(2) provides that an entity will be a passive entity if, "during the period on which margin is based, the entity's federal gross income consists of at least 90 percent of the following income:..." There are several specifically enumerated items of income that may be taken into account in determining if the 90 percent test is satisfied. Included in that list are "gains from the sale of real property, commodities traded on a commodities exchange, and securities." *See* Section 171.0003(a)(2)(C).

b. Recommendations

We recommend revising the quoted phrase to read as follows: "during the period on which margin is based, at least 90 percent of the entity's federal gross income consists of one or more of the following categories of income:..."
We recommend that the Legislature clarify whether "gains" from the sale of real property, commodities and securities is limited to "capital gains" or refers to all gain from the sale of those items, including gains that may be treated as ordinary income for federal income tax purposes. If the term "gain" is intended to refer to all income from the sale of those items, regardless of its character, Section 171.0003(a)(2)(C) could be amended to make this clear as follows:
"gains from the sale of real property, commodities traded on a commodities exchange, and securities, *regardless of whether the gain is characterized as ordinary or capital for federal income tax purposes*; . . ."

c. Explanations

The quoted provision above from Section 171.0003(a)(2) is intended to require that at least 90 percent of an entity's federal gross income to fall within one or more of the categories enumerated in Section 171.0003(a)(2). The first recommended revision above implements the intended test more clearly. The current language creates ambiguity because it can be read, for example, to require federal gross income to include an array of difference income sources that includes at least 90 percent of the various enumerated categories of income.

In addition, Section 171.0003(a)(2)(C) is currently ambiguous with respect to the character of gain from the sale of real property, commodities and securities that may be used to satisfy the 90 percent test. Specifically, it is unclear if the term "gain" should be construed to include all gain from the sale of those assets, including ordinary income, or should be limited to capital gain income only. If in fact all gain from the sale of those assets qualifies as passive income for purposes of the 90 percent test, the above proposed amendment should make this clear.

6. Passive Entities: Definition of "Securities"

a. Language at Issue

Section 171.0003(a)(2)(C) provides that gains from the sale of "securities" are qualifying income sources for purposes of determining whether an entity qualifies as a passive entity.

b. Recommendation

We recommend that the term "securities" be given the same meaning given to the term in Section 581-4 of The Securities Act, Vernon's Civil Statutes Article 581-4.

c. Explanation

The term "securities" is not defined under current franchise tax law or by HB3. The use of the definition of "securities" in The Securities Act will adopt a standard non-tax definition of "securities" and will clarify that a security is "any limited partner interest in a limited partnership, share, stock, treasury stock, stock certificate under a voting trust agreement, collateral trust certificate, equipment trust certificate, preorganization certificate or receipt, subscription or reorganization certificate, note, bond, debenture, mortgage certificate or other evidence of indebtedness, any form of commercial paper, certificate in or under a profit sharing or participation agreement, certificate or any instrument representing any interest in or under an oil, gas or mining lease, fee or title, or any certificate or instrument representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company, investment contract, or any other instrument commonly known as a security, whether similar to those herein referred to or not." The Securities Act definition makes clear that the term "securities" applies regardless of whether the "security" or "securities" are evidenced by a written instrument. The definition specifically excludes "any insurance policy, endowment policy, annuity contract, optional annuity contract, or any contract or agreement in relation to and in consequence of any such policy or contract, issued by an insurance company subject to the supervision or control of the Texas Department of Insurance when the form of such policy or contract has been duly filed with the Department as now or hereafter required by law."

7. Passive Entities: Dividend and Partnership Income

a. Language at Issue

Section 171.0003(a)(2)(A) and (B) provide that "income from a limited liability company" and "distributive shares of partnership income," respectively, are qualifying income sources for purposes of determining whether an entity qualifies as a passive entity.

b. Recommendations

We recommend that Section 171.0003(a)(2)(A) be revised to begin as follows: "dividends (including items treated as dividends for federal income tax purposes), interest..."

We recommend that Section 171.0003(a)(2)(B) be revised to read as follows: "distributive shares of income from entities taxed as partnerships for federal income tax purposes to the extent that those distributive shares of income are greater than zero."

c. Explanations

Certain partnerships and limited liability companies may elect to be taxed as corporations for federal income tax purposes. The suggested change to Section 171.0003(a)(2)(A) would insure that the owners of these entities may include under Section 171.0003(a)(2)(A) all gross income treated for federal income tax purposes as "dividends," regardless of how these items are labeled for non-tax purposes.

Conversely, certain non-partnership entities (*e.g.*, limited liability companies) may elect to be taxed as partnerships for federal income tax purposes. The suggested change to Section 171.0003(a)(2)(B) would insure that the owners of these entities may include the owners' distributive shares of income from such entities for purposes of the computation under Section 171.0003(a)(2).

8. Passive Entities: 10% Active Trade or Business Test

a. Language at Issue

Section 171.0003(a)(3) provides that an entity may not qualify as a passive entity if it receives more than 10 percent of its federal gross income from conducting an active trade or

business. Section 171.0003(a-1) provides that in making the computation under Section 171.0003(a)(3), income described by Section 171.0002(a)(2) (which defines the categories of income taken into account in determining whether an entity qualifies as passive) may not be treated as income from conducting an active trade or business. Section 171.0004 defines an "active trade or business" solely for purposes of Section 171.0003 and provides examples of activities that do and do not constitute the conduct of an active trade or business.

b. Recommendations

Depending on legislative intent, we recommend either that Sections 171.0003(a)(3) and 171.0004 be revised to state more clearly the "active trade or business" criteria that would cause an entity meeting the requirements of Section 171.003(a)(1)-(2) to not qualify as a passive entity, or in the alternative, that Sections 171.0003(a)(3) and 171.0004 be repealed. In the latter case, we also recommend the following three changes:

We recommend that Section 171.0003(a)(2)(D) be revised to read as follows: "royalties, bonuses, delay rental income from mineral properties, and income from non-operating working interests or other non-operating mineral interests; and..."

We recommend that Section 171.0003(a-1) be revised to read as follows: "The determination of whether an entity's income is described in Section 171.0003(a)(2) shall be made without regard to whether the entity generates such income in connection with the performance of active management or operational functions."

We recommend that the following new Section 171.0003(b)(3) be added: "income from royalties, patents, trademarks, and other similar intangible assets, if such assets are used by one or more commonly controlled entities (within the meaning of Section 171.0001(8)) with active management and operational functions in the process of earning income or profit."

c. Explanations

If at least 90 percent of an entity's federal gross income consists of the categories listed in Section 171.0003(a)(2), and income described by Section 171.0003(a)(2) may not be treated as income from conducting an active trade or business, then the entity will qualify as a passive entity without regard to whether more than 10 percent of its income would otherwise be considered income from conducting an active trade or business. Moreover, if less than 90 percent of an entity's federal gross income consists of the categories listed in Section 171.0003(a)(2), then the entity will not qualify as a passive entity even if less than 10 percent of its income is considered income from conducting an active trade or business. Accordingly, the active trade or business concept in the current margin tax is superfluous. The Legislature therefore either should revise the active trade or business provision to impose an additional substantive limitation on the definition of passive entity if such limitations reflect legislative intent, or in the alternative, should eliminate the concept to clarify that meeting the 90 percent test is all that is required for an entity to qualify as a passive entity.

If the 10 percent test is repealed, the meaningful concepts in the current active trade or business test definitions could be preserved by corresponding revisions to the retained portions of the passive entity definition. First, Section 171.0003(a-1) could be amended to specify that income in Section 171.0003(a)(2) can be used to meet the 90 percent test even if generated in active operations, while eliminating the reference to repealed Section 171.0003(a)(3). Second, proposed new Section 171.0003(b)(3) could preserve the intent of Section 171.0004(d) that income from acting as a holding company for an operating affiliate's royalties, patents, trademarks, and similar intangible assets cannot be used to meet the 90 percent test. The modifier "similar intangible assets" would insure that income from ownership interests in other entities will not be prevented from being used to satisfy the 90 percent test. Linking to the "commonly controlled" definition in Section 171.0001(8) would lend meaning to the otherwise unclear term "related entities." As the intangibles holding company appears to be the only concrete application of the active trade or business concept, the active trade or business definition could be incorporated into proposed new Section 171.0003(b)(3). Finally, the proposed revision to Section 171.0003(b)(2) could preserve the intent of Section 171.0004(e)(1) that nonoperating working interests, along with royalty interests, generate income that can be used to meet the 90 percent test.

9. Non-Corporate Entity Eligible For Certain Exemptions

a. Language at Issue

Section 171.1088, labeled "EXEMPTION—NONCORPORATE ENTITY ELIGIBLE FOR CERTAIN EXEMPTIONS," provides that "An entity that is not a corporation but that, because of its activities, would qualify for a specific exemption under this subchapter if it were a corporation, qualifies for the exemption and is exempt from the tax in the same manner and under the same conditions as a corporation."

b. Recommendation

We recommend that this section be amended to add a specific statement that "Trusts qualified under section 401(a) of the Internal Revenue Code are exempt from the tax."

c. Explanation

Section 171.088 is a short hand way of confirming that exemptions available under current law to corporate entities will apply under HB3 to non-corporate entities. While this generic provision may work well in many contexts, it would be better to include a specific exemption for qualified pension, profit-sharing and stock bonus plans, as defined in the Internal Revenue Code. Because trusts are not subject to the current franchise tax, the current franchise tax statute does not include a specific reference to these tax-exempt trust retirement plans, although it appears clear that the franchise tax is not intended to reach these qualified retirement plans. Indeed, federal law could or may prohibit state taxation of these plans. The proposed new language would state explicitly that tax-exempt retirement plans are not subject to the franchise tax.

B. Tax Rates (Section 171.002)

1. Reference to Privilege Period

a. Language at Issue

Section 171.002 provides that the franchise tax rate is one percent "per year of privilege period," or 0.5 percent

"per year of privilege period" for entities primarily engaged in retail or wholesale trade.

b. Recommendation

We recommend that the references in Section 171.002 to "per year of privilege period" be removed.

c. Explanation

The current version of Section 171.002 might be read as calculating the tax rate by multiplying the number of privilege periods in which an entity has done business in Texas by either one percent or 0.5 percent, as applicable. Removing "per year of privilege period" will eliminate this potential confusion. The language at issue appears to be an erroneous carryover from Section 171.002(a)(1) of the current franchise tax, which imposes a tax of "0.25 percent *per year of privilege period* of net taxable capital." (Emphasis added). The language is necessary in that context because the tax on taxable capital is imposed for a privilege period that may vary in length, but the tax is computed with respect to financial condition as of a single point in time. By contrast, Section 171.002(a)(2) of the current franchise tax imposes a tax simply on "4.5 percent of net taxable earned surplus" because, like "taxable margin," the statutory computation of "net taxable earned surplus" for a given period automatically takes account of the length of the privilege period.

2. Sale of Excess Telecommunications Capacity

a. Language at Issue

Section 171.002(c)(3) provides that a taxable entity will not qualify for the lower 0.5 percent tax rate that is available for entities primarily engaged in retail or wholesale trade if the entity provides retail or wholesale utilities.

b. Recommendation and Explanation

Many businesses in Texas, including businesses primarily engaged in retail or wholesale trade, commonly resell excess telecommunications capacity. It is unlikely that Section 171.002(c)(3) was intended to entirely preclude businesses primarily engaged in retail or wholesale trade from qualifying for the 0.5 percent tax rate simply because they may also make a few sales of excess telecommunications capacity. However, because there may be conflicting views among taxpayers on how to address this issue, we have chosen not to advocate any particular recommendation on resolving this issue other than to make note of it. In particular, retailers and wholesalers may argue that they should not be taxed at the higher 1% tax rate on any of their proceeds simply because they may make a few sales of their excess telecommunications capacity. Telecommunications providers, on the other hand, may generally view these retailers and wholesalers as competitors and argue that they should not be entitled to a reduced rate of tax while telecommunications providers are taxed at the higher rate. One possible solution may be to tax all proceeds from the sale of utilities at the higher 1% tax rate regardless of who the seller is, but permit retailers and wholesalers that otherwise qualify for the reduced rate, to use the reduced rate in computing their tax for all other proceeds.

C. Total Revenue

1. Guaranteed Payments

a. Language at Issue

Section 171.1011(c)(2)(A) requires that, in computing "total revenue" for a taxable entity treated for federal income tax purposes as a partnership, the following amounts should be added together: (i) the amount entered on line 1c of IRS Form 1065, (ii) the amounts entered on lines 4 through 7 of IRS Form 1065, and (iii) the amounts entered on lines 2 through 11 of IRS Form 1065, Schedule K. The total of this amount is then reduced by certain other amounts in Section 171.1011(c)(2)(B).

b. Recommendations

We recommend that Section 171.1011(c)(2)(A)(iii) be amended to read as follows: "the amounts entered on lines 2, 3 and 5 through 11, Internal Revenue Service Form 1065, Schedule K . . ."

We recommend that the legislature consider clarifying the treatment of guaranteed payments to partners who are legal entities rather than natural persons.

c. Explanations

As Section 171.1011(c)(2)(A) is currently written, it requires that the amount of guaranteed payments be included in total revenue twice. Guaranteed payments are included without offset in the income amounts described in subsections (i)-(ii) of Section 171.1011(c)(2)(A). By requiring also that guaranteed payments be "added back" to total revenue in subsection (iii) of Section 171.1011(c)(2)(A), they get included in total revenue twice. The first recommendation above would correct this apparent error.

In some instances, service providers are structured for non-tax reasons using an LLP or other pass-through entity as a "lower-tier" entity that provides services to customers. The lower-tier entity is in turn owned by pass-through entities such as PAs (professional associations) that are owned directly by individual service providers. Under this tiered arrangement, the individual service providers receive the same total compensation as if the upper-tier entities did not exist, i.e., as if the service providers were direct owners of the lower- tier pass-through entity. However, in form, the upper tier pass-through entities may receive from the lower-tier pass-through entity both "guaranteed payments" based on some measure of revenue, as well as shares of the lower-tier entities' net income after all expenses. The margin tax allows the upper-tier entities to exclude "net distributive income" received from the lower –tier entity. However, guaranteed payments to the upper-tier entities based on revenues or other measures do not appear to be excluded from the upper-tier entities' total revenues. Moreover, combined reporting does not appear to apply. Therefore, the margin tax appears to require each of the upper-tier entities and a lower-tier entity in a common business enterprise to include the guaranteed payments in total revenue, potentially causing a significantly increased total margin tax liability to result from the tiered pass-through ownership structure. If this result is unintended, the legislature should consider providing a subtraction from total revenues for guaranteed payments, subject to appropriate limitations.

2. Exclusions

a. Language at Issue

Section 171.1011(g) states that a taxable entity shall exclude from its total revenue, to the extent included therein, certain flow-through funds that are mandated by

contract to be distributed to other entities, including (i) sales commissions to non-employees, including split-fee real estate commissions; (ii) the tax basis under the Internal Revenue Code of securities underwritten; and (iii) certain subcontracting payments handled by a taxable entity to provide services, labor or materials in connection with the design, construction, remodeling or repair of improvements or the location of the boundaries of real property. For these purposes, “sales commissions” are either compensation paid to a person for services for which a real estate brokers or salesperson’s license is required, or compensation paid to a sales representative by a principal based on sales of the principal’s product and required to be reported on Internal Revenue Service Form 1099-MISC.

b. Recommendations

We recommend that the reference to “other entities” be changed to “other persons” to make clear that any of the items listed in Section 171.1011(g) may be excluded from total revenue regardless of whether the recipient is an entity or a natural person.

We recommend amending the exclusion for sales commissions to clarify whether excludable sales commissions can be paid to a person who receives the commission as an independent contractor but who may be an employee in some other capacity. The following language may be appropriate if an exclusion is available under those circumstances: “sales commissions that are not paid as employee compensation, including split-fee real estate commissions . . .”

We further recommend amending the exclusion for sales commissions to clarify whether excludable sales commissions can be paid to an entity. The following language may be appropriate if an exclusion is available under those circumstances: “compensation paid to a sales representative by a principal in an amount that is based on the amount or level of certain orders for or sales of the principal’s product and that the principal is required to report on Internal Revenue Service Form 1099-MISC, or would be required to report if the payment was made to a natural person.”

c. Explanations

Section 171.1011(g) currently suggests that only amounts mandated under contract to be distributed to *other entities* may be excluded from total revenue. But the recipient of those payments may very well be a natural person. Indeed, the reference to “non-employees” with respect to sales commissions appears to contemplate a natural person recipient. Unless the reference to “other entities” is changed to “other persons” there is a risk that an exclusion may not be permitted for recipients that are natural persons.

The phrase “sales commissions to nonemployees” leaves open the question of whether excludable sales commissions can ever be paid to a person who receives the commission as an independent contractor, but who may hold an employee position in some other capacity. For example, corporate officers are deemed to be employees by statute for federal income tax purposes. 26 U.S.C. § 3121(d). If that same person provides marketing services and is paid a commission as an independent contractor for the marketing services in the same manner that other sales persons are paid, are the commissions paid to that person excludable?

The condition that certain sales commissions are excludible only if required to be reported on Internal Revenue Service Form 1099-MISC may preclude exclusions from revenue of otherwise qualifying commissions paid to certain entities. For example, a payor is not required to issue a Form 1099-MISC in connection with a payment to a corporation. Accordingly, commission payments to third party sales representatives set up in entity form may not be excludible from revenues, even though—unlike commission payments to natural persons—the recipient of those commissions itself would be required to include the commission in taxable revenues.

D. Compensation Deduction (Section 171.1013)

1. Definition of Wages and Cash Compensation

a. Language at Issue

Section 171.1013(b)(1) allows a deduction for “wages and cash compensation” paid by a taxable entity to its officers, directors, owners, partners, and employees. Section 171.1013(a) provides that “wages and cash compensation” means “the amount entered in the Medicare wages and tips box of Internal Revenue Service Form W-2 or any subsequent form with a different number or designation that substantially provides the same information,” as well as distributive income from entities treated as partnerships or S corporations for federal income tax purposes and stock awards and stock options deducted for federal income tax purposes.

b. Recommendations

If consistent with legislative intent, we recommend that Section 171.1013(b)(1) be revised to allow a deduction for wages and cash compensation paid to “officers, directors, owners, partners, employees, and independent contractors” and that the definition of “wages and cash compensation” in Section 171.1013(a) be revised to read as follows: “...the amount entered in the Medicare wages and tips box of Internal Revenue Service Form W-2, the amount entered in box 7 of Internal Revenue Service Form 1099-MISC, or any subsequent form with a different number or designation that substantially provides the same information...”

We recommend that the definition of “wages and cash compensation” in Section 171.1013(a) be revised to read as follows: “...the amount entered in the Medicare wages and tips box of Internal Revenue Service Form W-2, the amount entered in box 7 of Internal Revenue Service Form 1099-MISC, or any subsequent form with a different number or designation that substantially provides the same information...”

c. Explanations

Compensation payments to independent contractors are reported on Internal Revenue Service Forms 1099-MISC, while wages and salaries to employees are reported on Internal Revenue Service Forms W-2. Because the margin tax defines deductible compensation with reference to amounts reported on Form W-2, it is unclear whether a compensation deduction is allowed for payments to independent contractors. Certain industries rely heavily on independent contractor labor for day-to-day operations, and others use significant independent contractor labor seasonally or when operating at peak capacity. We recommend that the compensation deduction provisions be clarified if necessary to include payments to independent contractors.

Even if Section 171.1013(b)(1) is not expanded to include compensation payments to independent contractors

generally, the recommended change to Section 171.1013(a) is necessary. Certain payments to individuals listed in Section 171.1013(b)(1) will be reported in box 7 (nonemployee compensation) of IRS Form 1099-MISC rather than on IRS Form W-2. For example, the IRS requires certain director fees and other remuneration to be reported in box 7 of Form 1099-MISC. Any such payments not made in the form of stock awards or stock options would not, without the proposed revision to Section 171.1013(a), be eligible for the compensation deduction.

2. Net Distributive Share of Income

a. Language at Issue

Section 171.1013(b)(1) states that an entity that elects to subtract compensation for the purpose of computing its taxable margin under Section 171.101 may include in that amount all wages and cash compensation paid by the taxable entity to its officers, directors, owners, partners, and employees. "Wages and cash compensation" is defined in part to include the net distributive income from partnerships and from trusts and limited liability companies treated as partnerships for federal income tax purposes, but only if the person receiving the distribution is a natural person. Section 171.1013(a)(1). "Wages and cash compensation" also includes the net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes, but only if the person receiving the distribution is a natural person. Section 171.1013(a)(2). Wages and cash compensation may not exceed $300,000 per person. Section 171.1013(c).

b. Recommendations

We recommend that the Legislature amend Section 171.1013(a)(1) and (2), which identifies items that are specifically included in wages and cash compensation, to read as follows:

> "(1) net distributive income from partnerships and from trusts and limited liability companies treated as partnerships or disregarded for federal income tax purposes, regardless of whether the income is actually distributed, but only if the person receiving the distribution is either a natural person, professional corporation or professional association."

> "(2) net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes, regardless of whether the income is actually distributed, but only if the person receiving the distribution is a natural person, professional corporation or professional association; and"

c. Explanations

Unless owners of disregarded entities are able to take advantage of the compensation deduction, such owners may have an incentive to use an alternative organizational structure solely for Texas franchise tax reasons. It is likely that all entities treated as pass-through entities for federal income tax purposes were intended to qualify for a compensation deduction for pass-through income.

There is currently some uncertainty with respect to whether a partnership or other pass-through entity is required to make an actual distribution of income to an owner to qualify that owner's distributive share of income as wage and cash compensation for purposes of the compensation deduction under Section 171.1013. Section 171.1013 makes references to the "distributive" share of income from various pass-through entities suggesting that actual distributions are not required. The same section also limits the deduction by requiring that persons receiving the distribution be natural persons. The Texas Comptroller has issued instructions to its tax returns under the new margins tax requiring actual distributions to qualify for the deduction available for the net distributive income of natural persons.[2]

We recommend that a deduction for an owner's distributive share of income be permitted for all pass-through owners, including natural person members of single member LLCs, regardless of whether actual distributions are made. Allowing a deduction for an owner's distributive share of income in the year that the income is generated regardless of whether any actual distributions of that income occur comes closer to matching the deduction with the income that generated it. Requiring actual distributions, on the other hand, creates a number of issues, including for example, whether the deduction is available for distributions of current year income only or is available for distributions of a prior year's undistributed income. If the deduction is available with respect to prior year undistributed income, it is possible that the benefit of the deduction may be lost or significantly diminished if the distribution is made in a year in which there is little or no taxable margin.

In addition, there are many professional practices in Texas that are operated through limited liability partnerships. Many of the practitioners who own these partnerships have chosen to establish wholly owned professional corporations or professional associations to hold their share of the partnership interest. For franchise tax purposes, there does not appear to be any significant reason for distinguishing between a professional who chooses to hold a partnership interest through a wholly owned professional corporation or professional association and one who chooses to own his interest directly. In either case, the professional services of the partnership are provided by the same individuals. For this reason, we recommend that the $300,000 deduction be extended to include the distributive share of income from a partnership allocable to professional corporations and professional associations.

3. Employer Share of Employment Taxes

a. Language at Issue

Section 171.1013(b)(2) allows a compensation deduction for the cost of benefits provided to officers, directors, owners, partners, and employees, "to the extent deductible for federal income tax purposes."

b. Recommendation

We recommend that Section 171.1013(b)(2) be clarified to address whether employer contributions for social security and Medicare are deductible benefits.

c. Explanation

Employer contributions for social security and Medicare are deductible for federal income tax purpose. However, because these are taxes imposed by law on the employer, there is some uncertainty as to whether they would qualify as "benefits."

4. Management Companies

a. Language at Issue

Section 171.1013(g) allows a compensation deduction to a taxable entity that is a managed entity for reimbursements made to the management company for wages and compensation as if the reimbursed amounts had been paid to employees of the managed entity.

Section 171.0001(11) defines a "management company" as a limited liability entity "that conducts all or part of the active trade or business of another entity in exchange for (A) a management fee and (B) reimbursement of specified costs incurred in the conduct of the active trade or business of the managed entity, including 'wages and cash compensation' as determined under Sections 171.1013(a) and (b)."

Section 171.0004(a) provides that the definition of "active trade or business" in Section 171.0004 applies only to Section 171.0003.

b. Recommendation

We recommend that the term "active trade or business" be defined for purposes of determining whether an entity is acting as a "management company" within the meaning of Section 171.0001(11).

c. Explanation

As the only definition of the term "active trade or business" in HB3 may not be applied in determining whether an entity is acting as a management company, an alternative definition of "active trade or business" should be provided for this purpose.

E. Cost of Goods Sold

1. Services Relating to Real Property

a. Language at Issue

Section 171.1012 permits a deduction for cost of goods sold. The term "goods" for purposes of the cost of goods sold deduction is defined as real or tangible personal property sold in the ordinary course of business. Section 171.1012(a)(1). Section 171.1012(i) states that a taxable entity may claim a cost of good sold deduction only if the entity owns the goods. It further provides that a taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in 34 Tex. Admin. Code sec. 3.357) of real property is considered to be an owner of that labor or materials and may include the costs, as allowed by Section 171.1012, in the computation of cost of goods sold. Section 171.1012(i).

b. Recommendation

We recommend that the language in Section 171.1012(i) relative to construction, improvement, remodeling, repair and maintenance services be amended to read as follows: "A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in 34 T.A.C. Section 3.357 (as in effect May 1, 2006)) of real property may claim a cost of goods sold deduction as allowed by Section 171.1012, including a deduction for the cost of labor and materials related to providing those services."

c. Explanation

Section 171.1012(i) is imprecise in its treatment of the cost of goods sold deduction available to persons providing services relating to construction, improvement, remodeling, repair, or maintenance of real property. It first states that a taxable entity may claim a cost of good sold deduction only if the entity owns the goods. It then states that a taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property is considered to be an owner of that labor or materials and may include the costs, as allowed by Section 171.1012, in the computation of cost of goods sold. The Legislature's intent appears to have been simply to permit persons providing these type services to claim a cost of goods sold deduction like that allowed for sellers of goods and to include labor and materials in that deduction. We therefore recommend amending this language as noted above to make this clear.

2. Capital Intensive Service Providers

a. Language at Issue

Section 171.1012 permits a deduction for cost of goods sold. The term "goods" for purposes of the cost of goods sold deduction is defined as real or tangible personal property sold in the ordinary course of business. Section 171.1012(a)(1). Tangible personal property is defined to specifically exclude intangible property and services. Section 171.1012(a)(3)(B).

b. Recommendation

If consistent with legislative intent, we recommend that the Legislature consider amending the Tax Code to permit a cost of sales deduction that would allow capital-intensive service providers to claim the same deductions available to persons selling goods under the current cost of goods sold deduction.

c. Explanation

Some taxpayers generally characterized as service providers incur substantial capital costs related to the provision of their services that significantly exceed the amount of any compensation deductions they may otherwise be entitled to claim under HB3. Because the term "goods" for purposes of the cost of goods sold deduction does not include the provision of services, these service providers are not currently entitled to claim a cost of goods sold deduction. Examples of such service providers include pipeline transportation services provider and electricity transmission and distribution utilities. A service provider engaged in providing such services would likely have large capital expenditures, but relatively small compensation amounts, and therefore may be more akin to a seller of goods than a typical service provider. After its capital expenditures are taken into account, this service provider may have a very small profit margin. Under the new Texas margin tax, however, this service provider is not currently entitled to claim a deduction for the significant costs related to it operations that are not in the form of compensation deductible under Section 171.1013. We recommend that the Legislature consider amending the Tax Code to address this possibly unintended consequence.

3. Contract Manufacturers

a. Language at Issue

Section 171.1012(j) states that a taxable entity may claim a cost of goods sold deduction only if that entity owns the goods. The determination of whether a taxable entity is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity. Contract manufacturers do not generally own the goods they manufacture and may not therefore be able to claim a cost of goods sold deduction with respect to the goods they manufacture.

b. Recommendation

We recommend that the Legislature consider allowing contract manufacturers to claim a cost of goods sold deduction.

c. Explanation

Under the general rule of Section 171.1012(j), contract manufacturers may not be able to claim a cost of goods sold deduction because they generally do not own the goods they manufacture. But they do incur the same types of costs that other manufacturers incur, such as cost of facilities and equipment. The Legislature should consider whether contract manufacturers they should be permitted a cost of goods sold deduction.

4. Rental and Leasing Companies

a. Language at Issue

Section 171.1012(k-1) permits a "motor vehicle rental or leasing company that remits a tax on gross receipts imposed under Section 152.026" to subtract as cost of goods sold the costs otherwise deductible in relation to tangible personal property that the entity rents or leases in the ordinary course of business. Section 152.026 imposes a gross receipts tax only on the rental (as opposed to the lease) of motor vehicles. Section 152.089 states that the tax imposed by Chapter 152 does not apply to interstate motor vehicles.

b. Recommendation

We recommend that Section 171.1012(k-1) be amended to read as follows: "(1) a motor vehicle rental or leasing company . . . ."

c. Explanation

There are two significant issues with respect to the language in Section 171.1012(k-1) that the Legislature should consider carefully. The first has to do with the fact that Section 171.1012(k-1) permits a cost of goods sold deduction only for companies that remit tax on gross receipts imposed under Section 152.026. Section 152.026 imposes a gross receipts tax only on the rental of motor vehicles. Chapter 152 draws a clear distinction between the lease and rental of motor vehicles, with only the latter being subject to the gross receipts in Section 152.026. See Tex. Tax. Code §§ 152.001; 152.026. Because leases do not appear to be subject to the gross receipts tax in Section 152.026, it seems unlikely that a leased vehicle would ever qualify for a cost of goods sold deduction under Section 171.10012(k-1). Given that Section 171.10012(k-1) specifically references a "leasing company," this result seems inconsistent with Legislative intent.
The second issue has to do with the fact that interstate motor vehicles do not appear to qualify for the cost of goods sold deduction in Section 171.10012(k-1). Because interstate motor vehicles are not subject to the gross receipts tax in Section 152.026, it does not appear that they could ever qualify for a cost of goods sold deduction under Section 171.10012(k-1). This difference in treatment between domestic and interstate motor vehicles could result in a challenge to the constitutionality of either the franchise tax or the gross receipts tax in Chapter 152, or both.

5. Employment Taxes

a. Language at Issue

Section 171.1012 states that the cost of goods sold deduction amount includes all direct costs of acquiring or producing the goods, including among other things labor costs. Section 171.1012(c)(1). The term "labor costs" is not defined.

b. Recommendation

We recommend that Section 171.1012(c)(1) be amended to read as follows: "labor costs, including all related employment taxes."

c. Explanation

While the term "labor costs" in Section 171.1012(c)(1) would no doubt include payments made to persons providing labor services (e.g., employees), there is some uncertainty with respect to whether an employer's share of employment taxes should be included in this amount as well. This ambiguity could be clarified by specifically stating that the term includes all employment taxes as noted above.

6. Transactions Between Members of an Affiliated Group

a. Language at Issue

Section 171.1012(l) provides that a payment between two members of an affiliated group who do not both join in a combined report may be subtracted as a cost of goods by the payor only if it is a transaction made at arm's length. The term "arm's length" is defined, but no provisions specify the consequences of a transaction not made on an arm's length basis.

b. Recommendation

We recommend that the Legislature add a provision at the end of Section 171.1012(l) stating, "Notwithstanding any other provision of this section, a payment made by one member of an affiliated group to another member of that affiliated group not included in the combined group may be subtracted as a cost of goods sold only to the extent of the amount that would have been paid if the transaction had been entered into on an arm's length basis between unrelated parties."

c. Explanation

There is currently some uncertainty regarding the consequences of a payment between members of an affiliated group that is not made on an arms-length basis. In particular, should the payment be disallowed as a deduction

in full or should it be permitted to the extent that an arm's length price can be established? We believe that the latter represents the better approach. Disallowing the deduction in its entirety could result in unduly harsh consequences in many instances.

7. Direct and Necessary Costs

a. Language at Issue

In several parts of Section 171.1012, House Bill 3 permits a deduction for "direct" costs of producing goods. In Section 171.1012(c), "cost of goods" sold is defined to include all "direct" costs of acquiring or producing goods. The term is further defined to include the cost of renting or leasing equipment, facilities, or real property "directly" used for the production of goods, (Section 171.1012(c)(7)), the cost of repairing and maintaining equipment, facilities, or real property "directly" used for the production of goods, (Section 171.1012(c) (8)), the costs attributable to research, experimental, engineering, and design activities "directly" related to the production of goods, (Section 171.1012(c)(9)), the cost of utilities "directly used" in the production of goods, (Section 171.1012(d)(8)), certain costs of quality control including among other things, inspection "directly allocable" to the production of the goods, (Section 171.1012(d)(9)), and certain licensing or franchise costs directly associated with the goods produced, (Section 171.1012(e)(10)). In addition, depreciation, depletion and amortization, to the extent "associated with and necessary for the production of goods" qualify as cost of goods sold. Section 171.1012(c)(6).

b. Recommendation

We recommend that the Legislature clarify the proximity that must exist between the costs at issue and the goods produced. For example, is a cost of goods sold deduction for equipment used in production available only for equipment that causes a chemical or physical change to the product produced? With respect to real property used in production, is a cost of goods sold deduction available only for property used in the actual manufacturing process (as opposed to for example office facilities)? With respect to the cost of utilities, is this deduction limited to utilities used only in the manufacturing area and only during the actual production of property or should it likewise be available for other locations such as office and support facilities?

c. Explanation

We believe that references to "direct," "associated with" and "necessary" are vague and will likely result in unnecessary disputes between taxpayers and the Texas Comptroller. In an analogous context involving the manufacturing exemption for sales tax purposes, there has been considerable controversy regarding the required proximity between equipment and manufacturing activities in determining the applicability of the manufacturing exemption. *See, e.g., Comptroller v. Tyler Pipe*, 919 S.W.2d 157 (Tex. App.—Austin 1996). Lacking further legislative guidance, the Texas Comptroller might import authority and policy developed for manufacturing exemptions from sales and use tax in order to define the required proximity for margin tax purposes for inclusion of direct costs as part of cost of goods sold. However, in keeping with the requirement that exemptions from tax should be narrowly construed, the sales tax definitions are quite restrictive. By contrast, the margin tax cost of goods sold concept is intended to ensure accurate measurement of the margin, or tax base, which may dictate a less restrictive reading. In addition, the sales tax concepts were developed in the limited context of manufacturing or processing of tangible personal property, while the margin tax cost of goods sold concept must apply to a much broader range of business activities.

8. Definition of Sale: Does it Include Leases?

a. Language at Issue

House Bill 3 permits a taxpayer to deduct either cost of goods sold or compensation in arriving at its taxable margin. Section 171.101. It provides a definition of key terms including "goods," "production," and "tangible personal property." See Section 171.1012(a). It does not, however, provide a definition of the term "sold."

b. Recommendation

We recommend that the Legislature define the term "sold" for purposes of the cost of goods sold deduction. In particular, should this term be construed to include any transfer of title or possession, including an exchange, barter, lease or rental of property? The Legislature may want consider defining this term by reference to definition of the terms "sale" and "purchase" for sales and use tax purposes in Section 151.005 of the Texas Tax Code.

c. Explanation

There is currently ambiguity with respect to how broadly the term "sale" should be defined under the new franchise tax rules for purposes of the cost of goods sold deduction. In the sales tax context, the term "sale" or "purchase" is defined broadly to include, among other things, the transfer of title or possession of tangible personal property and the exchange, barter, lease or rental of tangible personal property. See Tex. Tax. Code § 151.005. Should the term "sold" for purposes of the cost of goods sold deduction be construed in the same manner? A person engaged in the leasing of personal property may incur substantial costs associated with the acquisition and leasing of that property. But if a lease does not qualify as a sale under the new franchise tax rules, that person would not be entitled to a cost of goods sold deduction. Section 171.1012(k-1) states that entities engaged in renting or leasing motor vehicles or heavy construction equipment may claim a cost of goods sold deduction, suggesting that other persons engaged in renting or leasing of property are not entitled to a similar cost of goods sold deduction. But without a specific definition of the term "sale," this is not entirely clear.

9. Inventories

a. Language at Issue

Section 171.1012(g) states that a taxable entity that is allowed a subtraction for cost of goods sold and that is subject to Section 263A, 460, or 471, Internal Revenue Code, shall capitalize that cost in the same manner and to the same extent that the taxable entity is required or allowed to capitalize the cost under federal law and regulations, except for costs excluded under Subsection (e), or in accordance with Subsections (c), (d), and (f).

b. Recommendation:

We recommend amending the language in Section 171.1012(g) to read as follows:

"A taxable entity that is allowed a subtraction for cost of goods sold and that is subject to Section 263A, 460, or 471, Internal Revenue Code, shall capitalize that cost *or maintain inventories* in the same manner and to the same extent that the taxable entity is required or allowed to capitalize the cost *or maintain inventories* under federal law and regulations, except for costs excluded under Subsection (e), or in accordance with Subsections (c), (d), and (f)."

c. Explanation

Currently, there appears to be some ambiguity as to whether HB3 requires taxpayers to maintain inventories in computing their cost of goods sold deduction amount. The current tax forms prescribed by the Texas Comptroller for computing cost of goods sold do not take into account beginning or ending inventory amounts. Failure to take beginning and ending inventories into account in computing the cost of goods sold deduction amount could result in a cost of goods sold deduction amount that does not in fact reflect the cost of goods sold. For example, if 100% of goods are produced in Year 1, but are all sold in Year 2, all productions costs would be deductible in Year 1, notwithstanding that none of the goods are sold in that year. Moreover, particularly because negative taxable margin is not carried over to reduce taxable margin in subsequent years, see Section 171.101(c), no deduction relating to the production of those goods would be permitted in Year 2. The proposed amendment above would prevent this potential discrepancy by making it clear that inventories must be maintained in computing the cost of goods sold deduction amount.

F. Apportionment (Sections 171.103, 171.105, 171.1055, 171.106, 171.107, 171.108)

1. Location of Payor Rule

a. Language at Issue — Section 171.103(a) sets forth several categories of transactions that generate gross receipts from business done in Texas for purposes of apportioning margin.

b. Recommendation — We recommend that Section 171.103(a)(6) be renumbered as Section 171.103(a)(7), and that the following new Section 171.103(a)(6) be added: "to the extent included in total revenue pursuant to Section 171.1011, dividends, distributions, distributive income, or interest paid by, or the sale of an intangible asset to, a taxable entity organized under the laws of the State of Texas."

Alternatively, we recommend that Section 171.103(a)(6) be renumbered as Section 171.103(a)(7), and that the following new Section 171.103(a)(6) be added: "to the extent included in total revenue pursuant to Section 171.1011, dividends, distributions, distributive income, or interest paid by, or the sale of an intangible asset to, a corporation or limited liability company organized under the laws of the State of Texas."

c. Explanation — Current administrative rules provide that receipts from dividends and interest paid by a corporation, and distributions paid by a limited liability company, are sourced to the state of organization of the payor for apportionment purposes. Current administrative rules also provide that sales of intangible assets are sourced to the location of the payor for the intangibles. For corporate and limited liability company payors, the location of the payor is the state of organization. Taxpayers have long relied upon these "location of payor" rules for apportioning receipts in structuring operations, and codifying these rules would insure that taxpayers may continue to rely upon them after the passage of HB3.

Under current administrative rules, receipts from partnerships are treated differently from receipts from corporations and limited liability companies. Partners' receipts from their distributive shares of partnership income are sourced as if earned directly by the partners. The location of a partnership payor for purposes of applying the "location of payor" rule is the partnership's principal place of business rather than the partnership's state of organization. Treating receipts from partnerships differently is reasonable under current franchise tax law, as partnerships are not taxed directly under current law. However, as most partnerships (and other legal entities that are not corporations or LLCs) are taxed directly under HB3, we recommend that the "location of payor" rule be extended to receipts from these taxable entities.

If the legislature does not extend the "location of payor" rule to receipts from all taxable entities, we recommend that the existing "location of payor" rule, which applies to corporations and limited liability companies, be codified. Our second recommendation reflects this alternative approach.

G. Reporting

1. Combined Groups: Attribution Rules

a. Language at Issue

Taxable entities that are part of an affiliated group engaged in a unitary business must file a combined group report in lieu of individual reports based on the combined group's business. Section 171.1014(a). The term "affiliated group" is defined as a group of one or more entities in which a controlling interest is owned by a common owner or owners or by one or more member entities. A controlling interest exists if there is 80% or more "direct" or "indirect" ownership. Section 171.0001(8). The term "indirect" is not defined.

b. Recommendation

We recommend providing a definition of the term "indirect" in Section 171.0001(8).

c. Explanation

The reference to indirect ownership in the definition of the term "controlling interest" for combined reporting purposes suggests that some attribution may be in order. But without further guidance, there will be considerable uncertainty in determining if the requisite controlling interest exists. For example, should ownership be attributed from a corporation to its shareholders, or from a partnership to its partners, and if so, how and under what circumstances. Likewise, should ownership be attributed from a child to a parent or from a trust to a beneficiary or grantor? Do these circumstances constitute "indirect" ownership? These are all issues that, if not addressed by the Legislature, may have to be resolved through litigation.

2. Combined Groups: Joint and Several Liability

a. Language at Issue

Section 171.1014 states that a combined group is a single entity for purposes of the application of the franchise

tax, but does not otherwise address the allocation of liability between the various entities that are members of the combined group.

b. Recommendation

We recommend that the Legislature amend Section 171.1014(b) to read as follows: "The combined group is a single taxable entity for purposes of the application of the tax imposed under this chapter. Each member of the combined group shall be liable for the combined group's franchise tax liability, but only to the extent of the percentage of the Texas receipts included in the numerator of the combined apportionment formula under Section 171.103(b) that is attributable to that member entity."

c. Explanation

Imposing joint and several liability among members of a combined group carries an element of simplicity, but also carries the risk of disproportionately imposing liability on member entities that contributed little or nothing to the tax base. We recommend that the Legislature instead allocate liability among members of a combined group based on the activity that generated it. The recommendation above would allocate liability based on a member entity's allocable share of Texas receipts included in the numerator of the apportionment formula.

3. Combined Groups: Deduction Elections

a. Language at Issue

Section 171.1014(d) states that for purposes of Section 171.101, a combined group shall make an election to subtract either cost of goods sold or compensation that applies to all of its members.

b. Recommendation

We recommend that the Legislature consider the effects of requiring that a cost of goods sold or compensation deduction election be made on a combined group basis as is currently the case under Section 171.101. If the Legislature determines that these implications are not consistent with Legislative intent, we recommend that the Legislature amend Section 1014(d) to permit each entity that is a member of a combined group to elect individually either a cost of goods sold or compensation deduction. This could be accomplished by amending Section 1014(d) to read as follows:

"For purposes of Section 171.101, each member of a combined group shall make an election to subtract either cost of goods sold or compensation as if the member were a taxable entity that is not part of a combined group."

c. Explanation

The benefit of either a cost of goods sold or compensation deduction will vary depending on the business that a particular entity is engaged in. A combined group presumably will make its annual election between a cost of goods sold deduction and a compensation deduction based on which approach result in the lowest tax for the entire combined group. However, the uniform election may require use of a deduction basis that is beneficial for some group members but not beneficial for other group members. This disparity is particularly the case where one entity is a service provider and another is engaged in selling goods, e.g., the group may elect cost of goods sold, but the service provider is not allowed to claim a cost of goods sold deduction. The uniform election therefore may result in different tax burdens on individual group members than would be the case if they were not commonly owned. This discrepancy raises a fundamental question of whether the unequal taxation is intended or constitutionally permissible. Moreover, the discrepancy could have specific adverse effects on, e.g., (i) owners of minority interests in a group member forced into an unfavorable deduction approach and (ii) persons whose compensation from a group member forced into an unfavorable deduction approach is determined with reference to the entity's net income. The above proposed amendment would permit each member of the combined group to make an election on a separate entity basis. This approach would permit each entity to claim an election most beneficial to it.

4. Tiered Partnerships

a. Language at Issue

Section 171.1015 includes certain reporting rules that apply specifically to certain pass-through entities, including partnerships, that are owned by one or more other taxable entities. Section 171.1015 refers to the partnership or pass-through entity as an "upper tier partnership" and its taxable entity owners as "lower tier entities."

b. Recommendation

We recommend amending Section 171.1015 so that the partnership or other pass-through entity is referred to as a "lower tier entity" and its taxable entity owners are referred to as "upper tier entities," which is essentially the reverse of how those terms are currently used in Section 171.1015.

c. Explanation

The references to lower and upper tier entities in Section 171.1015 as they currently exist in Section 171.1015 are confusing and counterintuitive. References to the "lower tier" entity actually refer to what would generally be considered an upper tier entity, whereas references to the "upper tier" entities actually refer to what would generally be considered a "lower tier" entity. These references appear to have been inadvertently switched.

H. Temporary Credit

1. Net Operating Losses

a. Language at Issue

Section 171.111 creates a temporary credit against tax due on taxable margin. A taxpayer may notify the Texas Comptroller in writing of its intent to preserve its right to claim the credit allowed under Section 171.111 no later than March 1, 2007 after which it may claim the credit for not more than 20 consecutive privilege periods. The formula provided for in Section 171.111 for determining the tax credit appears to be primarily structured to preserve the benefit of unused net operating losses in the form of a credit. The credit is equal to the product of a complex formula that takes into account net operating loss carryforwards on the last day of its taxable year ending in 2006, apportioning the amount in the same manner that taxable margin is apportioned under Section 171.106 on the first report due on or after January 1, 2007, multiplying that amount by 10%, and multiplying the product by the tax rate prescribed under Section 171.002(a)(2). The

Texas Comptroller has issued Proposed Rule 3.594 extending the due date for making the election from March 1, 2007 to September 1, 2007.

b. Recommendations

We recommend extending the due date for making the election from March 1, 2007 to the due date for filing the 2008 franchise tax return.

We recommend clarifying the formula and providing definitions for key terms used in the formula set forth in Section 171.111, including the terms "deductible temporary differences," "net operating loss carryforwards," related valuation allowance amounts," and "net deferred tax items."

We recommend clarifying whether this credit exists with respect to anyone with unused net operating losses for federal income tax purposes or is limited to persons with unused net operating losses for franchise tax purposes only.

We recommend clarifying that, in determining the tax rate to be applied in arriving at the amount of the credit, the tax rate in Section 171.002(a)(2) as it existed before January 1, 2008 should be used.

We recommend that the reference to "20 consecutive privilege periods" in Section 171.111 be changed to "10 consecutive privilege periods."

c. Explanations

The current deadline of March 1, 2007 is not practicable for making this election for a number of reasons, including (i) by this date, taxpayers do not have the benefit of knowing what Legislative changes to these election provisions will be made; (ii) by this date, many and perhaps most taxpayers have not completed either their 2006 federal income tax returns or their 2007 Texas franchise tax returns; and (iii) this date predates the Comptroller's extended deadline of September 1, 2007 and there may a question as to whether the Comptroller has authority to extend this deadline. The Comptroller's extended deadline of September 1, 2007 may also be unworkable for many taxpayers because, due to extensions, many taxpayers will not have filed either their 2006 federal tax returns or their 2007 Texas franchise tax returns by that date. September 1, 2007 also allows very little time following the end of the Legislative session for the Comptroller to prepare forms for making the election and for taxpayers to review, prepare the computations and complete the forms. In addition, there is a significant risk that many taxpayers will be unaware of the need to make the election until they have their 2008 franchise tax returns prepared, which will of course be much later than either of these dates. For these reasons, we recommend changing the deadline for making the election to correspond with the due date for filing the 2008 franchise tax returns. By imposing the same deadline for making the election and filing the first tax returns under the new franchise tax rules, the Legislature would (i) make the election more administratively feasible for taxpayers and (ii) help minimize a potential trap for unwary taxpayers.

The formula in Section 171.111 is also currently ambiguous. There is particular confusion as to whether the Legislature intended to measure the net operating loss amount upon which the credit is based by reference to federal law, accounting standards or business losses as computed under the prior franchise tax code provisions. Clarification could be accomplished in part by providing definitions for key terms, including those mentioned above.

The applicable tax rate in Section 171.111(b)(4) in determining the amount of the credit is the tax rate prescribed by Section 171.002(a)(2). That section, however, is repealed by HB3. Our recommendation above would clarify that the applicable rate is that prescribed by Section 171.002(a)(2) before its repeal by HB3. A business loss as of the date HB3 was enacted would have been available to reduce a taxpayer's tax liability at the old rate (e.g., a $100 loss would have saved a taxpayer $4.50 under the old law). So it seems appropriate to apply the old rate in order to preserve to the taxpayer the value of an already accrued loss.

The reference to "20 consecutive privilege periods" is a carryover from a prior tax code section and should be changed to 10 consecutive privilege periods. A 20-year period for claiming the credit would permit taxpayers to claim 200% of the benefit attributable to unused net operating losses, given that a taxpayer may claim 1/10th of the benefit attributable to such losses each year.

I. Transition Provisions (HB3, Section 22)

1. Accounting Period for 2008 Returns

a. Language at Issue

Section 22(b) of HB3 includes provisions for determining the accounting period for entities that become subject to tax under HB3, but does not provide similar rules for entities that were previously subject to the franchise tax. Section 171.1532 provides rules for establishing the accounting periods for "initial reports" and subsequent annual reports under the new tax. Because entities that were already subject to the franchise tax do not represent newly organized entities, entities just beginning to do business in Texas or entities previously subject to the margin tax, none of the provisions in Section 171.1532 for determining the accounting period upon which taxable margin is based apply to those entities. Section 171.1532, 171.000(4).

b. Recommendation

We recommend that the Legislature provide guidance clarifying the accounting period that should be used for purposes of establishing the accounting period that should be included in the 2008 franchise tax returns for entities that were already subject to the franchise tax in 2007. This could be accomplished by adding subsection (c) to Section 171.1532 to include the following language:

"The tax covering the 2008 privilege period for entities that were subject to the franchise tax in 2007 shall be based on business done by the taxable entity during the period beginning with the day after the last date upon which the franchise tax liability for the 2007 privilege period was based, regardless of whether based on taxable capital or earned surplus, and ending with its last accounting period ending date for federal income tax purposes in the year before the year in which the report is originally due."

c. Explanation

There are currently no rules in HB3 that explain what the accounting period should be for purposes of computing the taxable margin of an entity for the 2008 tax year that was previously subject to the franchise tax. The

Legislature probably assumed that the taxable margin would cover the period beginning with the end of the period that was covered in the prior franchise tax return. But this is not stated anywhere in HB3, nor can it be clearly extrapolated from any of the other rules in HB3.

2. Special Exit Tax Applicable For 2007 Dissolutions and Conversions

a. Language at Issue

Section 22(b)(3) of HB3 provides that an entity subject to the current franchise tax "at any time after December 31, 2006, and before January 1, 2008, but not subject to the franchise tax on January 1, 2008, shall file a final report for the privilege of doing business at any time after June 30, 2007, and before January 1, 2008, based on the period:

> (A) beginning on the later of (i) January 1, 2007; or (ii) the date the entity was organized in Texas or, if a foreign entity, the date it began doing business in Texas; and
>
> (B) ending on the date the entity became no longer subject to the franchise tax.

b. Recommendation/Explanation

We recommend that the following issues be addressed with respect to Section 22(b)(3):

(1) An entity that terminates its presence in Texas after December 31, 2006 but before June 30, 2007 appears to be required to file a final report under Section 22(b)(3). Section 22(b)(3) provides, however, that this final report would be for the privilege of doing business "at any time after June 30, 2007, and before January 1, 2008." It seems incongruous to require an entity that is no longer doing business as of June 30, 2007 to pay for the privilege of doing business during the period from July 1, 2007 through December 31, 2007. We recommend that the final report requirement of Section 22(b)(3) be imposed only on entities doing business in Texas between July 1, 2007 and December 31, 2007, and that the final report be based on business done beginning on the later of July 1, 2007 or the date the entity was organized in Texas or, if foreign, began doing business in Texas.

(2) Section 171.0011 of the current franchise tax imposes an "additional tax" on a withdrawing corporation or limited liability company for the period beginning on the day after the last day for which the tax imposed on net taxable earned surplus was computed and ending on the date the withdrawing entity is no longer subject to the earned surplus component of the tax. We recommend an addition to Section 22(b)(3) clarifying that the additional tax under Section 171.0011 of the current franchise tax will not apply to an entity that is required to file a final report under Section 22(b)(3). It should also be made clear whether the tax paid in connection with the final report will be the margin tax or the tax on net taxable earned surplus under the current franchise tax.

(3) As an alternative to the recommendations in the preceding two paragraphs, we recommend that Section 22(b)(3) be deleted in its entirety. As discussed in the previous paragraph, Section 171.0011 of the current franchise tax imposes an additional tax on withdrawing entities that are subject to the current franchise tax. This additional tax already addresses the 2007 withdrawals by currently taxable entities that Section 22(b)(3) is designed to address.

3. Terminating, Merging, Consolidating or Dividing Partnerships

a. Language at Issue

Section 22(c) of HB3 provides that an existing partnership is considered as continuing if it is not terminated. Section 22(d) provides that a partnership is considered terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. Section 22(e) provides that for a merger or consolidation of two or more partnerships, the resulting partnership is considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership. Section 22(f) provides that for a division of a partnership into two or more partnerships, the resulting partnerships, other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership, are considered a continuation of the prior partnership.

b. Recommendation

We recommend that Sections 22(d) through (f) be revised to read as follows:

> (d) A partnership is considered terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a taxable partnership.
>
> (e) For a merger or consolidation of two or more partnerships, the resulting taxable partnership is, for purposes of this Act, considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting taxable entity.
>
> (f) For a division of a partnership into two or more partnerships, the resulting taxable partnership, other than any resulting taxable partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership, are for purposes of this Act considered a continuation of the prior partnership.

c. Explanation

In a situation where a limited partnership converts to a general partnership prior to the January 1, 2008 effective date of HB3, the current language might be interpreted as requiring the otherwise nontaxable general partnership to continue to be taxed. This potential problem is avoided by providing that only taxable partnerships will be considered continuations of terminating partnerships for purposes of the Section 22 continuation provisions.

4. Combined Reports

a. Language at Issue

Section 22 of HB3 is silent with respect to reporting by combined groups.

b. Recommendation/Explanation

Combined reporting does not exist under the current franchise tax. It is unclear whether combined groups will be treated as new entities subject to the transitional filing rules under Section 22. Certain combined groups may include entities with different accounting years. It is not clear how the beginning date and accounting period for such groups will be determined. We recommend that guidance be provided in this area.

ENDNOTES

1 Citations to "Sections" in these Comments refer to Chapter 171 of the Texas Tax Code Ann., as amended by H.B. 3, 79th Leg., 3rd C.S. (2006), effective for franchise tax reports due on or after January 1, 2008.

2 The Comptroller's instructions state "Net distributive income for the calculation of compensation is the amount of guaranteed payments and distributions made during the accounting period . . . " See Texas Comptroller, Instructions For Completing Texas Franchise Tax Information Report Due February 15, 2007.

FIN 48: SOLVING TAX UNCERTAINTY WITH ACCOUNTING UNCERTAINTY

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The Financial Accounting Standards Board (FASB) issued new standards that alter the manner in which entities must measure and recognize tax positions in their financial statements. FASB Interpretation No. 48 (FIN 48) was intended to clarify the manner in which entities must account for tax uncertainties, although it may have ultimately created more uncertainties than it clarified. It is hard to determine the broad impact of FIN 48 because of its recent application, but it will certainly affect an entity's financial statement disclosures as well as the entity's legal strategies in dealing with the IRS and other tax authorities.

FIN 48 became effective for fiscal years beginning after December 15, 2006, and applies to all entities that are currently covered by FASB Statement 109, as well as nonprofit organizations, pass-through entities, and entities whose tax liability is subject to 100% credit for dividends paid. All tax positions, including positions taken or expected to be taken that impact current or deferred income or liabilities, are impacted by FIN 48. The term "tax position" is so broad that it includes a decision not to file a tax return, a decision to classify a transaction or entity as tax exempt, or an allocation or shift of income between jurisdictions. Thus, almost every tax-related decision could be considered a tax position.

FIN 48 has been described as adopting a two-step process through which an entity must first recognize, and then measure, its tax positions. A tax position will be recognized if it is more likely than not (i.e., greater than a 50% likelihood) to be sustained upon examination by the taxing authority. An entity must then determine the amount of such recognition.

In determining whether a position is more likely than not to be sustained, each tax position must be evaluated independently without regard to whether such position may be offset or aggregated with another position. In this evaluation, FIN 48 establishes a presumption that all positions will be audited by the taxing authority, and thus prevents the entity from basing its calculations on the chance that the position will not trigger an audit. This may create problems for an entity, for example, that does not file a tax return in a particular jurisdiction because it believes it does not have sufficient "nexus" with that jurisdiction. Unless it is able to establish that it is more likely than not to prevail on the issue of "nexus," the entity will be required to accrue tax liabilities indefinitely.

The "more-likely-than-not" standard also creates problems in defining and measuring the actual "tax position" to be analyzed. For example, an entity may have difficulty establishing it is more likely than not that a broadly defined tax credit will be sustained in full. Thus, an entity may not be able to report part of a tax benefit to which it is legally entitled to claim. The FASB provides some guidance that, in limited circumstances, the entity may use a narrower "unit of account," provided that it is consistently applied. The timing of a position is distinguishable from the sustainability of the position in determining whether a position will be sustained. For example, the decision to take an immediate $100 deduction for an expense rather than amortizing it over time does not impact the validity of whether the position itself (i.e., a $100 tax benefit) will be sustained.

Not only must recognized tax positions be accounted for and accrued, but penalties and interest are also accrued under FIN 48. Interest accrues at a statutory rate on the difference between the tax benefit expected to be recognized under general tax principles and the amount as recognized in accordance with FIN 48. Entities must also account for positions that do not meet the minimum statutory requirements for the avoidance of penalties, taking into account the presumption of audit detection and other presumptions prescribed by FIN 48. Under FIN 48, entities are given the discretion to classify interest and penalties as either an income tax expense or as an interest or other expense.

With respect to measuring a recognized tax position, FIN 48 permits entities to fully recognize tax positions that are based upon "clear and unambiguous tax law." For all other tax positions, the entity is restricted to recognizing only the largest amount of tax benefit for which there is greater than a 50% likelihood of being sustained. The result of this regime is that an entity must construct a cumulative table of probable outcomes for each tax position that is not fully sustainable by unambiguous tax law. Assume an entity desires to take a $100 deduction and the entity determined it only has a 5% chance of the full $100 deduction, a 55% likelihood of at least a $60 deduction, and an 85% chance of at least a $40 deduction. The entity may recognize the largest benefit for which there is, cumulatively, greater than a 50% likelihood of being sustained (i.e., $60 deduction). An entity must re-evaluate its positions prior to each reporting period to determine whether any of its positions has been impacted by new available information.

The FASB makes a false assumption that entities will be able to create such a cumulative table of probabilities effectively. The reality of the corporate world is that companies rely upon

the opinions of attorneys and accountants prior to taking certain actions. Although some law firms and accounting firms might be willing to give an opinion as to whether a particular tax position is more likely than not to be sustained, it is highly unlikely that any attorney or accountant would ever opine as to a breakdown of percentages of the likelihood a position will be sustained.

FIN 48 may also force entities to modify their legal strategies in resolving disputes with the tax authorities. Because the authorities often overstate tax deficiencies and their assessments are often presumed to be correct under the law, an entity must overcome a high burden to satisfy the "more-likely-than-not" standard. Accordingly, this may have a significant impact on an entity's decision to claim a tax position to which it is legally entitled.

Perhaps one of the more controversial aspects of FIN 48 is the disclosure requirements that may provide a roadmap to the IRS and other authorities detailing the entity's tax strategies. Among other disclosures, FIN 48 requires entities to disclose on their financial statements the amount of any unrecognized tax benefits that, if recognized, would impact the entity's effective tax rate, information about tax positions for which it is "reasonably possible" that the total amounts of unrecognized tax benefits will significantly increase or decrease within the next 12 months, and a description of tax years that remain subject to examination by major tax jurisdictions. Thus, an entity would theoretically be required to provide information about unrecognized tax positions of which the statute of limitations is set to expire.

Although the FASB had reason to make changes to reporting and accounting standards as a result of certain tax shelters and the Enron investigation, it has seemingly launched a missile to kill a mouse in the FIN 48 disclosure requirements. FIN 48 incorrectly assumes that sustaining a tax position may be measured with objective, statistical precision, and, at the end of the day, it is the client who will face the difficult decision of accounting for and quantifying certain of those tax positions for which no lawyer or accountant will opine.

ENDNOTES

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TAX SHELTERS AND THE SIX-YEAR STATUTE OF LIMITATIONS: THE IRS MOUNTS AN INADEQUATE ATTACK UPON THE COLONY

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The statute of limitations for assessment of federal tax is generally three years.[2] Over the past few years, the IRS has been unable to examine and adjust many returns within this three-year period and has been the subject of criticism for this reason.[3] In an effort to beat the clock, the IRS has begun to take an aggressive stance in arguing for a broad application of the extended six-year statute of limitations under Internal Revenue Code ("IRC") Section 6501(e)(1)(A), which was previously a fairly narrow exception to the three-year limitations period. Under this exception, the limitations period for assessment is extended to six years when a return omits more than 25 percent of the gross income stated in the return.[4] In numerous pending cases, taxpayers are challenging the IRS's attempts to impose this extended limitations period to their returns. This article discusses the history of the six-year statute of limitations and the IRS's current efforts to expand application of the statute.

The Six-Year Statute

The general three-year statute of limitations is extended to six years pursuant to Section 6501(e)(1)(A) which provides:

> (A) General rule.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within six years after the return was filed. For purposes of this subparagraph -
>
> (i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and
>
> (ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.[5]

Likewise, Section 6229(c) extends the three-year TEFRA[6] statute of limitations contained in Section 6229(a) to six years for omission of gross income exceeding 25% of the amount of gross income stated in the return. Expressed in mathematical terms, the six-year limitations period applies when:

$$\frac{\text{“Omitted” Amount}}{\text{Gross Income Stated in the Return}} > 0.25$$

If a taxpayer simply fails to report an item of gross income, applying the six-year statute of limitations is straightforward. The amount omitted is divided by the gross income stated in the return. If the dividend exceeds 25%, the six-year limitations period applies. But the application is not straightforward in other situations.[7]

I. Supreme Court Precedent – The Colony

A. Code Section 275(c) of the 1939 Code

The Supreme Court interpreted the meaning of the word "omits" as used in Section 6501(e)(1)(A)'s predecessor, Section 275(c) of the 1939 Code, almost half a century ago in the *Colony, Inc. v. Commissioner*.[8] Section 275(c) provided in relevant part:

> § 275. Period of limitation on assessment and collection. Except as provided in section 276—

> (c) Omission from gross income. If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed or a proceeding in court for collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.[9]

The general statutory language is the same as the one contained in the current Section 6501(e)(1)(A) except that the limitations period was five rather than six years. As seen above, Section 6501(e)(1)(A) additionally defines "gross income" in the case of a trade or business.[10] It also contains a disclosure safe harbor.[11]

B. Facts in *The Colony*

In *The Colony*, the taxpayer was in the business of developing and selling residential lots.[12] In calculating its basis in the lots, the taxpayer included development costs.[13] For its 1946 and 1947 taxable years, the taxpayer reported gain from the sales of the lots using this increased basis. The IRS determined that the taxpayer improperly included the development costs in its basis and that the taxpayer had understated the amount of gain includible in gross income.[14] The IRS mailed notices of deficiency to the taxpayer more than three but less than five years after the taxpayer filed the returns.[15] The taxpayer contended that the notices were untimely.

The taxpayer argued that the extended limitations period in Code Section 275(c) did not apply because the omission resulted from an overstatement of cost of goods sold, rather than from an "omission" of gross receipts.[16] The Tax Court disagreed and expansively read Section 275(c). It held that "omits from gross income" embraces not only an "omission" from income (as in the case of failure to report), but also an understatement of income resulting from the taxpayer's miscalculation of profits by overstating basis.[17] Thus, the Tax Court held that the extended limitations period applied and the assessment was timely.[18]

The taxpayer eventually appealed to the Supreme Court where the IRS argued that "amount" suggests "a concentration on the quantitative aspect of the error—that is, whether or not gross income was understated by as much as 25%."[19] This argument focused on the definition of "gross income." The Supreme Court remarked that "this view is somewhat reinforced if, in reading the [statutory language], one touches slightly on the word 'omits' and bears down hard on the words 'gross income,' for where a cost item is overstated, as in the case before us, gross income is affected to the same degree as when a gross-receipt item of the same amount is completely omitted from a tax return."[20]

In contrast, the taxpayer argued that the IRS's reading failed to take full account of the word "omits," when Congress could have chosen other words such as "reduces" or "understates."[21] Under the word's ordinary meaning, "omits" means "to leave out or unmentioned; not to insert, include, or name[.]"[22] Thus, the taxpayer contended that Section 275(c) applied only in situations in which specific receipts or accrual of income items are left out of the computation of gross income.[23]

C. The Supreme Court's Holding in *The Colony*

The Supreme Court noted that the statutory language was ambiguous but in the legislative history found "persuasive evidence that Congress was addressing itself to the specific situations where a taxpayer actually omitted some income receipt or accrual in his computation of gross income, and not more generally to errors in that computation arising from other causes."[24] The Supreme Court determined that "in enacting [Section] 275(c), Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors."[25] Where the understatement of a tax arose from an error in reporting an item disclosed on the face of the return, the Commissioner was not at a disadvantage in detecting the error.[26] Therefore, the Supreme Court held that the IRS's assessment against the taxpayer was barred by the general three-year statute of limitations and Section 275(c) was not applicable.[27] Significantly, in reaching its decision, the Supreme Court noted that its conclusion was "in harmony with the unambiguous language of [Section] 6501(e)(1)(A)[.]"[28]

II. The IRS's Current Reading of the Six-Year Statute

The IRS sets forth its arguments regarding the six-year statute of limitations in recently-issued Private Letter Ruling 200537029 and Chief Counsel Advisories 200609024 and 200628021. These arguments are: 1) an overstatement of basis results in an understatement of gain, i.e., an "omission" of gross income; 2) Section 6501(e)(1)(A)(i)'s definition of gross income in the case of a trade or business is only applicable to sales of goods created by the business (i.e., inventory); and 3) the total amount of gross income stated in the return is calculated based on the "gain" stated in the return—rather than the stated amount realized before diminution by basis—and that the amount "omitted" depends on whether the IRS's *adjustment* results in a gain (i.e., an "omission" of gross income) or merely eliminates a loss (i.e., no "omission").

A. Private Letter Ruling 200537029

In June 2005, the IRS issued Private Letter Ruling 200537029 (the "PLR") addressing the six-year limitations period under Section 6501(e)(1)(A). In the PLR, the partnership return reported the gross receipts from a sale of property, but understated the gain because of a basis step-up prior to the sale. The IRS alleged that the basis of the property was zero and that the partnership engaged in a series of steps designed to orchestrate the basis step-up.

This alleged basis overstatement, the IRS believed, results in applying the six-year limitations period because "gross income" in non-business property sales means *gain*, not *gross* receipts, from the sale. The IRS argued that this is "straight forward and that any uncertainty results only from trying to apply statements in [*The Colony*] concerning the extended assessment period for omission in the IRC of 1939 to the revised provision in the IRC of 1954, which remains unchanged in the IRC of 1986, and from taking statements about equating gross receipts with gross income in the case of a trade or business . . . out of context." Hence, the IRS believes that *The Colony* does not provide any authority for treating gross receipts as gross income for the sale of non-business properties.

Although the PLR has no authority as precedent,[29] it reveals the IRS's consistent mischaracterization of *The Colony* and Section 6501(e)(1)(A). *The Colony* did not decide what constitutes "gross income"—be that gain or gross

receipts. Rather, *The Colony* stands for the proposition that where gross receipts of a sale of property are fully disclosed, there is no "omission" of income.

B. Chief Counsel Advisory 200609024

In Chief Counsel Advisory 200609024 ("CCA 9024"), the IRS demonstrated again its focus on the quantitative analysis of Section 6501(e)(1)(A), and the lack of focus on the word "omits" or "omission." In CCA 9024, the following items of income were reported on the taxpayer's return:

	Income	
Gross Receipts	$1,000,000	
Cost of Goods Sold	250,000	
Gross Profit		$750,000
Interest Income		300,000
Capital Gain	200,000	
Capital Loss	(500,000)	
Net Capital Gain		0
Total Income		$1,050,000

CCA 9024 presented two issues: 1) how the amount of "gross income stated in the return" should be determined for purposes of Section 6501(e)(1) where the computation shown includes items of capital loss as well as items of capital gain, and 2) whether a capital loss transaction may result in an "omission" of gross income for purposes of Section 6501(e)(1) if the loss is disallowed in its entirety.

ISSUE 1: "Amount of Gross Income Stated In the Return" Does Not Take Into Account Capital Loss

CCA 9024 began its analysis with the definition of "gross income" under Section 61. The CCA reiterated that Section 61 includes in income *gain*, not *gross receipts*, from the sale of property. In determining the total amount of capital gain, CCA 9024 concluded that "gross income" does not allow netting of capital loss against capital gain. Therefore, for purposes of Section 6501(e)(1)(A), the IRS stated that the "amount of gross income stated in the return" should be determined as follows:

Gross Profit	$750,000	
Interest Income	300,000	
Capital Gain	200,000	
Cost of Goods Sold	250,000	(per Section 6501(e)(1)(A)(i)
Total Gross Income Stated	$1,500,000	

ISSUE 2: No "Gross Income" Omitted if Adjustment of Capital Loss Does Not Produce Capital Gain.

CCA 9024 concluded that the same treatment (i.e. the non-netting approach) with respect to capital gain and loss should apply in determining the "amount of gross income omitted" from the return. When an adjustment for a sale results in the complete elimination of a loss (for example, when the basis was overstated), there is no *omission* of income if the adjustment only eliminates the loss and does not result in gain. In demonstrating this principle, CCA 9024 provided the following example. A return reports a $100 loss on a sale resulting from an amount realized of $50 and a basis of $150. The IRS adjusts the basis down to $50, resulting in the disallowance of the entire loss, but no gain on the sale. The IRS concluded that there is no omission of income in this example. In contrast, if the IRS adjusts the basis down to $10, resulting in the disallowance of the entire loss *and* $40 of gain on the sale, there is an omission of $40.

Nowhere did CCA 9024 mention *The Colony* even though it is dispositive in cases where gross receipts from a sale transaction are fully reported and the adjustment to income results from the overstatement of basis of the property sold. The CCA ignored that there must be an *omission*, which is not merely a computational matter. The Supreme Court in *The Colony* rejected the very same arguments made by the IRS in CCA 9024.

C. Chief Counsel Advisory 200628021

In Chief Counsel Advisory 200628021 ("CCA 28021"), the IRS took the position that the gross-receipts-as-gross-income rule is only applicable to sales of goods and services (i.e, inventory) and does not apply to sales of other business assets. In CCA 28021, the Taxpayer/Partnership omitted certain gain from the sale of its business asset to an unrelated party. The IRS did not clarify the nature of the "business asset" involved other than to state that it was not a good or service. Prior to the sale, the Partnership engaged in several transactions that inflated the basis of the business asset sold. Specifically, the Partnership took three steps to achieve the basis enhancement.

First, the Partnership was created by the Transferor Partner (1% partner) and Redeemed Partner (99% owner). Redeemed Partner was owned by Holding Corporation, which in turn was owned by the Transferor Partner. The partnership redeemed the Redeemed Partner's 99% interest in the Partnership by issuing a promissory note guaranteed by the Transferor Partner. Transferor Partner included the amount of the note in its outside basis under Section 752(a), thereby creating a disparity between inside and outside basis in the Partnership.

Next, the Transferor Partner transferred its interest in the Partnership to Transferee Partner, which was also owned by Transferor Partner, and the Partnership made an election under Section 754 with a Section 743(b) adjustment.

Finally, the Partnership sold the business asset to an unrelated purchaser for cash after the basis of the asset was adjusted pursuant to Section 743. As a result of the above steps, the gain on the sale of the appreciated business asset of the Partnership was deferred until payments on the notes were made.

The Partnership filed a final (as well as the initial) return for the tax year at issue. The Partnership reported the gain on Form 4797, which in an attachment showed the sales proceeds of the business asset. Although the first page of the Form 1065 was an IRS form, most of the rest of the return was filed on a state form. State Schedule D-1 "Sales of Business Property" showed the gain from the sale of the business asset, the amount of depreciation deduction taken, the cost or basis of the business asset, and the resulting gain from the sale. Thus, the Partnership reported the gross receipts from the sale of the business asset.

Despite the reporting by the Partnership of its gross receipts, the IRS determined that Section 6501(e)(1)(A)(i) did not apply. The IRS found that "[t]he sale at issue in Taxpayer/Partnership is not a sale of its goods or services, but, rather, of an asset created by Taxpayer/Partnership in the course of its trade or business that helps it sell goods or services." Accordingly, the IRS concluded that the

gross-receipts-as-gross-income rule under Section 6501(e)(1)(A)(i) did not apply because the business asset at issue was not inventory. The IRS further found that the Taxpayer/Partnership omitted gross income because gain was omitted from the return by reason of the inflated basis.

The IRS's interpretation of Section 6501(e)(1)(A)(i) in CCA 28021 is troubling in two respects. First, the IRS's reading of Section 6501(e)(1)(A)(i) narrowly applies the gross-receipts-as-gross-income rule only to sales of "goods" that the taxpayer produces or sells (i.e. inventory), and not to sales of assets used in a trade or business to produce such goods. Thus, under the IRS's interpretation, the gross-receipts-as-gross-income rule would not apply to other assets used by the taxpayer in a trade or business.

Second, the IRS's analysis in CCA 28021 further demonstrates the IRS's disregard of the Supreme Court's decision in *The Colony* that an understatement of gain from an overstatement of basis does not result in an omission of gross income. In CCA 28021, the IRS argued that its interpretation of Section 6501(e)(1)(A)(i) is consistent with *The Colony* because the taxpayer in *The Colony* sold inventory – its residential lots – and reported its gross receipts from that sale on its tax returns. Thus, the IRS believes that *The Colony* is in harmony with Section 6501(e)(1)(A) because the facts of the case fit the "gross receipts" test of Section 6501(e)(1)(A)(i). In CCA 28021, the IRS stated that "6501(e)'s current language shows that, *after The Colony's transaction*, Congress clarified the meaning of 'gross income' such that while *The Colony*'s holding would remain the same under the current Code, it is not dispositive of the facts of the [case in CCA 28021]." (emphasis added.)

But the IRS's reasoning is temporally flawed—the 1954 Code, which added Section 6501(e)(1)(A)(i), was enacted *before* the Supreme Court's 1958 decision in *The Colony*. Congress could not have been addressing the Supreme Court's decision in *The Colony* in enacting Section 6501(e)(1)(A)(i). Moreover, while the facts of *The Colony* would fit the "gross receipts" rule of Section 6501(e)(1)(A)(i), it appears that the facts of *The Colony* also would fit the adequate disclosure safe harbor provision of Section 6501(e)(1)(A)(ii), as will be discussed. Thus, there is more than one way that *The Colony* is "in harmony" with the current statute. Accordingly, *The Colony* remains the controlling authority in determining whether there is an "omission" of gross income resulting from an overstatement of basis and understatement of gain.

III. "Adequate Disclosure" under Section 6501(e)(1)(A)(ii)

The IRS's current position fails to account for the Supreme Court's holding in *The Colony* that there is no "omission" of income sufficient to trigger the six-year statute when items are disclosed on the returns at issue. This disclosure "safe harbor" is now codified in Section 6501(e)(1)(A)(ii):

> in determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

But how much must the taxpayer disclose in order to fall within the safe harbor? The following discusses the disclosure rule first announced in *The Colony* and the cases that followed it in analyzing the disclosure requirement.

A. History of the Adequate Disclosure Safe Harbor Provision

As already discussed, the Supreme Court's decision in *The Colony* interpreted the precursor to the present six-year statute, Section 275(c) of the 1939 Code. Although Section 275(c) did not contain an explicit "adequate disclosure" safe harbor as provided under the current Section 6501(e)(1)(A)(ii), *The Colony* and the majority of the circuit court cases that preceded it had considered the extent of the taxpayer's disclosures on the return in determining whether there was an "omission" warranting an extended statute of limitations.[30] Thus, even though the disclosure safe harbor provision was not enacted until 1954, there was already an existing body of circuit court case law finding certain disclosures sufficient to allow the IRS to detect errors, resulting in a finding that there was no omission of gross income.[31] Indeed, the Supreme Court in *The Colony* endorsed these circuit courts' analyses when it found that the taxpayer's disclosure of the sales proceeds and basis provided the IRS enough of a "clue" to detect the error on the return such that no "omission" could be said to have occurred.

B. Adequate Disclosure Under *The Colony*

The facts and legal arguments presented in *The Colony* have already been discussed. In its opinion, the Supreme Court implicitly endorsed the majority view in the circuit courts. The Court rejected the IRS's argument that the statute focused primarily on the amount of income omitted. The Court found that the legislative history clearly indicated Congress' intent to give the IRS the benefit of the extended statute only when there is an "omission" of income, that is, when an item is completely left off the return. The Court went on to note that this definition of "omission" made sense, given the statute's purpose:

> [I]n enacting § 275(c) Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. *In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage*.[32]

Importantly, the Supreme Court concluded by holding that its interpretation of Section 275(c) was "in harmony with the unambiguous language of § 6501(e)(1)(A)."

C. *The Colony* as Precedent

In the years after *The Colony*, many courts referred to the Supreme Court's interpretation of what triggered the extended statute of limitations as the "clue" test, relying on the Supreme Court's language that where "the return on its face provides no clue to the existence of the omitted item" the extended statute will apply.[33] Contrary to the IRS's recent position that *The Colony* should be disregarded, there is a clear line of authority spanning forty-eight years since *The Colony* applying the "clue" test as an interpretative measure of when Section 6501(e)(1)(A)(ii)'s safe harbor provision should apply. Under Section 6501(e)(1)(A)(ii), the extended statute of limitations does not apply when a taxpayer discloses the omitted item on the return in a manner "adequate to apprise the Secretary of the nature and amount

of such item." The "clue" test provides the courts with a guide of what is adequate disclosure to avoid the extended statute.

The most obvious application of *The Colony*'s "clue" test has been to cases where a taxpayer completely leaves out an item of income and makes no reference to related returns.[34] In those cases, there is no "clue" on the return about the omitted item, and the extended statute of limitations applies. However, the "clue" test has been equally and consistently applied to cases in which a taxpayer reports an item in some fashion on the return but improperly accounts for the item in determining its tax liability.[35]

1. *The "Clue" Test: The Current Standard*

The "clue" test calls for an analysis of 1) whether the taxpayer's position is reported in keeping with IRS requirements, even though it is at odds with the IRS's position regarding tax treatment;[36] and 2) whether the taxpayer has given enough information to trigger follow-up by a reasonable revenue agent.[37] As such, the "clue" test is inherently fact-specific to each case.

Several courts have articulated frequently-cited versions of the "clue" test. *In Quick Trust*, the Tax Court held that the "touchstone in cases of this type is whether respondent has been furnished with a 'clue' to the existence of the error. Concededly, this does not mean simply a 'clue' which would be sufficient to intrigue a Sherlock Holmes. But neither does it mean a detailed revelation of each and every underlying fact."[38] The court also noted that "nothing in the statute requires disclosure of the exact amount" of the omitted income.[39]

In *Benderoff*, the Eighth Circuit stated that the "proper test thus appears to be whether the return provides a clue as to the omitted item…The clue provided by the undistributed taxable income was there for the Commissioner to observe, heed, and investigate and a reasonable follow-up on such a clue would have confirmed the fact that a distribution had been made[.]"[40]

As an additional part of the "clue" test, it is well-established that, in determining whether a taxpayer's disclosures are adequate to avoid the six-year statute under Section 6501(e)(1)(A)(ii), the reviewing court must look at the taxpayer's return and all related flow-through returns. In *Harlan v. Commissioner*, the Tax Court recently reaffirmed and extended this rule in reviewing a second-tier partnership return in determining whether there had been adequate disclosure.[41]

D. *CC&F Western* and the IRS' Current Litigation Position

1. *CC&F Western*

Despite forty-odd years of case precedent endorsing *The Colony*, there has been a movement over the last few years to weaken the value as precedent of this opinion and its "clue" test. The leading case challenging *The Colony*'s ongoing viability is the First Circuit's opinion in *CC&F Western Operations Ltd. Partnership v. Commissioner*.[42] Curiously, considering the weight of authority ascribed to the case by later readers, the First Circuit in *CC&F Western* explicitly refused to hold that *The Colony* was not good law and did not articulate a new standard of disclosure under Section 6501(e)(1)(A)(ii).

In *CC&F Western*, two business entities formed a partnership specifically to sell certain partnership interests in twelve parties that owned and held real estate to an investor. A portion of the sales proceeds was applied to satisfy the liabilities that attached to the real estate. In reporting the sale of the various partnership interests on Form 4797, the taxpayer-partnership understated the amount of the sales proceeds because it failed to include in it the proceeds applied to satisfy the liabilities. The IRS determined that the taxpayer-partnership should have included the amounts applied to satisfy the liabilities in the sales proceeds. This payment of debt was completely missing from the returns, although the taxpayer-partnership's shares of the second-tier partnerships' liabilities were listed on twelve separate Schedule K-1s.

The First Circuit reviewed the partnership returns and the returns of the individual partners and held that the six-year statute of limitations applied to the case because the sale of the partnership interests had not been adequately disclosed, under any standard of review. The only hint at the payment of liabilities was the listing of liabilities on the taxpayer-partners' Schedule K-1s prior to the transaction. In addition, the only way to determine the full amount of the liabilities was to aggregate figures from the twelve Schedule K-1s attached to the partnership return, and there was no link on any of the returns between the liabilities and the sale of the partnership interests.

In holding that the transaction at issue was inadequately disclosed, triggering the six-year statute, the First Circuit discussed the relationship between *The Colony*'s "clue" test and the current Section 6501(e)(1)(A)(ii). The court noted that other courts had used the "clue" test in connection with the safe-harbor provision of Section 6501(e)(1)(A)(ii) regarding adequate disclosure. However, the court stated in dicta that there was no connection between the "clue" test and the current standard for adequate disclosure under Section 6501(e)(1)(A)(ii): "the use of the clue language in decisions construing section 6501's adequate disclosure provision likely reflects an impulse to create a sense of continuity (unfortunately false) between *The Colony* and section 6501's adequate disclosure test." The court stated that the current language of Section 6501(e)(1)(A)(ii), "adequate to apprise the Secretary of the nature and amount[,]" "establishes a much stiffer test than a mere clue[.]" Importantly, the First Circuit declined to decide what such a "stiffer test" would be: "We need not decide these questions because … [the taxpayer] still loses in the present case [even under *The Colony*'s "clue" test]."

2. *IRS' Litigation Position As Shown CCA 200628021*

Emboldened by *CC&F Western*, the IRS's took an aggressive position in CCA 28021 interpreting Section 6501(e)(1)(A)(ii) contrary to *The Colony*. As discussed in Section II.C above, the transactions at issue in the CCA involved the Partnership issuing a promissory note, guaranteed by the Transferor Partner, to the Redeemed Partner in redemption of his interest in the Partnership. As a result of its assumption of the note, the Transferor Partner increased its outside basis in the Partnership by the amount of the note, creating a discrepancy between his outside and inside basis. Transferor Partner then transferred its partnership interests to the Transferee Partner, triggering the Section 754 election in place and adjusting the Transferee Partner's inside basis under Section 743(b). The step-up in basis eliminated part of the gain on the sale of the business asset.

On its return, the Partnership reported the gross proceeds from the sale, the cost of the business asset, and the gain from the sale. It also attached a statement to the

return indicating the Section 754 election and the computation and amount of the Section 743(b) adjustment. In addition, another attachment shows large amounts of capital contribution and distribution.

Arguing for a stiffer adequate disclosure test and citing to *CC&F Western*, the IRS contended that the disclosure of the above items was insufficient to qualify for the disclosure safe harbor under Section 6501(e)(1)(A)(ii). The IRS dwelled on the fact that, despite the reporting of the Section 743(b) basis computation, there was no disclosure about the "genesis of the outside basis adjustment" that generated the Section 743(b) basis adjustment. Further, the IRS protested that large dollar amounts in the nature of capital contribution and distribution are not adequate by themselves to satisfy the disclosure requirement because the large numbers do not disclose the nature of the omission that relates to those amounts. The IRS would have required the Partnership to disclose on its return or an attached statement that the promissory note was assumed by the Transferor Partner and that the Transferor Partner increased its outside basis by the amount of the note. This is an extreme position that calls for the taxpayer to provide narratives explaining each and every step of the taxpayer's activities and the tax positions taken with respect to such activities. Indeed, the stiffer disclosure test advocated by the IRS effectively would require the taxpayer to post red flags all over its returns so that the IRS would be "adequately apprised."

3. *Further Misplaced Reliance on CC&F Western*

This year, a district court relied upon *CC&F Western* to challenge the continuing validity of *The Colony*. In an unreported decision, *In re G-I Holdings*, the United States District Court for the District of New Jersey agreed with the First Circuit's dicta in *CC&F Western* criticizing the "clue" test. The district court held that the "adequate disclosure" test under Section 6501(e)(1)(A)(ii) is different from, and stricter than, *The Colony*'s "clue" test. Although the First Circuit in *CC&F Western* had expressly declined to state what the new, stiffer adequate disclosure test was, the New Jersey court seized upon language in *CC&F Western* to fashion its own new standard.[43] The court stated that the "adequate disclosure" test requires that the transaction be "disclosed in substance" and requires "that the tax return reveal more than obscure, disconnected marks on a treasure map which the IRS was expected to decipher at its peril."[44] The district court recently affirmed its decision in an order denying the taxpayer's motion for reconsideration.

While the *G-I Holdings* court approved of the IRS's current litigating position, the court appears to have misconstrued the relevant case law. In the almost fifty years since *The Colony*, the only reported case that questions the applicability of the Supreme Court's "clue" language in *The Colony* to Section 6501(e)(1)(A) is *CC&F Western*. But even *CC&F Western* did not go so far as to disregard *The Colony* or find it obsolete. In *CC&F Western*, the First Circuit held that the taxpayer's disclosures failed under any standard, and the court explicitly declined to "decide these questions" that it raised about *The Colony*. Thus, the IRS needs stronger precedent on which to base its argument that *The Colony* is no longer good law than *CC&F Western*'s dicta. Moreover, the First Circuit's reasoning in *CC&F Western* is questionable at best because it fails to take into account the substantial case law which holds that *The Colony* applies to Section 6501. The opinion also fails to take into account the Supreme Court's clear statement in *The Colony* that the Court's holding was "in harmony" with the current Section 6501.

E. IRS's Current Position in *Grapevine Imports, Ltd.*

Similarly, in *Grapevine Imports, Ltd.*[45] the Government advocates the same stiffer disclosure standard it argued for in *G-I Holdings*. The case is pending in the Court of Federal Claims, and the issue of the applicability of the six-year statute of limitations under Section 6501 is squarely before the court. A hearing was held in January 2007 on the issue of whether the taxpayers "omitted" income within the meaning of Section 6501(e)(1)(A)(i). A second hearing will be scheduled, if needed, on the issue of adequate disclosure under Section 6501(e)(1)(A)(ii).

In *Grapevine*, the partners of Grapevine Imports, Ltd., a Texas general partnership, engaged in certain short sales of U.S. securities and contributed the proceeds and obligations from the short sales to the Partnership as contributions to capital. The partners increased their outside basis by the amount of short sale proceeds contributed but did not decrease the partners' outside basis by the amount of short sale obligations assumed by Grapevine because the partners did not treat the short sale obligations as Section 752 liabilities. In essence, the short sale transactions created a basis step-up in the partners' outside basis in Grapevine. When the partners ultimately sold their interests in Grapevine, the partners realized and reported a capital loss of $45,077. The IRS claims that the short sale obligations should be treated as Section 752 liabilities; therefore, the partners' outside basis should have been decreased by the amount of the short sale obligations assumed by Grapevine.

On Grapevine's return, Grapevine reported the loss from the closing of the short sale transactions. The partnership return also showed large amounts of capital contributions and distributions during the year at issue. The partners' individual return reported the gross proceeds from the sale of partnership interest, the enhanced basis, and the resulting loss.

Despite the disclosures on Grapevine and its partners' returns, the Government has argued that such disclosures are misleading and do not apprise the IRS of the nature of the omission. Specifically, the Government contends that the returns "disclosed nothing about their use of an abusive shelter to manufacture basis."[46] The Government also argues that the attached statement made it appear as if Grapevine opened and closed the short sale transactions, rather than that the partners opened the short sale transactions and contributed them to Grapevine.[47]

It is unclear how the debate over *The Colony* will play out in *Grapevine*. In a prior opinion granting partial summary judgment in the case, Judge Allegra commented on the IRS's current position without deciding whether it was correct. The court stated that "[w]ere this court writing on a *tabula rasa*, it might well conclude that either section 6501(e)(1)(A) or 6229(c)(2) is triggered even where an item of income is partially reported. But that is not the state of affairs, and this court has no desire to consider whether *The Colony* was supplanted by the 1954 Code, unless the facts here so require."[48] The court noted *CC&F Western* and stated that there is a debate about the ongoing viability of *The Colony*'s holding.

As suggested by Judge Allegra's comments, *Grapevine* will be one of the first cases other than *G-I Holdings* to address directly the IRS's current litigation position regarding the six-year statute of limitations. Despite the court's hesitation to consider whether *The Colony* remains good law, it is probable that the *Grapevine* court will be asked to rule on the issue in upcoming hearings. As such, *Grapevine* has the potential to

affect many other pending cases in which the IRS contends the six-year statute should apply and is a case to watch.

Conclusion

Over the last few years, the IRS has mounted an attack upon the longstanding interpretation of the six-year statute of limitations under Section 6501(e)(1)(A) in order to gain broader use of the extended statute. The IRS has argued for a limited application of the definition of gross income under Section 6501(e)(1)(A)(i) and has pushed for a stiffer test for adequate disclosure, the safe harbor provision of Section 6501(e)(1)(A)(ii). In so doing, the IRS has argued strenuously that the only relevant United States Supreme Court decision on the extended statute of limitations, *The Colony*, and its "clue" test for adequate disclosure are not good law.

Despite the IRS's efforts and arguments, its reading is not supported by statutory language, *The Colony* opinion itself, or the forty-eight years of case law that follow *The Colony*. The "clue" test has been seriously questioned in only one reported case, and the First Circuit's findings in that case are arguably dicta and incorrect. However, support for the IRS's position may be growing, since a district court has recently cited *CC&F Western* regarding the six-year statute of limitations.

If these cases indicate a trend, it is a disturbing one and could provide the IRS with a much easier burden to invoke the six-year statute. The IRS's current litigation position is at odds with the Supreme Court's directive in *The Colony* that the statute is meant to provide an extended period of limitations only when the IRS is "at a special disadvantage in detecting errors" due to the taxpayer's insufficient reporting, and not to every case with an understatement of 25% or more of gross income. It remains the IRS's obligation to examine returns in a timely manner and select appropriate returns for audit. The IRS's failure to do so cannot be considered a "special disadvantage" sufficient to invoke the six-year statute. Instead, the six-year statute is only available to the IRS when it cannot perform the examination and audit function due to the taxpayer's failure to adequately report items that may be considered income. The longstanding precedent of *The Colony* and the "clue" test allow for no other interpretation of the six-year statute.

ENDNOTES

1 Meadows, Collier, Reed, Cousins & Blau, LLP, 901 Main Street, Suite 3700, Dallas, Texas 75202. twelty@meadowscollier.com, lgavioli@meadowscollier.com.
2 I.R.C. § 6501(a).
3 See Alison Bennett, I*RS May Need More Time to Finish Exams, Assess Taxes on Shelter Deals, TIGTA Says*, 65 Daily Tax Rep. (BNA) G-1 (Apr. 5, 2006); Treasury Inspector General for Tax Administration, BOSS Settlement Initiative Assessment, No. 2006-30-065 at 16 (March 2006) (IRS notes that assessments were deliberately delayed to ensure issue development).
4 I.R.C. § 6501(e)(1)(A).
5 I.R.C. § 6501(e)(1)(A).
6 "TEFRA" stands for the Tax Equity and Fiscal Responsibility Act of 1982 and refers to the Tax Treatment of Partnership Items under I.R.C. §§ 6221 through 6234. Whether the TEFRA statute of limitations is a separate, exclusive statute of limitations for partnership items or is merely an extension of the non-partnership item statute of limitations continues to be hotly litigated. *See AD Global Fund LLC v. United States*, 67 Fed. Cl. 657 (2005), *interlocutory appeal granted*, 68 Fed. Cl. 663 (Nov. 8, 2005); *Andantech, L.L.C, et. al. v. Commissioner*, 331 F.3d 972 (D.C. Cir. 2003); *Rhone-Poulenc Surfactants and Specialties, L.P. v, Commissioner*, 114 T.C. 533 (2000); *see also, Grapevine Imports, Ltd. v. United States*, Case No. 05-296T (Fed. Cl. filed March 11, 2005); *J & J Fernandez Ventures, L.P. v. United States*, Case No. 05-26T (Fed. Cl. filed Jan. 11, 2005).
7 For example, what if the taxpayer properly reports every item of income but the IRS adjusts an item based on a difference in legal interpretation? Did the taxpayer "omit" gross income? *See e.g., Davis v. Hightower*, 230 F.2d 549 (5th Cir. 1956) (an omission from gross income does not occur where the taxpayer "accurately fills in every blank space provided for his use in the income tax return . . . and arrives at an incorrect computation of the tax only by reason of a difference in opinion between him and the Commissioner as to the legal construction to be applied to a disclosed transaction").
8 *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958).
9 I.R.C. § 275(c) (1939) (repealed 1954).
10 *See* I.R.C. § 6501(e)(1)(A)(i).
11 *See* I.R.C. § 6501(e)(1)(A)(ii).
12 *Colony, Inc. v. Commissioner*, 26 T.C. 30, at 31 (1956), *aff'g* 244 F.2d (6th Cir. 1957), rev'd, 357 U.S. 28 (1958).
13 26 T.C. at 35.
14 *See id.* at 39.
15 *Id.* at 48.
16 *Id.* at 48-49.
17 *See The Colony*, 357 U.S. 28, 31.
18 *The Colony*, 26 T.C. at 49.
19 *The Colony*, 357 U.S. at 32.
20 *Id.*
21 *Id.*
22 *Id.*
23 *Id.* at 33.
24 *Id.*.
25 *Id.* at 36.
26 *Id.*
27 *Id.* at 37.
28 *Id.*
29 IRC § 6110(k)(3).
30 *Goodenow v. Commissioner*, 238 F.2d 20 (8th Cir. 1956); *Davis v. Hightower*, 230 F.2d 549 (5th Cir. 1956); *Slaff v. Commissioner*, 220 F.2d 65 (9th Cir. 1955); *Deakman-Wells Co. v. Commissioner*, 213 F.2d 894 (3d Cir. 1954); *Uptegrove Lumber Co. v. Commissioner*, 204 F.2d 570 (3d Cir. 1953).
31 *See, e.g., Deakman-Wells*, 213 F.2d at 901 ("the statute applies only where the taxpayer has failed to make a return of some taxable gain … and not a case such as this where he merely understates the final figure in his gross income computation, the item in question having been disclosed in the return but eliminated in the computation of the final figure").
32 *Id.* at 37.
33 *See, e.g., Benderoff v. United States*, 398 F.2d 132, 135-38 (8th Cir. 1968) ("the proper test appears to be whether the return provides a clue as to the omitted item").
34 *See, e.g., Phinney v. Chambers*, 392 F.2d 680, 683 (5th Cir. 1968) (citing *The Colony* and finding omission when taxpayer made no reference at all to payments received on an installment note); *Bishop v. United States*, 338 F. Supp. 1336, 1349-53 (N.D. Miss. 1970) (citing the clue test and finding omission when no reference made in returns to gifts received from an estate); *Connell Bus. Co. v. Commissioner*, T.C. Memo 2004-131, 87 T.C.M. (CCH) 1384 at *4 (Jun. 1, 2004) (citing the clue test and finding an omission when taxpayer made no reference at all to trust from which it received income and no report of said income).
35 *See, e.g., Benderoff v. United States*, 398 F.2d 132, 135-38 (8th Cir. 1968) (finding no omission when dividends from S-Corp were reported on the return but listed as nontaxable); *University Country Club v. Commissioner*, 64 T.C. 460, 468-72 (1975) (finding no omission when taxpayer listed capital surplus account in detail and characterized the amounts as capital stock rather than income); *Quick Trust v. Commissioner*, 54 T.C. 1336, 1346 (1970) (finding no omission when taxpayer reported inflated basis in partnership because taxpayer referred to partnership in its return); *Walker v. Commissioner*, 46 T.C. 630, 639-40 (1966) (finding no omission when taxpayer reported full amount of installment sale to be taken as income in the future that should have been taken as present income).

36 *See, e.g., Davis v. Hightower*, 230 F.2d 549 (5th Cir. 1956) ("the full and complete statement by the taxpayer of every gross item of income and gain received by him as required by the return itself" defeats the application of the extended statute of limitations).

37 *Benderoff*, 398 F.2d at 137 (the "clue" must allow the "Commissioner to observe, heed, and investigate" the item); *Estate of Frane*, 98 T.C. 341, 355 (1992) *rev'd in part on other grounds* 998 F.2d 567 (8th Cir. 1993) (the "clue" must be "sufficiently detailed … so that a decision as to whether to select the return for audit may be a reasonably informed one") (internal citations omitted). There has been significant debate in the recent, unreported *G-I Holdings* case about whether the standard under Section 6501(e)(1)(A)(ii) is that of a "reasonable man" or a "reasonable revenue agent." *In re G-I Holdings Inc.*, No. 02-3082, slip op. at 10 n.3 (D.N.J. Sept. 8, 2006). While the *G-I Holdings* court refused to decide the issue, this appears to be a distinction without a difference. The statute itself clearly indicates that the information in the return must be "adequate to apprise the Secretary" (emphasis added), a standard which by its terms incorporates the skill and knowledge of a typical IRS examiner. The IRS has made much of language in a 1975 Tax Court case, *University Country Club v. Commissioner*, which states that the standard is that of a "reasonable man." 64 T.C. 460, 471 (1975). However, the court in that case was merely distinguishing between a subjective standard, which the IRS wanted, and objective standard, which the court found was correct. *Id.* Moreover, it is clear from the context of the Tax Court's statements that there was no question that the objective standard of Section 6501(e)(1)(A)(ii) took into account the knowledge of the IRS: the court variously refers to the standard as "adequate to so apprise the Commissioner" and "adequate … for the Commissioner to observe[.]" *Id.* at 469-70.

38 *Quick Trust v. Commissioner*, 54 T.C. 1336, 1347 (1970) (emphasis added).

39 *Id.*

40 *Benderoff*, 398 F.2d at 136-37.

41 116 T.C. 31, 53 (2001). The Tax Court stated the accepted rule: "in dealing with documents that were not physically attached to the taxpayer's return, we have consistently drawn a line between (1) documents that have been filed as tax returns of other taxpayers, and (2) documents that even if filed as tax returns, were not tax returns of other taxpayers [i.e., returns of flow-through entities like S-Corporations and partnerships]. Documents in the former category have not been taken into account …. On the other hand, the second category … have been treated as adjuncts to and part of the taxpayers' tax returns for purposes of" Section 6501 analysis.

Notably, the IRS has recently taken the position contrary to *Harlan* and other cases that a court should only review the taxpayer's return and no other returns in applying Section 6501(e)(1)(A). In *Grapevine Imports, Ltd. v. United States*, No. 05-296T (Fed Cl., filed March 11, 2005), the IRS argues that the 1997 amendments made to the definition of "return" in Section 6501(a) supersede the prior case law defining "return" for Section 6501(e)(1)(A) purposes. The 1997 amendments redefined "return" under Section 6501(a) to include only the taxpayer's return and no flow-through returns. However, the 1997 amendments referenced by the IRS appear to relate only to which return should start the running of the statute of limitations, and the amendments bring the statute into compliance with the U.S. Supreme Court's reading in *Bufferd v. Commissioner*, 506 U.S. 523 (1993). These amendments do not purport to redefine "return" under Section 6501(e)(1)(A). The IRS's reading also conflicts with its own Treasury Regulation 1.702-1(c)(2), which specifically directs that gross income for each partner for Section 6501(e) purposes includes income listed on the individual and partnership returns. The Court of Federal Claims has yet not ruled on the validity of the IRS's position in *Grapevine*.

42 273 F.3d 402 (1st Cir. 2001).

43 *In re G-I Holdings Inc.,* No. 02-3082, slip op. at 9 (D.N.J. Sept. 8, 2006).

44 *Id.* at 10.

45 *Grapevine Imports, Ltd. v. United States*, No. 05-296T (Fed Cl., filed March 11, 2005).

46 Brief Supporting United States' Cross Motion for Partial Summary Judgment at 51, *Grapevine Imports, Ltd. v. United States*, Case No. 05-296T.

47 *Grapevine Imports, Ltd. v. United States*, No. 05-296T, slip op. at 24(Fed Cl.Jun. 14, 2006).

FEDERAL TAX IMPLICATIONS OF IRREGULARITIES IN STOCK OPTION GRANT TIMING

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I. INTRODUCTION

In today's environment of heightened scrutiny of the timing of stock option grants, much attention has been given to the accounting consequences and Securities Exchange Commission ("SEC") reporting issues relating to improperly timed grants. It is a common belief that as long as a stock option grant date is properly tracked from an accounting perspective and an SEC reporting perspective, irregularities in the grant timing of a stock option are not problematic. However, by focusing on the accounting and SEC reporting issues, practitioners are prone to overlook several key tax issues involving stock options with questionable grant dates. Specifically, irregularities in the timing of a stock option grant may create a discounted stock option, which can result in significant unintended tax consequences for both the grantor and the optionee. This article discusses the federal tax implications that arise from the unintended grant of discounted stock options under sections 422, 162(m) and 409A of the Internal Revenue Code of 1986, as amended (the "Code").[1]

A discounted stock option is a stock option that, as of the time of grant (as determined under the Code), has an exercise price less than the fair market value of the underlying stock. Prior to 2005, discounted stock options caused few problems and received minimal attention from a federal tax perspective. Admittedly, section 422, which governs the granting of incentive stock options ("ISOs") designed to receive favorable capital gains treatment, has always prohibited the grant of discounted stock options. However, section 422 only applies to the limited subset of stock options intended to qualify as ISOs. Moreover, the Internal Revenue Service ("IRS") did not have a recognized practice of challenging the grant date a company assigned to its stock option grants. Additionally, while section 162(m) has potentially limited the deductibility of the compensation resulting from a discounted stock option since 1994, section 162(m) only applies to option grants made to the top five officers of a publicly traded company. Likewise, as was the case with ISOs, the IRS did not generally challenge a company's grant date timing so the discount issue did not arise and deductions were not typically questioned as improper.

However, on October 3, 2004, Congress enacted section 409A. Section 409A and the proposed regulations issued thereunder (collectively, "section 409A") significantly impact the attractiveness of discounted stock options. Generally, section 409A provides that a discounted stock option will be considered deferred compensation on the date on which it vests. As a result, a discounted stock option subject to section 409A may not be exercised freely at any time after it vests but rather, in order to avoid certain adverse tax consequences, must be exercised at the times permitted under section 409A. Hence, beginning in late 2004, practitioners started to advise clients to avoid awarding discounted stock options. This course of action was a significant departure from past practices in the case of options that did not need to comply with the rules of sections 422 and 162(m) since, prior to the enactment of section 409A, options that were not ISOs or that were not granted to one of the top five officers of a publicly traded corporation were primarily governed by section 83.

Section 83 does not prohibit or adversely tax most discounted stock options. In fact, section 83 does not even apply to the ***grant*** of a stock option unless the stock option has a readily ascertainable fair market value.[2] Moreover, the applicable regulations under section 83 do not distinguish between a discounted stock option and a nondiscounted stock option. Therefore, in theory, the grant of any stock option, no matter how deep the discount, would not be taxed either at the time of grant or at the time of vesting under section 83.[3] Section 83 does, however, apply to stock options at the time of the ***exercise*** of the option. Specifically, section 83 mandates that the optionee include in gross income the difference between the value of the underlying stock at the time of exercise and any exercise price paid to exercise the option.

Nonetheless, the proliferation of discounted stock options has declined considerably in recent years. Even if one is not concerned with the problems created under sections 422 and 162(m), section 409A has made virtually all discounted stock options problematic, especially for the optionee. With this background in mind, it is interesting that the issue of when an option is granted for federal tax purposes has finally received considerable attention. While in years past, practitioners were not particularly concerned with whether they created a discounted stock option, inadvertently or otherwise, the determination of whether a stock option is discounted has become crucial for tax practitioners.

The recent backdating[4] scandal has undoubtedly been the catalyst in focusing regulatory attention on the date of grant issue and it is within this context that we will explore the application of sections 422, 162(m) and 409A to stock options with a discounted exercise price resulting from grant timing irregularities.

II. Section 422

A. Rule Description

Companies that have engaged in stock option backdating resulting in discounted options and individuals who have received discounted stock options may be subject to additional tax liability to the extent the options at issue were improperly treated as ISOs. As a general rule, an employee who receives an ISO may defer recognition of income until he sells the underlying stock and that income is taxed at long-term capital gain rates, provided the applicable holding period requirements are met.[5]

Section 422 sets out the requirements for an option to qualify as an ISO. Most relevant in the context of option grant timing irregularities is the requirement that the ISO have an exercise price "not less than the fair market value of the stock at the time such option is granted" (such time hereinafter referred to as the "grant date").[6] And, in the case of individuals who own ten percent (10%) or more of the company, to qualify as an ISO, the option must have an exercise price not less than 110% of the fair market value of the underlying stock on the grant date. Where option backdating has occurred, whether through intentional fraud or as a result of untimely or haphazard compliance with plan terms or corporate formalities, there is unlikely to be the required harmony between the exercise price and the fair market value of the underlying stock.

In determining whether a company has a discounted option issue with respect to its backdated ISOs, it is important to understand what date is considered the grant date for purposes of section 422. Pinning down the grant date is critical because, as indicated above, for an option to qualify as an ISO it must have an exercise price not less than the fair market value of the underlying stock on the grant date. As a result (1) the exercise price must be fixed on the grant date, and (2) the exercise price must not be less than the fair market value of the underlying stock on the grant date. The regulations issued under section 421 of the Code provide that "the [grant date] and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of [an ISO]."[7] The regulation goes on to provide that an offer of stock for sale is not considered complete until the date on which (1) the maximum number of shares that can be purchased under the option and (2) the minimum option price are fixed or determinable.[8]

Thus in the emblematic nonfraudulent option backdating situation, where an option with a fixed exercise price is awarded to an employee on a date prior to the date on which all directors (or committee members) have officially consented to the award (the grant date for purposes of section 422 of the Code), the option likely may not qualify as an ISO because the underlying stock may not have a fair market value, on the later grant date, equal to or lesser than the fair market value of the stock on the date on which the option was putatively awarded (*i.e.*, if the stock price has increased, the option is "discounted").

B. Implications of Noncompliance

If an option intended to be an ISO does not have an exercise price at or above the grant date fair market value of the underlying stock, it is a nonqualified stock option.[9] While the disqualification of ISOs that are only slightly in the money is drastic, it is explicitly required by the regulations. The disqualification of an ISO has tax consequences to both employee and employer.

Employee Tax Consequences. An employee who thought he received an ISO, but who in fact received a discounted nonqualified stock option (hereinafter a "Disqualified ISO"), may owe additional tax at ordinary income rates on the difference between the fair market value of the underlying stock and the exercise price on the date of exercise of the Disqualified ISO. This additional tax is payable in the year of exercise. In addition, a Disqualified ISO may give rise to employee liability under the Federal Insurance Contribution Act ("FICA").

Employer Tax Consequences. Generally, the exercise of a nonqualified stock option is subject (whereas the exercise of an ISO is not subject) to federal income tax withholding and employment taxes. Therefore, an employer may be liable for failing to withhold the appropriate amounts under federal income tax withholding rules. A Disqualified ISO may also give rise to employer liability under FICA and the Federal Unemployment Tax Act ("FUTA"). However, the employer may be able to claim a deduction for the amount the employee recognizes as income from the exercise of the Disqualified ISO.[10]

C. Practical Example

Assume on Day 1 the chairman of the board of directors of Company A, a publicly traded Delaware corporation, contacts the chief executive officer and general counsel of Company A to discuss the grant of an ISO to an executive Company A recently hired. On the same day the general counsel prepares a unanimous written consent approving an award of 100 ISOs with an exercise price of $100, the fair market value of a share of Company A stock on Day 1, and circulates the consent to the members of the compensation committee of the board of directors. An award agreement containing these terms is also prepared and delivered to the new executive. The last member of the compensation committee to sign the unanimous written consent signs it on Day 5. The general counsel of Company A files the unanimous consent in the records of the Company Day 5. On Day 5 Company A stock trades at $105 a share.

Section 141(f) the Delaware General Corporation Law provides, in relevant part, that "any action required or permitted to be taken at any meeting of the board of directors or any committee thereof . . . may be taken without a meeting if all members of the board [or committee] . . . consent thereto in writing . . . and the writing . . . [is] filed with the minutes of the proceedings of the board, or committee."[11] As a result, absent additional facts not presented in this example, the grant date for purposes of section 422 did not occur until Day 5, when the fair market value of Company A's stock is $105 a share. Given that the ISO has an exercise price of $100, it is a discounted, nonqualified option and the unintended tax consequences described above would result.

D. Correction Methods

Unfortunately, whether an option is an ISO or a nonqualified stock option is determined as of the date of grant.[12] As a result, unlike the correction method for options failing to comply with section 409A (described below), a Disqualified ISO cannot become a qualified ISO by increasing its exercise price. Thus there is no way to "correct" a Disqualified ISO. Rather, a company that has issued Disqualified ISOs should inform the recipients of the options' status as nonqualified stock options and disclose the proper tax treatment. For those Disqualified ISOs that have been exercised, the company should inform the employee as to how he should have reported the income recognized by such exercise. To the extent the exercise occurred in a prior year, the company should correct the Form W-2 previously sent to the employee, and the company should review whether it had any withholding obligation at the time of exercise or has an unclaimed deduction, as described above.

III. Section 162(m)

A. Rule Description

Section 162(m) generally provides that a publicly held corporation[13] may not deduct compensation paid to certain "covered employees" to the extent the total compensation for the taxable year with respect to such employee exceeds $1,000,000. "Covered employees" include, as of the close of the taxable year, the chief executive officer of the corporation and the additional executives of the corporation whose compensation is required to be reported to shareholders under the Securities and Exchange Act of 1934 (the "Exchange Act").[14] Section 162(m) provides an exception to the $1,000,000 deduction limit for "qualified performance-based compensation." Compensation taxable to a covered employee upon the exercise of an option qualifies as "qualified performance-based compensation" so long as the option (1) was granted by a compensation committee of the board of directors of the corporation that is comprised solely of two or more outside directors, (2) the material terms of the award were disclosed to and approved by a majority of the stockholders of the corporation, which disclosure stated the maximum number of shares that could be granted to any one employee during a specified period and described the employees eligible to receive options,[15] and (3) such option has an exercise price equal to the fair market value of the underlying stock of the corporation on the date of grant.

Discounted options clearly do not satisfy the performance based compensation requirements of section 162(m) since they do not have an exercise price equal to the fair market value of the underlying stock on the date of grant. Section 162(m) does not define the term "date of grant" though, most likely, this term should be interpreted in line with the regulations under section 422 to refer to the date when the corporation completes the required corporate action related to the grant. When a corporation selects the exercise price for an option based on the fair market value of the corporation's stock on Day 1 but does not complete the corporate action necessary to authorize the grant until Day 2, this creates a backdated option that will be discounted if the company's stock price is higher on Day 2 than on Day 1. Since the discount violates section 162(m), ***all*** income recognized by an executive upon exercise of the option will be counted for purposes of determining whether the $1,000,000 deductibility limitation under section 162(m) has been exceeded. Though this result may seem inequitable, especially in cases where the discount is small or was created inadvertently, the regulations under section 162(m) are explicit that any discount will cause all of the compensation attributable to the grant or award to fail to be performance based compensation.

Although not necessarily an option grant timing issue, an option can fail to comply with the performance based compensation requirements of section 162(m) in other ways, such as if the company's compensation committee is determined not to be independent (*i.e.*, if the option grants were not approved by a committee of outside directors) or if the authority to grant options to covered employees is delegated to an individual. Under section 162(m), an outside director is an individual other than (1) a current employee or officer of a publicly-held corporation, (2) a former officer of the corporation, or (3) a former employee of the corporation who receives compensation for prior services during the taxable year (other than benefits under a tax-qualified retirement plan). To be an outside director, an individual also cannot receive remuneration[16] (including any payment in exchange for goods or services) from the corporation, either directly or indirectly, in any capacity other than as a director. There could also be a section 162(m) violation if the terms of a backdated option do not match the terms approved by the compensation committee.

B. Implications of Noncompliance

If a corporation grants a stock option in violation of section 162(m), the corporation will lose the section 162(m) deduction for any income recognized by the executive for the year in excess of $1,000,000. This could result in lost deductions going back for multiple years and, in many cases, the corporation may have improperly deducted significant amounts of excess compensation. In cases where options have gained significant value over a period of years due to stock appreciation, the value of a lost deduction and the resulting tax liability could be considerable.

In addition to paying the past due taxes, the corporation could also owe interest and penalties on the delinquent amount and may need to restate its past financial statements to account for the newly discovered tax liability. While we are not aware of any final reported decisions in which a court has imposed liability related to option backdating under section 162(m), in at least one recent shareholder derivative action against corporate officers and directors, the plaintiff alleged breach of the fiduciary duties of good faith, trust, loyalty and due care based on violation of section 162(m).[17] Any potential liability with respect to section 162(m) will be limited, however, to acts or omissions that occurred on or after January 1, 1994, which is the date section 162(m) became effective.

C. Practical Example

Several public companies have received press for engaging in intentional stock option backdating practices, which can have important implications in the section 162(m) context since these types of practices will cast doubt on the independence of the corporation's compensation committee members. The company could, for instance, have failed to implement proper internal controls for section 162(m) purposes, which would be the case if the board of directors delegated sole authority to grant options to one of the company's chief officers, in essence creating a single member compensation committee. On the other hand, the company could have properly created a compensation committee of outside directors to make option grants to its covered employees, but one or more of the committee members agreed with a top executive to make certain backdated grants in exchange for improper remuneration. The compensation committee described in each of these examples then engages in such tactics as tracking historical stock prices and waiting until the end of each quarter to make option grants on the dates when the company's stock price is at its lowest point. To evidence the grants, a committee member drafts compensation committee minutes, which are signed and dated as if the grants occurred on the low dates.

In these types of situations, the company's compensation committee does not meet the independence standards established in section 162(m) nor are the "grant dates" for purposes of section 162(m) the same as the putative date of grant on the face of the option. This will cause any option grants made by the committee to fail to qualify as performance based compensation under section 162(m) and will cause the corporation to lose its deduction for the income the covered employee recognizes upon exercise. For example, assume that a corporation with a compensation committee engaging in one of the fraudulent practices described above paid an executive $1,000,000 in salary and bonus for the year 2002. Also in the year 2002, the executive exercised options he was previously granted by the compensation committee and recognized $2,000,000 of income as a result of the exercise. The corporation, either in blatant disregard of or oblivious to the violation of section 162(m), takes a deduction of $3,000,000 with respect to the executive's compensation in the year 2002. Because of the section 162(m) violation, $2,000,000 of the above referenced deduction was improperly taken by the corporation, and the corporation could owe an additional $700,000 in federal income taxes (assuming the deduction was needed to offset corporate income taxable at a rate of 35%), related penalties and interest, and may be required to restate financial statements if the problem is not timely discovered. Of course, this will be the result regardless of whether the backdating is done intentionally, since the grants will independently fail section 162(m) if the compensation committee is not independent or the options are discounted.

D. Correction Methods

Once a grant has been made in violation of section 162(m), whether because it is discounted and/or because the corporation's compensation committee is not independent, the company has lost its ability to treat the option as qualified performance based compensation that is exempt from the $1,000,000 deduction limit. This is not necessarily problematic if, for instance, the company was not intending to take a deduction for the option related income or the executive's compensation for the year, including any income received upon exercise of the option, will not exceed $1,000,000. A corporation can add provisions to its nonqualified deferred compensation plan whereby amounts that are nondeductible under section 162(m) will be automatically deferred to the earliest date on which payment will not result in a lost deduction (i.e., because the individual is no longer a covered employee or because he has received less than $1,000,000 in compensation, other than qualified performance based compensation that satisfies section 162(m)).[18]

In instances where these strategies are not feasible or desirable, however, the corporation will have to rely on having comprehensive policies and procedures in place to ensure that its grant process does not result in the granting of inadvertent discounted options that lead to an improper deduction by the corporation. Any option granting policy should require that grants to potential "covered employees" under section 162(m) be made by a compensation committee comprised solely of outside directors, unless determined otherwise by the compensation committee. A corporation should also design controls in its equity tracking system that will specifically highlight any option grants to potential covered employees that do not satisfy the section 162(m) requirements so that the corporation is aware of this failure before any improper deduction can be taken.

IV. Section 409A

A. Rule Description

Section 409A generally became applicable on January 1, 2005, and limits the ability of employees to defer compensation pursuant to certain nonqualified deferred compensation arrangements. In addition, section 409A applies to discounted options. Specifically, if a company grants a discounted option to an employee, the option may only be exercised upon a section 409A compliant distribution event, which generally must be established at the time of grant. Section 409A compliant distribution events are limited to (1) the date the employee separates from service, (2) the date the individual becomes disabled, (3) the date of the individual's death, (4) a specified time or pursuant to a fixed

schedule specified in the option plan or the option agreement, (5) a change in the ownership or effective control of the company or in the ownership of a substantial portion of the assets of the company, or (6) the occurrence of an unforeseeable emergency, as each is determined pursuant to section 409A.[19] The time of distribution, once established, can only be changed in certain limited circumstances as set forth in section 409A.

Because options are generally designed to be freely exercisable after vesting, if a company is unaware that an option is discounted, the option will most likely not be designed to comply with section 409A (*i.e.*, to be exercisable only on one of the events specified above). Consequently, if it is later discovered that options were, in fact, granted at a discount, they will violate section 409A.

B. Implications of Noncompliance

A violation of section 409A will result in the assessment of additional taxes against the award holder. While current IRS proposed regulations do not specify the portion of a discounted option that is subject to tax under section 409A, Notice 2006-100[20] provides that the holder of a discounted option would be taxed on an amount equal to (1) the difference between the fair market value of the underlying stock on December 31 of the year in which the option vests and the exercise price of the option, plus (2) an amount equal to 20% of the amount determined pursuant to (1) above, plus (3) interest, at the IRS's underpayment rate plus 1%, for the period beginning on the date of vesting and ending on the date the option holder pays the additional taxes owed pursuant to section 409A. This tax only impacts option holders and does not result in any additional taxes or the loss of any deduction to the employer.

Note that, in the option backdating context, it is easy to create delinquent employer, payroll and withholding taxes. For example, if the discovery of option backdating resulted in income associated with the discounted options in the past, an employer's federal income tax withholding could be delinquent. Further, if the discounted option problem were uncovered in a subsequent calendar year, prior year income tax reporting by the company could be inaccurate.

C. Practical Example

In addition to the delinquent signing of a unanimous written consent described in Section II above, one of the more common situations that results in the inadvertent grant of discounted options is action taken by executive officers who do not have the authority to grant options. For example, executives could determine due to market fluctuation that a particular date is favorable for making option grants to employees outside of the executive suite. This could legitimately occur where the executives believe the market has, for example, overreacted to bad news presenting the opportunity to grant options to employees to purchase company stock at a value. In such a circumstance, the executives might determine the employees who should receive shares and the number of shares to be received with an exercise price equal to the fair market value on such date, with the intention of receiving board or compensation committee approval at a later date.

If the officers taking such actions have not been delegated the authority to grant options by the appropriate governing body of the company, the corporate action necessary to grant the award will not have occurred until the proper governing body later acts.

Assume that company stock has been trading at $10-12 per share for a period of several weeks. On February 1, 2005, the stock drops to $8 per share and the chief executive officer of the company instructs the vice president of human resources to prepare option award agreements granting options to purchase 1,000 shares vesting on the first and second anniversaries of the date of grant to employees at the $8 exercise price. Several weeks later the general counsel prepares a unanimous written consent for the compensation committee that is fully executed on March 15, 2005, when the fair market value of the stock is $12 per share. Assuming that these employees will not be covered employees for purposes of section 162(m), the compensation committee could have delegated to the CEO the authority to make these grants. Assuming that the compensation committee did not delegate this authority, however, then the grant date fair market value under the options is actually $12 per share resulting in a discounted option. Consequently, absent timely correction of the problem, on February 1, 2006, and February 1, 2007, the option holders will each be taxed on the difference between the fair market value of the underlying stock on December 31 of the year in which the option vests[21] and the exercise price of the option, plus the additional tax under section 409A of 20% of such amount (plus interest, if applicable), notwithstanding the fact that the options were not exercised. Assuming the fair market value of the stock was $14 on December 31, 2006, and will be $15 on December 31, 2007, the taxes in 2006 to each option holder are $3,600 (i.e. ($6.00 x 500 shares) + (20% x ($6.00 x 500 shares))) and the additional taxes in 2007 would be at least $4,200. In addition, assuming the options vesting in 2006 were not exercised in 2006, on December 31, 2007, there is an extra dollar of appreciation on the 500 shares vesting in 2006 that was not yet captured. As of the time of publication of this article, the IRS had not yet disclosed how this additional appreciation will be taxed.

D. Correction Methods

The IRS has suggested two methods of correction for discounted options. First, the grant date discount could be eliminated by raising the exercise price. Second, the option could be amended to limit the exercise of the option to a 409A compliant time or event.[22]

Although in certain circumstances, an option holder may be willing to agree to increase the exercise price under his option in order to avoid additional taxation under section 409A (e.g., where the discount is very small and appreciation of the stock has been significant) in many cases companies will desire to pay the option holders the amount by which the exercise price was increased. Pursuant to the transition relief set forth under section 409A, as extended by Notice 2006-79,[23] payment to the employee to compensate him for the increased exercise price may not be made in the same year in which the correction was performed; rather, it must be paid in unvested property that vests in a later year or as a cash payment in a later year subject to the general rules of section 409A.

Therefore, if a discount is eliminated in calendar year 2006, the option holder must either receive unvested property for the discount that does vest prior to January 1, 2007, or receive a cash payment or vested property no earlier than January 1, 2007. Notice 2006-79 extended this relief to December 31, 2007, for most option holders provided that any payment with respect to options corrected in 2007 must be paid in unvested property that vests on or after January 1,

2008, or as a cash payment on or after January 1, 2008, subject to the general rules of section 409A. Notably, Notice 2006-79 did not extend this relief for persons who, as of the date of grant of the option, were subject to the disclosure requirements of section 16(a) of the Exchange Act with respect to the company in circumstances where the company either has reported or reasonably expects to report a financial expense due to a discounted option that was not timely reported on the company's financial statements or reports. For such persons, any discounted option correction must have been made by December 31, 2006. In other words, companies that had reported a financial expense with respect to backdated options must have corrected backdated options to section 16 officers and directors by year end 2006.

The second possible correction would be to bring the option into compliance with section 409A by limiting exercise of the award to section 409A compliant times or events. Because section 409A allows a date certain deferral to be distributed in a specified calendar year, an option could be modified to be exercisable in a specified calendar year (*i.e.*, the remainder of the calendar year of vesting,[24] or to avoid a short exercise period for options vesting at year end, the calendar year following the year in which the options vest). Alternatively, the option could be exercisable only at termination of employment or the earlier of or later of termination of employment and a specified calendar year.

These correction methods are most useful for discounted options that have not yet been exercised. Options subject to section 409A that have previously been exercised pose unique problems. If the exercise occurred in 2005, the exercise itself corrects the problem pursuant to transition relief that allowed for the termination of a deferred compensation arrangement in whole or in part and immediate payment of the deferred compensation. Exercises in 2006, however, are more problematic. It is unclear whether such options can be corrected. Options exercised in connection with a termination of employment in 2006 arguably have been exercised in compliance with section 409A. Possibly, a company could go to an option holder and request immediate payment of the discount in exchange for property that does not vest prior to January 1, 2007 or a deferred cash payment payable on or after January 1, 2007, if it can be argued that the plan document would prohibit the exercise of an option in violation of section 409A. However, it is likely that the IRS will take any exercise of a discounted option in 2006, where the term of the option otherwise extended beyond 2006, will result in the imposition of taxes under section 409A. Announcement 2007-18 provides a program for employers to pay the taxes arising under section 409A for "rank and file" employees who exercised discounted stock options in 2006. The IRS provides in Announcement 2007-18 that, "[i]n the absence of affirmative steps taken before the exercise of a stock right to avoid a violation of section 409A, the exercise of a discounted stock right during 2006, where the term of the stock right otherwise extended beyond 2006, generally is treated as an impermissible payment of nonqualified deferred compensation under section 409A." Although, the IRS is speaking in generalities, given that the relief provided under the IRS program is limited and that the taxes under section 409A ar still imposed, albeit paid by the employer, it seems unlikely that the IRS will consider corrective action taken after the exercise of the discounted option as a possible solution.

V. Conclusion

Companies that have reason to believe that stock option grant timing inconsistencies may have arisen in their grant practices should examine their stock option grants as soon as possible. The IRS Large and Mid-Size Business Division is in the early stages of examining backdated stock option issues. In fact, the Large and Mid-Size Business Division's Deputy, Commissioner Bruce Unger, stated in July that the agency is examining up to 40 public companies for possible Code violations related to the backdating of stock options.[25]

Moreover, regardless of whether a company suspects that past grant timing issues occurred, any company is well advised to structure practices going forward to avoid the types of issues that may draw IRS attention. The best way to avoid stock option grant timing issues is simply to carefully monitor practices to assure that the grant date for stock options does not precede the date that all corporate actions are completed for the grant of the option. There are several steps that may be taken to facilitate such a compliance initiative. For instance, instituting a practice of only granting options at fixed dates throughout the year will significantly reduce the likelihood of developing timing issues. Additionally, any company would be well advised to develop a general stock option grant policy that, if followed, would ensure that all requisite corporate actions were completed before the grant date specified in the applicable option agreement.

Overall, while the Code provides several traps that are not necessarily easy to avoid under the option granting practices adhered to by many companies in the past, understanding the applicable rules and developing a strategy to implement a compliant policy going forward should eliminate prospective concerns.

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ENDNOTES

1 Unless otherwise indicated herein, all section references are to the Code.

2 As a practical matter, few compensatory stock options have a readily ascertainable fair market value. Generally, an option only has a readily ascertainable fair market value if it is actively traded on an established market. Absent active trading on an established market, an option has a readily ascertainable fair market value only if the option is transferable and immediately exercisable in full, the option's value is not significantly affected by any restriction on the option or the stock to be acquired on exercise, other than a lien or other condition to secure payment of the purchase price, and the fair market value of the option privilege can be measured with reasonable accuracy. This test is rarely met in the case of compensatory stock options.

3 Admittedly, many practitioners felt that, under section 83, creating a significant discount would put an optionee in immediate constructive receipt of the stock option proceeds. For instance, if the stock underlying an option had a fair market value of $100 per share and the exercise price of the stock option was $1.00 per share, many practitioners felt that the ability to receive the underlying proceeds at the time of vesting was so certain that the optionee should be taxed at the time of vesting of the option. Nevertheless, many options were still heavily discounted, with some practitioners relying on a somewhat related analysis by the United States Supreme Court to justify a discount of up to 80% of the value of the underlying stock at the time of grant. *See C.I.R. v. LoBue*, 351 U.S. 243 (1956).

4 For purposes of this article, the term "backdating" is used, interchangeably, to describe the fraudulent practice of selecting an option grant date in the past, as well as the intentional or unintentional failure to adhere to required corporate formalities, resulting in an actual grant date that is later than the putative date of grant on the face of the option.

5 The tax consequences to the holder of an ISO are quite complex. Generally, the optionee has no tax consequences with respect to the receipt or exercise of an ISO; however the amount by which the fair market value of the stock received upon the exercise exceeds the exercise price is generally a tax preference adjustment for purposes of the alternative minimum tax calculation. The tax consequences to the optionee from the sale of stock acquired on the exercise depends upon the length of time from the grant of the ISO to the date of sale and on the length of time from the exercise of the ISO until the date of sale of the underlying stock. If the applicable holding period requirements are met (i.e., two years from grant and one year from exercise), the income realized is taxed at favorable long term capital gains rates; if not, ordinary income is recognized.

6 § 422(b)(4), (d).

7 Treas. Reg. § 1.421-1(c)(1).

8 *Id.*

9 § 422(b).

10 *See* § 421(b) (allowing employer deduction for ISOs disqualified by reason of violating holding period requirements).

11 Although the statute and certain interpretations by the Delaware Court of Chancery suggest that the consent must be signed and filed with the corporate records to be effective, this strict interpretation may be tempered by dicta found in *Kalageorgi v. Victor Kamkin, Inc.*, 750 A.2d 531 (Del. Ch. 1999), *aff'd*, 748 A.2d 913 (Del. 2000).

12 Treas. Reg. § 1.421-3(c)(1).

13 The limitations of section 162(m) do not apply to noncorporate entities.

14 Technically, section 162(m) refers to the four most highly compensated officers of the corporation for the taxable year other than the chief executive officer, although recent changes to Regulation S-K under the Exchange Act and the Securities Act of 1933 may result in a change to the executives for whom disclosure is required in executive compensation disclosures prepared in 2007 and all later years. The IRS has informally indicated that the revised securities disclosure requirements will alter the definition of covered employee under section 162(m).

15 Typically this requisite shareholder approval is obtained with respect to the plan document pursuant to which options are granted rather than with respect to individual awards.

16 Remuneration includes (1) payment to an entity in which the director has a beneficial ownership interest greater than 50%, (2) payment (other than *de minimis* payment) in the preceding taxable year to an entity in which the director has a beneficial interest between 5% and 50%, and (3) payment (other than *de minimis* payment) in the preceding tax year to an entity by which the director is employed as other than a director.

17 *See Hill v. Gani*, C 06 3396 (N.D. Cal. Filed May 24, 2006).

18 However, if a corporation does provide in its deferred compensation plan that any amounts not deductible under section 162(m) will be deferred, the removal of such provision (i.e., to allow nondeductible amounts to be paid to a covered employee) will result in a violation of section 409A and additional taxes to the covered employee.

19 § 409A(a)(2); Prop. Treas. Reg. 1.409A-3.

20 2006-51 I.R.B.

21 Notice 2006-100 specifies that the amount of income includible in a taxpayer's income in 2006 with respect to a discounted option is determined on December 31, 2006. Presumably, this means that December 31 is also the applicable date in 2005 and 2007 and in later years.

22 Where correction involves the modification of the terms of options with the consent of option holders, the applicability of the tender offer rules under the Exchange Act should be considered.

23 2006-43 I.R.B.

24 This design feature would technically fall outside the limitations of section 409A by satisfying the "short term deferral" exception to section 409A.

25 November 8, 2006, Bureau of National Affairs, Daily Tax Report.

NEW TEMPORARY REGULATIONS ADDRESS RELATED PARTY SERVICE TRANSACTIONS

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I. Introduction

Like all transfer pricing issues, transfer pricing for service transactions involves allocating income between related parties. When one related party performs services for another related party, the recipient of such services generally must pay an arm's length charge for such services. This "arm's length" standard is the standard under Section 482,[2] but it is also an international standard applied by most countries.[3]

Illustration 1

OilCo is a U.S.-based multinational oil company. OilCo has wholly owned foreign affiliates that engage in oil and gas exploration activities. OilCo provides to its foreign affiliates technical support for its affiliates oil field drilling operations. OilCo has a department, based in the United States, that is staffed with engineers, geologists, and other professionals as appropriate to provide advice concerning where, how, and when to conduct exploration and drilling operations.

Under Section 482, OilCo must receive arm's length compensation for the services it provides to its foreign affiliates in Illustration 1.

The purpose of the arm's length standard is that related parties generally care about their global profit as a group and may be indifferent as to where such profit is reported. Accordingly, such parties may be motivated to report a larger amount of profit in a jurisdiction where they have a lower tax rate or where they have a loss they would like to utilize. Tax authorities apply the arm's length standard to prevent arbitrary shifting of income by requiring related party transactions to be priced as if they were between unrelated parties. Thus, tax authorities utilize this arm's length standard to prevent tax base erosion.

In recent years, the appropriate treatment of related party service transactions has become one of the critical international transfer pricing issues[4] There are several reasons for this including the following:

1. The use of "management service" allocations has been a traditional means of reducing the income of foreign subsidiary operations, often due to the absence of local withholding taxes on such payments. Tax authorities have become alert to the question of whether actual services and benefits have been provided.[5]

2. Treasury was concerned that the cost-only provisions of the 1968 Regulations could be misused, leading Treasury to produce new guidance in 2003 which drew significant criticism, and revised guidance in 2006, all related to determining whether related party services qualify for cost-only reimbursement under the Treasury Regulations.[6]

3. As the complexity of transfer pricing matters has evolved in recent years, together with the emergence of significant penalties, including the ability to avoid such penalties with the opinion restrictions imposed by IRS Circular 230, documentation requirements, and increased emphasis on corporate controls, multinational groups have sought to develop simplified functional structures. Such arrangements often involve the definition of one controlled entity as the risk-taker and other controlled parties as service providers.[7]

4. The relationship between intangible property transfers and the provision of related party services.[8]

5. The performance of services in the United States for related offshore parties has been a subject of significant controversy in recent years from transfer pricing and related standpoints.[9]

II. U.S. Regulatory Guidance

The existing, final Treasury Regulations addressing related party service transactions were promulgated in 1968 (the "1968 Regulations"). Since the issuance of the 1968 Regulations, cross-border services have become an increasingly large and important segment of the U.S. and global economies. Also, cross-border service transactions make up an increasingly significant segment of cross-border transactions between members of multi-national corporate enterprises.

In September of 2003, the IRS and Treasury Department issued Proposed Treasury Regulations addressing related party service transactions (the "Proposed Regulations").[10] The Proposed Regulations created specified methods for related party service transactions and generally addressed the application of pricing methods for such transactions. In addition, the Proposed Regulations addressed the allocation of income from intangibles and the use or imputation of contingent payment arrangements.

In August 2006, the IRS and the Treasury Department published Final and Temporary Regulations on related party service transactions (the "Temporary Regulations").[11] The Temporary Regulations are generally consistent with the Proposed Regulations and address specified methods for related party service transactions and the application of pricing methods for such transactions. Like the Proposed Regulations, the Temporary Regulations address the allocation of income from intangibles and the use or imputation of contingent payment arrangements, although such matters will not be addressed in this article.[12]

The Temporary Regulations are generally effective for taxable years beginning after December 31, 2006.[13] However, the IRS recently announced that the effective date for the Temporary Regulations will be extended, but the relief will fall short of the one-year extension requested by many taxpayers.[14]

III. Standard for Evaluating the Pricing of Related Party Service Transactions

A. General Rule

Where one member of a group of controlled entities provides services (e.g., marketing, managerial, administrative or technical services) directly or indirectly to another member of such group, the charge for such services must be an arm's length charge.[15]

B. Services Must Provide a Benefit

The traditional distinction between related party services that can and cannot be charged is that the services must provide a benefit to the recipient. A related concept is that so-called stewardship activities may not be charged.

The 1968 Regulations included such terms, and there has been some case law elucidation of the bare provisions of the 1968 Regulations. The Temporary Regulations provide significantly greater specificity, obviously seeking to expand the range of services that may be charged out from U.S.-based multi-national enterprises ("MNEs").

1. Benefit

The Temporary Regulations provide that an activity is generally considered to provide a benefit to the recipient if such activity directly results in a "reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position," or that may reasonably be anticipated to do so.[16] An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity.[17] Furthermore, a benefit may result to the owner of an intangible if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of that intangible.[18]

An activity is not considered to provide a benefit to the recipient if, at the time the activity is performed, the present or reasonably anticipated benefit from that activity is so indirect or remote that the recipient would not be willing to pay, on either a fixed or contingent-payment basis, an uncontrolled party to perform a similar activity, and would not be willing to perform such activity for itself for this purpose.[19] The determination whether the benefit from an activity is indirect or remote is based on the nature of the activity and the situation of the recipient, taking into consideration all facts and circumstances. For example, a study and associated management restructuring may provide efficiency benefits at the parent company level, but only indirect and remote benefits to a foreign subsidiary;[20] whereas, such a study and restructuring directed at a foreign subsidiary may provide such subsidiary with specific and identifiable benefits.[21]

An activity is not considered to provide a benefit to the recipient if it duplicates an activity that is performed, or that reasonably may be anticipated to be performed, by another controlled taxpayer, unless the duplicative activity itself provides an additional benefit to the recipient.[22]

Illustration 2

USCo's in-house legal staff has specialized expertise in several areas, including intellectual property law. ForCo is a wholly owned subsidiary of USCo and is involved in negotiations with an unrelated party to enter into a complex joint venture that includes multiple licenses and cross-licenses of patents and copyrights. ForCo retains outside counsel that specializes in intellectual property law to review the transaction documents. Outside counsel advises that the terms for the proposed transaction are advantageous to ForCo and that the contracts are valid and fully enforceable. Before ForCo executes the contracts, the legal staff of USCo also reviews the transaction documents and concurs in the opinion provided by outside counsel.[23]

Although the benefits provided by USCo's legal staff are clearly duplicative, the Temporary Regulations conclude that such services reduce the commercial risk associated with the transaction in a way that confers an additional benefit upon ForCo.[24] We believe the conclusion reached in this example is misleadingly overbroad, as it is unlikely that an unrelated party in the position of ForCo would pay for the duplicative services provided by USCo's legal staff.

2. Stewardship or shareholder activities

The Temporary Regulations follow the 1968 Regulations and the Proposed Regulations, as well as the OECD Guidelines, and provide that an activity is not considered to provide a benefit to the service recipient if the "sole effect"[25] of the activity in question is to protect the renderer's capital investment in the recipient or in other members of the controlled group, or if the activity relates primarily to compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, where the renderer controls every other member in such group.[26] Activities in the nature of day-to-day management generally do not relate to protection of the renderer's capital investment.[27] Expenses incurred by a parent to enable a foreign subsidiary to pay dividends do not provide benefit to subsidiary,[28] whereas expenses that would increase the subsidiary's profitability would provide such a benefit.[29] Based on analysis of the facts and circumstances, activities in connection with a corporate reorganization may be considered to provide a benefit to one or more controlled taxpayers. [30]

Illustration 3

USCo has a wholly owned subsidiary ForCo. USCo periodically reviews the management and operational results of ForCo. ForCo has adequate staffing to perform such functions as required for its own benefit.

The services provided in Illustration 3 appear to be undertaken for the benefit of USCo (i.e., to preserve, protect, and monitor its investment in ForCo), not for the benefit of the business operations of ForCo. In Illustration 3, it appears that the services are supervisory in nature, because ForCo was adequately staffed. The services also seem to be for the benefit of USCo in its capacity as a shareholder, making a charge for such services inappropriate.[31]

3. Membership in controlled group not a benefit

A controlled taxpayer generally will not be considered to obtain a benefit which arises from the controlled taxpayer's status as a member of a controlled group (a "passive association" benefit).[32] A controlled taxpayer' status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.[33]

IV. Methods for Pricing Related Party Service Transactions

The 1968 Regulations did not have "specified" methods for pricing related party service transactions.[34] This arises from the fact that the regulations haven't been modified since 1968 and were not updated with the other portions of the Section 482 regulations in the mid-1990's, when the various methods for tangible and intangible property (e.g., comparable profits and profit split methods) were added to the regulations. Instead, the 1968 Regulations simply provide that an "arm's length" charge must be made for related party services.[35]

The recently promulgated Temporary Treasury Regulations reference six specified methods that may be used to price related party service transactions.[36] The specified methods are as follows:

1. Services cost method,[37] which is the replacement of the simplified cost based method of the Proposed Regulations and is, frankly, a new and improved adaptation of the cost-only reimbursement for non-integral services in the 1968 Regulations;

2. Comparable uncontrolled services price method,[38] which is an adaptation of the tangible goods comparable uncontrolled price ("CUP") method in the services context and is intended to "run parallel" to the CUP method;[39]

3. Gross services margin method,[40] which is, in effect, an adaptation of the tangible goods resale price method in the services context, principally contemplated to be used in connection with agent services (provided to other members of the affiliate group) or intermediary services (provided to an uncontrolled party through another controlled entity);

4. Cost of services plus method,[41] which is intended to be applicable where the controlled taxpayer provides the same or similar services to controlled and uncontrolled parties (which is the principal situation in which a taxpayer would have access to the gross profit markup in comparable uncontrolled services transactions).[42] In essence, the cost of services plus method is an adaptation of the in the services context of the tangible goods cost plus method. There is a helpful definition of "comparable transactional costs," upon which the cost mark-up is to be applied;

5. Comparable profits method ("CPM"),[43] which is an adaptation of the tangible goods CPM method in the services context. In general, the CPM for services evaluates whether the amount charged in a controlled services transaction is arm's length by reference to objective measures of profitability (profit level indicators) derived from financial information regarding uncontrolled taxpayers that

engage in similar services transactions under similar circumstances. The CPM for services applies only where the renderer of controlled services is the tested party.[44] The common profit level indicator to be used in this regard is suggested to be operating profit to total services costs; and

6. Profit split method,[45] which is an adaptation of the tangible goods profit split method in the services context. The profit split method is "ordinarily used in controlled services transactions involving a combination of non-routine contributions by multiple controlled taxpayers."[46] Specifically, the profit split method applies if a controlled services transaction has one or more material elements for which it is not possible to determine a market-based return.[47]

In addition to the foregoing specified pricing methods, the Temporary Regulations provide that other methods may be used, provided that in applying an unspecified method to services the realistic alternatives to be considered include "economically similar transactions structured as other than services transactions."[48]

The cumulative effect of these provisions is to make available in connection with the transfer pricing of controlled services the analytical tools that are available in connection with the transfer pricing of transfers of tangible and intangible property.

V. Best Method Rule

Under the Treasury Regulations promulgated pursuant to Section 482, there is no strict hierarchy of transfer pricing methods for transfers of tangible or intangible property. Further, particular transaction types are not assigned exclusively to particular methods. Instead, the Treasury Regulations prescribe a more flexible "best method" approach. The best method is the method that provides the most reliable measure of an arm's length result.[49]

The 1968 Regulations did not explicitly incorporate the "best method rule" for related party service transactions. However, the best method rule will be applicable to service transactions under the Temporary Regulations.[50]

VI. Cost Only Reimbursement for Related Party Services

A. Background

Plainly, the most controversial provision of the Temporary Regulations is the new services cost method ("SCM").[51] A central provision of the 1968 Regulations was the allowance of cost-only reimbursement for services that did not meet one of four tests to be treated as "integral" services.[52] The OECD Guidelines do not contain a similar provision explicitly authorizing cost-only reimbursement, unless such is determined to be the arm's length result.

The Treasury and the Internal Revenue Service (the "IRS") have obviously been concerned that MNEs may take advantage of the cost-only provisions of the 1968 Regulations to include services that should bear an arm's length mark-up. In response to this concern, the Proposed Regulations eliminated the "non-integral" test of the 1968 Regulations and replaced it with the "simplified cost-based" method ("SCBM").[53] The SCBM was anything but simple, with its complicated schedule of margins (from 0 to 10 percent) and its confusing requirement to define and select comparable company economic sets matching the schedule. The SCBM was heavily criticized by taxpayers and commentators. The Temporary Regulations eliminate the SCBM in favor of the SCM.

The Preamble to the Temporary Regulations provides a clear explanation of the intention behind the SCM, by reference to underlying U.S. international tax base defense policy, transfer pricing concepts, and the objections to the SCBM set forth in the Proposed Regulations.[54] Specifically, the Preamble to the Temporary Regulations provides that:

> The goal was to provide certainty concerning the pricing of low margin services, thus allowing the compliance efforts of both taxpayers and the Service to concentrate on those services for which a robust transfer pricing analysis is particularly appropriate.[55]

As discussed in the Preamble to the Temporary Regulations, commentators suggested a range of proposed alternatives to the SCBM regime. One was simply to return to the cost only approach in the 1968 Regulations. The Treasury and IRS declined to follow this approach, since the 1968 Regulations are "fairly rudimentary in nature, particularly, in today's tax compliance environment" and open to "substantial manipulation by taxpayers (both inbound and outbound)."[56]

> Moreover, there have been extensive and far-reaching developments in the services economy since the existing regulations were published in 1968, with real prospects that many intragroup services have values significantly in excess of their cost.[57]

Additional proposals by commentators included development of a list of activities that would qualify to be priced at cost or detailed provisions regarding cost sharing arrangements for low value services performed on a centralized basis, and other options.[58]

While the Treasury Department and IRS did not embrace these alternative proposals, they did recognize that the Section 482 services regulations potentially affect a large volume of intra-group back office services that are common across many industries. Accordingly, they determined that it would be in the interest of good tax administration to minimize the compliance burdens applicable to such services, especially to the extent that the arm's length markups are low and the activities do not significantly contribute to business success or failure.[59]

The Preamble to the Temporary Regulations states, and restates, that the fundamental purpose of the SCM, and the intention of the Treasury and IRS, is to facilitate a focus of transfer pricing compliance resources of both taxpayers and the IRS principally on "significant valuation issues."[60] Accordingly, it is anticipated that in most cases the examination of relevant services will focus only on verification of total services costs and their appropriate allocation.[61]

B. Temporary Regulations: Services Cost Method

Under Temp. Treas. Reg. § 1.482-9T(b), there are two categories of covered services that are eligible for the SCM if the conditions on application of the method are met. In essence, these categories are low risk and low margin services. If services fall into a covered service category, the services may be charged at cost with no markup.

Unlike the 1968 Regulations, the Temporary Regulations set a relatively low eligibility threshold requiring only that the

taxpayer reasonably conclude in its business judgment that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or businesses of the renderer, the recipient, or both. The business judgment rule refers to the reasonable business judgment of the taxpayer, not the tax examiner.[62]

1. Specified Covered Services

The first category consists of specified covered services identified in a revenue procedure published by the IRS.[63] According to the Preamble to the Temporary Regulations, the services identified in this revenue procedure will "constitute support services of a type common across industry sectors and generally do not involve a significant arm's length markup on total services costs."[64] These services will be "back office services typical within multinational groups."[65] The list of specified covered services is not intended to be an exclusive list but, instead, is intended to be a representative sample of traditional back office services.[66] Moreover, IRS officials recently announced that the list of services eligible to be charged at cost would be revised in order to address taxpayer concerns that there were "too many holes" in the list of covered services.[67] The comments by taxpayers, commentators and the Treasury – IRS on the list of specified covered services reflects the fundamental problem with administering transfer pricing by utilizing a list, as the subtleties of specific arrangements between taxpayers will be glossed over creating the potential for less principled and logical results.

2. Low Margin Covered Services

The second category of covered services is certain "low margin covered" services. "Low margin covered services consist of services for which the median comparable arm's length markup on total services costs is less than or equal to seven percent."[68] This is an incredibly broad safe harbor provided by the Treasury Department and IRS. According to Treasury and IRS officials, the Treasury Department and IRS do not expect taxpayers to run comparable sets to establish that services meet the 7% safe harbor.[69]

3. Applicable Conditions

Under Temp. Reg. § 1.482-9T(b)(3), there are only two conditions imposed on taxpayers to comply with SCM qualifications;

i) Adequate books and records

ii) Not Excluded Services

Under Temp. Reg. § 1.482-9T(b)(3)(i), taxpayers must maintain adequate books and records of their covered services transactions. Such records must include: a statement evidencing the intention to apply the SCM, a description of the services in question, identification of the renderer and recipient, and sufficient documentation and adequate detail to permit verification of the total services costs incurred and methods used to allocate and apportion such costs.

Under Temp. Reg. § 1.482-9T(b)(3)(ii), the same list of controlled transactions that are <u>not</u> eligible to be priced under the method as under the proposed SCBM. The list of Excluded Transactions is as follows:

(1) Manufacturing;
(2) Production;
(3) Extraction, exploration or processing of natural resources;
(4) Construction;
(5) Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement;
(6) Research, development, or experimentation;
(7) Engineering or scientific;
(8) Financial transactions, including guarantees; and
(9) Insurance or reinsurance.

In the Preamble to the Temporary Regulations, the Treasury Department and the IRS indicate that the foregoing excluded services "tend to be high margin transactions, transactions for which total services costs constitute an inappropriate reference point, or other types of transactions that should be subject to a more robust arm's length analysis under the general section 482 rules."[70]

4. SCM Election

Under Temp. Reg. § 1.482-9T(b)(3)(i), a single procedural requirement applies under the SCM. The taxpayer must maintain documentation of covered services costs and their allocation and a statement evidencing the taxpayer's intention to apply the SCM. According to Treasury and IRS officials, the expression of intention to apply the SCM can occur at any time up to litigation.[71] However, Treasury and IRS officials have indicated that it would be appropriate to include such an election in the taxpayer's annual documentation.[72] It is important to note that the SCM is an elective method.[73]

5. Comments

In essence, the SCM is a more specific, and precise implementation of the cost only provisions of the 1968 Regulations. This method was promulgated for the purpose of facilitating efficiency in the deployment of resources on behalf of both taxpayers and the IRS, completing their compliance and examination functions, respectively. This was achieved by providing an efficient mechanism for addressing and providing certainty for the pricing of low margin services. In our judgment, this goal has been admirably achieved.

There has been rather strident criticism of the SCM, as requiring exactly what the Treasury and the IRS were seeking to avoid – namely, unnecessary quantification of risks and functions, with consequent need to produce various ranges of comparability sets for each discrete service. With all due respect, such criticism seems entirely misplaced.

We conducted a relatively simple comparable search of several of the specified covered services identified under the Service's Announcement 2006-50, and the results of that search indicate that the median margins for such services are well below the seven percent threshold established under the Temporary Regulations. Such a finding would seem to suggest that the Treasury and IRS were fairly generous in setting a relatively low bar for admission into the SCM. It should be noted that the comparable sets chosen were relatively large "unbiased" sets with few "qualifications" or conditions as should likely be the case of "routine" back office services.

Covered Services	Q1	Med.	Q3
HR	-1.8%	2.2%	7.4%
Computer Support	-11%	2.3%	8.8%

Network Support	-6.7%	1.8%	6.4%
Database services	1.6%	2.9%	6.0%

C. Shared Services Arrangements

One suggestion with respect to the Proposed Regulations had been that the final services regulations should embrace the concept of the OECD Guidelines concerning, in essence, the use of cost sharing concepts with respect to related party services.[74] The concept is straightforward. As MNEs continually globalize their operations, the elimination of duplicative functions is critical, inevitably leading to increased use of central services arrangements (for all types of functions).

For example, assume a U.K.-based MNE decides to centralize its call center activities in a certain location, closing all other facilities in the world. Tax authorities in countries where call centers are closed may perceive that intangible property has been removed from their tax base and deposited in the new central call center location. In this situation, the OECD Guidelines embrace cost-sharing or contribution principles for transfer pricing purposes, which, in essence, are that the services are shared for the overall benefit if the group for the purpose of reducing costs. Accordingly, the transfer pricing method should be cost sharing with no markup. Such shared service, or central service, arrangements are common in contemporary Advance Pricing Agreement and Competent Authority cases.

The 1968 Regulations antedated the OECD Guideline provisions. Accordingly, the suggestion was that the Treasury and IRS should embrace the OECD principles as a means of achieving the object of simplifying the compliance process on both sides of the table and coordinating with the OECD.

This invitation was accepted in the Temporary Regulations, which provide explicit guidance on shared services arrangements (“SSAs”).[75] In general, an SSA must:

1. Include two or more participants;

2. Include as participants all controlled taxpayers that benefit from one or more covered services subject to the SSA; and

3. Be structured such that each covered service (or group of covered services) confers a benefit on at least one participant. A participant is a controlled taxpayer that reasonably anticipates benefits from covered services subject to the SSA and that substantially complies with the SSA requirements.[76]

Under an SSA, the arm’s length charge to each participant is the portion of the total costs of the services otherwise determined under the SCM that is properly allocated to such participant based on its respective share of the reasonably anticipated benefits from the arrangement.[77]

For purposes of an SSA, two or more covered services may be aggregated, provided that the aggregation is reasonable based on the facts and circumstances, including whether it reasonably reflects the relative magnitude of the benefits that the participants reasonably anticipate from the services in question.[78] Such aggregation may, but need not, correspond to the aggregation used in applying other provisions of the SCM. Interestingly, the Preamble provides that if the taxpayer reasonably concludes that the SSA (including any aggregation for purposes of the SSA) results in an allocation of the costs of covered services that provides the most reliable measure of the participants’ respective shares of the reasonably anticipated benefits from those services, then “the Commissioner may not adjust such allocation basis.”[79]

VII. Conclusion

The Temporary Regulations are, in broad strokes, consistent with the 1968 Regulations, though there is a significant expansion of the details of determining the arm’s length charge for a controlled services transactions. The creation of specified methods for pricing services and the specific application of the best method rule represent a welcomed enhancement of the guidance provided in the 1968 Regulations.

The evolution of the cost-only rules of the 1968 Regulations to the SCM of the Temporary Regulations simply reflects the serious tax base defense concerns of the Treasury and IRS with respect to significant transfer pricing matters, as well as their interest in facilitating compliance and efficient examination of the normal range of routine matters.

On balance, we believe that the Temporary Regulations reflect a commendable effort by the IRS and Treasury to simplify what has become a complex area transfer pricing, from both substantive and compliance standpoints. Perhaps predictably, the reaction of commentators has tended to be critical of certain elements of the Temporary Regulations, especially the new SCM.[80] In particular, commentators have suggested that utilization of the SCM will require extensive functional and comparable analysis. We believe such criticism of the SCM is entirely misplaced, as the stated intention of the SCM is to alleviate both the IRS and taxpayers from the burdens of significant analysis and documentation related to low risk services. The IRS and Treasury have made this point crystal clear and suggestions to the contrary invite suspicion of motivations unrelated to actual compliance with the Temporary Regulations.

We believe the Temporary Regulations reflect a thoughtful effort to evolve traditional U.S. and OECD concepts to address the transfer pricing issues that exist in the economic environment at the beginning of the 21st Century. In any event, the debate concerning the Temporary Regulations will reflect an interesting collaborative effort of taxpayers, practitioners and the Treasury – IRS to find approaches that are mutually acceptable, as well as in compliance with U.S. treaty obligations and the OECD Guidelines.

ENDNOTES

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2 Unless otherwise indicated, Section references are to the Internal Revenue Code of 1986, as amended.

3 See “United States Model Technical Explanation Accompanying the U.S. Model Income Tax Convention of Nov. 15, 2006,” Preamble and ¶ 9, No. 221 BNA Daily Tax Rept. (Nov. 16, 2006).

4 E.g., “Ernst & Young Transfer Pricing 1999 Global Survey: Practices, Perceptions, and Trends for 2000 and Beyond,” 19 Tax Notes Int’l 1907 (Nov. 15, 1999) (intercompany services continue to be viewed by multi-national enterprises as the transactions most susceptible to transfer pricing disputes worldwide).

5 “Ernst & Young Global Transfer Pricing Update — January 2002,” 25 Tax Notes Int’l 343 (Jan. 28, 2002) (survey of tax authorities

around the world indicates that the pricing of intercompany services, and in particular administrative/managerial and technical services, is the type of intercompany transaction that is most likely be audited and adjusted by tax authorities).

6 The ability to take advantage of the cost-only safe harbor under the Treasury Regulations is discussed below.

7 See Lowell, Briger & Martin, U.S. International Transfer Pricing ¶ 6.02[6] (WG&L 2004) ("U.S. International Transfer Pricing").

8 See U.S. International Transfer Pricing ¶ 5.07.

9 See U.S. International Transfer Pricing ¶ 5.07.

10 Fed. Reg. Vol. 68, No. 175, p. 53447.

11 T.D. 9278.

12 For coverage of these issues, see U.S. International Transfer Pricing ¶¶ 5.05[9] and 6.06[c].

13 Temp. Treas. Reg. § 1.482-9T(n).

14 Wright, "IRS to Revise List of Services Chargeable at Cost, Delay Temporary Regulations' Date," No. 233 BNA Daily Tax Reporter page G-4 (Dec. 5, 2006).

15 Treas. Reg. § 1.482-1(b).

16 Temp. Treas. Reg. § 1.482-9T(l)(3)(i).

17 For example, a benefit may be provided by a global advertising campaign, Temp. Treas. Reg. § 1.482-9T(l)(5), Example 1.

18 Temp. Treas. Reg. § 1.482-9T(l)(3)(i).

19 Temp. Treas. Reg. § 1.482-9T(l)(3)(ii).

20 Temp. Treas. Reg. § 1.482-9T(l)(5), Example 2.

21 Temp. Treas. Reg. § 1.482-9T(l)(5), Example 3.

22 Temp. Treas. Reg. § 1.482-9T(l)(3)(iii). Treasury functions performed by a parent and a foreign subsidiary will not be duplicative, Temp. Treas. Reg. § 1.482-9T(l)(5), Example 4, but will be if the subsidiary performs similar functions for itself. Temp. Treas. Reg. § 1.482-9T(l)(5), Example 5.

23 Temp. Treas. Reg. § 1.482-9(l)(5), Example 6 (legal services).

24 Id.

25 Temp. Treas. Reg. §1.482-9T(l)(3)(iv). In the Preamble to the Temporary Regulations, it is noted that the language in the 2003 proposed regulations had been "primary" effect, which was changed to the "sole effect" rather than the "primary effect" of an activity to clarify that a shareholder activity is one of which the sole effect is either to protect the renderer's capital investment in one or more members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements specifically applicable to the renderer, or both. This conforms to the general definition of benefit in Temp. Treas. Reg. §1.482-9T(l)(3)(i).

26 Temp. Treas. Reg. § 1.482-9T(l)(3)(iv). See Temp. Treas. Reg. § 1.482-9T(l)(4), Example 7 (financial information required by securities or corporate laws of parent country are shareholder activities); compare Temp. Treas. Reg. § 1.482-9T(l)(4), Example 8 (financial information required by securities or corporate laws of parent country also utilized by subsidiary in its country not shareholder activity).

27 Temp. Treas. Reg. § 1.482-9T(l)(5), Example 13 (personnel activities are day-to-day management and provide benefit to foreign subsidiary).

28 Temp. Treas. Reg. § 1.482-9T(l)(5), Example 10.

29 Temp. Treas. Reg. § 1.482-9T(l)(5), Example 12.

30 Temp. Treas. Reg. §1.482-9T(l)(3)(iv).

31 Id.

32 Temp. Treas. Reg. § 1.482-9T(l)(3)(v). Temp. Treas. Reg. § 1.482-9T(l)(5), Example 15 (ability to get contract due to membership in group not a benefit).

33 Temp. Treas. Reg. § 1.482-9T(l)(3)(v). See Temp. Treas. Reg. § 1.482-9T(l)(5), Example 16 (guarantee of performance is a benefit); Temp. Treas. Reg. § 1.482-9T(l)(5), Example 17 (newly acquired foreign subsidiary receives contract after acquisition by group, receives a benefit); Temp. Treas. Reg. § 1.482-9T(l)(5), Example 19 (group membership taken into account to determine comparability).

34 See Preamble to Proposed Regulations addressing related party service transactions promulgated on September 5, 2003. 68 Fed. Reg. 53448. The 1968 Regulations also do not explicitly incorporate the "best method rule," although the best method rule would be applicable to service transactions under the Temporary Regulations. Temp. Treas. Reg. § 1.482-9T(a).

35 Treas. Reg. § 1.482-2(b).

36 Temp. Treas. Reg. § 1.482-9T(a).

37 Temp. Treas. Reg. §1.482-9T(b). The services cost method is discussed in detail below.

38 Treas. Reg. §1.482-9T(c).

39 See T.D. 9278 (the "Preamble to Temporary Regulations") at A.2.

40 Temp. Treas. Reg. §1.482-9T(d).

41 Temp. Treas. Reg. §1.482-9T(e).

42 See Preamble to Temporary Regulations at ¶ A.4.

43 Temp. Treas. Reg. §1.482-9T(f).

44 See Preamble to Temporary Regulations at ¶ A.5.

45 Temp. Treas. Reg. §1.482-9T(g).

46 See Temp. Treas. Reg. §1.482-9T(g)(1).

47 See Preamble to Temporary Regulations at ¶ A.6.

48 See Temp. Treas. Reg. §1.482-9T(h).

49 Treas. Reg. § 1.482-1(c)(1).

50 Temp. Treas. Reg. § 1.482-9T(a).

51 Treas. Reg. §1.482-9T(b).

52 See U.S. International Transfer Pricing ¶ 6.04[3].

53 Prop. Treas. Reg. § 1.482-9(f); see U.S. International Transfer Pricing ¶ 6.06[5][b].

54 See Preamble to Temporary Regulations ¶ A.1.a.

55 Id.

56 Id.

57 Id.

58 Id.

59 See generally "Branch 6 Chief Clarifies Application of Cost Method, Other Aspects of New Temporary Services Regulations," 15 BNA Transfer Pricing Rep. 338 (Sep. 13, 2006).

60 See Preamble to Temporary Regulations ¶ A.1.b.

61 Id.

62 Wright, "IRS to Revise List of Services Chargeable at Cost, Delay Temporary Regulations' Date," No. 233 BNA Daily Tax Reporter page G-4 (Dec. 5, 2006).

63 See Announcement 2006-50, 2006-34 I.R.B.

64 Preamble to Temporary Regulations ¶ A.1.b.

65 Id.

66 Nutt, "Tax Officials Comment on U.S. Transfer Pricing Services Regs," 2006 WTD 204-1 (Oct. 23, 2006).

67 Wright, "IRS to Revise List of Services Chargeable at Cost, Delay Temporary Regulations' Date," No. 233 BNA Daily Tax Reporter page G-4 (Dec. 5, 2006).

68 Preamble to Temporary Regulations ¶ A.1.b; Temp. Treas. Reg. § 1.482-9T(b)(4)(ii).

69 Nutt, "Tax Officials Comment on U.S. Transfer Pricing Services Regs," 2006 WTD 204-1 (Oct. 23, 2006).

70 Preamble to Temporary Regulations ¶ A.1.b.

71 Nutt, "Tax Officials Comment on U.S. Transfer Pricing Services Regs," 2006 WTD 204-1 (Oct. 23, 2006).

72 Id.

73 Wright, "IRS to Revise List of Services Chargeable at Cost, Delay Temporary Regulations' Date," No. 233 BNA Daily Tax Reporter page G-4 (Dec. 5, 2006).

74 See generally "Branch 6 Chief Clarifies Application of Cost Method, Other Aspects of New Temporary Services Regulations," 15 BNA Transfer Pricing Rep. 338 (Sep. 13, 2006).

75 See Temp. Treas. Reg. § 1.482-9T(b)(5).

76 Id.

77 See Temp. Treas. Reg. § 1.482-9T(b)(5)(ii)(B). Examples illustrate these concepts. See Temp. Treas. Reg. §§ 1.482-9T(b)(6), Example 18 (centralized data processing); Example 19 (human resources); Example 20 (human resources, headcount allocation method); Example 21 (human resources, transaction volume allocation method)

78 See Temp. Treas. Reg. § 1.482-9T(b)(5)(iii)(B).

79 See Preamble to Temporary Regulations at ¶ A.1.c.

80 See U.S. International Transfer Pricing ¶ 6.06[6][b][ix].

TEXAS PROPERTY TAX LAW DEVELOPMENTS

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DEBTORS REORGANIZING IN BANKRUPTCY MAY NOT ADJUST THE INTEREST RATE ON A TAX LIEN TRANSFER LOAN; ATTORNEY'S FEES TO ENFORCE COLLECTION OF A LOAN IN BANKRUPTCY ARE RECOVERABLE WITHIN THE LIMITATIONS SPECIFIED IN THE PROPERTY TAX CODE.

In re: Davis, No. 06-41279-RFN-13 (N.D. Tex., August 30, 2006). (to be published).

Taxpayer borrowed money from lender to pay property taxes and agreed to pay 18% interest on the loan. As a part of the transaction, the tax lien was transferred to the lender from the tax office. Taxpayer filed for Chapter 13 protection under the Bankruptcy Code and filed a plan seeking to repay the loan at an 8.5% interest rate rather than the contractual 18% rate. The lender filed an objection to the plan, and the court ruled that Section 511 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provides that interest rates on both tax claims owed to tax offices and tax loans made by private lenders are to be determined under state law, not bankruptcy law. Since 18% interest is allowed under the Property Tax Code for such loans, taxpayers are required to repay loans at the higher rates allowed by state law. The court further found that attorney's fees, subject to the Property Tax Code's 15% limitation, are recoverable in bankruptcy proceedings on objections to plans.

PARTY APPEALING TAX MASTER'S DETERMINATION IN A DELINQUENT TAX CASE MAY NOT BYPASS THE DISTRICT COURT AND RESERVE PORTIONS OF AN APPEAL FOR REVIEW BY A COURT OF APPEALS; IN A MULTIPARTY CASE, A NON-APPEALING DEFENDANT RISKS UNFAVORABLE CONSEQUENCES BY FAILING TO APPEAR AT TRIAL BEFORE THE DISTRICT COURT.

Hebisen v. Clear Creek Independent School District, No. 14-04-00983-CV (Tex. App. –Houston [14th Dist.] October 10, 2006, no pet. h.). (to be published).

Tax office sued to collect delinquent personal property taxes from multiple individuals sharing an office suite. The individuals defended on the grounds that they did not owe the taxes. Trial was held before a Tax Master who ruled in favor of the tax office. One of the defendants filed an appeal, and attempted to limit the grounds of review by the district court. Upon hearing, the district court upheld the Tax Master's ruling and added two more years of delinquency to the judgment, applying that ruling to all parties in the suit, not just the individual who appealed. The "appealing" defendant sought review from the Court of Appeals of portions of the Tax Master's determination that were not considered by the district court, claiming that the district court was not required to rule on them because of the limited nature of the appeal. The non-appealing defendant challenged the right of the district court to increase his tax liability since he had accepted the Tax Master's determination. The court of appeals held that a district court has jurisdiction to consider all matters in an appeal from a Master's ruling, and that a party may not bypass the district court and seek review from a court of appeals of a Master's findings. By failing to present those matters to the district court, the party waived his right to seek review of those matters from the appellate court. It further held the district court has the right to review, accept, reject or modify a Master's ruling, and that it had the right to add subsequent years to the original determination. Had the non-appealing party appeared at trial, he could have objected to the court's consideration of this evidence as being beyond the scope of the limited appeal. By failing to appear, the non-appealing party waived his rights to complain of the increased amount of the judgment.

IF A PARENT COMPANY OF AN OWNER OF AN APARTMENT COMPLEX IS A COMMUNITY HOUSING DEVELOPMENT ORGANIZATION (CHDO") AND HAS THE RIGHT TO COMPEL TRANSFER OF THE APARTMENT COMPLEX TO ITSELF, IT IS THE EQUITABLE OWNER OF THE PROPERTY AND MAY QUALIFY THE PROPERTY FOR EXEMPTION FROM TAXATION; THE STATUTORY AMENDMENT REQUIRING 100% OWNERSHIP OF A GENERAL PARTNER BY A CHDO WAS INTENDED TO LIMIT THE PARTIES WHO COULD QUALIFY FOR EXEMPTION.

TRQ Captain's Landing L.P. v. Galveston Central Appraisal District, No. 01-05-00496-CV (Tex. App. – Houston [1st Dist.] October 5, 2006, no pet. h.). (to be published).

A limited partnership owned an apartment complex. A community housing development corporation ("CHDO") set up a limited liability company and through it acquired a 100% interest in both the general and limited partner of the limited partnership. Title to the complex remained in the limited partnership. The limited liability company filed for a community housing exemption for the property, and was denied. The court held that the exemption should have been granted since the CHDO was the equitable owner of the complex because it possessed the present right to compel the delivery of legal title to itself as the 100% owner of all of the underlying entities. It further ruled that the statutory amendment requiring direct 100% ownership of a general partner by a CHDO was intended to limit, not expand, the number of entities who could qualify for this exemption, and applied only to properties that were constructed after December 31, 2001. Properties constructed before that date qualify for exemption so long as a CHDO owns the general partner either legally or equitably.

EXHAUSTION OF ADMINISTRATIVE REMEDIES BEFORE AN APPRAISAL REVIEW BOARD IS JURISDICTIONAL; A DISTRICT COURT HAS JURISDICTION TO CONSIDER A MATTER ON APPEAL NOTWITHSTANDING THE FAILURE TO MARK A GROUND OF PROTEST ON A NOTICE OF PROTEST FORM IF THE APPRAISAL REVIEW BOARD CONSIDERED THE MATTER AND RULED ON IT.

Midland Central Appraisal District v. Plains Marketing, L.P., No. 11-06-00048-CV (Tex. App.–Eastland, September 21, 2006, no pet. h.). (to be published).

An oil marketing company filed a notice of protest challenging an appraisal of oil on the grounds of excessive value and unequal treatment. At the appraisal review board hearing, the representative of the district noted that the real nature of the dispute was whether the oil qualified for interstate commerce exemption, but that the taxpayer had not marked this ground on its notice of protest. The representative objected to the appraisal review board's consideration of this unprotested ground. All of the testimony and argument at the hearing

pertained to whether the property qualified for the exemption. The appraisal review board denied the protest, and the taxpayer sued in district court for exemption. The appraisal district sought dismissal of the suit on the grounds that the taxpayer had failed to exhaust administrative remedies due to its failure to properly mark the notice of protest form. The court of appeals held that exhaustion of administrative remedies is jurisdictional, and that a taxpayer may not allege one ground at the appraisal review board and then appeal to district court on an entirely separate ground. However, given the fact that the appraisal review board considered the matter and ruled on it, jurisdiction was proper before the district court. The court stated that the appraisal review board had the right to refuse to consider the testimony on the grounds that it was beyond the scope of the written notice of protest or that it could have continued the hearing so as to allow the appraisal district sufficient time to prepare for a hearing on those grounds.

A TAXPAYER MAY NOT SEEK RECOVERY OF ATTORNEY'S FEES UNDER THE DECLARATORY JUDGMENT ACT IN AN APPEAL OF AN APPRAISAL REVIEW BOARD DETERMINATION UNLESS THE TAXPAYER IS CHALLENGING THE CONSTITUTIONALITY OF A STATUTE OR RULE OR THAT THE DISTRICT IS IMPROPERLY EXERCISING POWERS RESERVED TO ANOTHER ENTITY; AWARD OF ATTORNEY'S FEES TO A PREVAILING TAXPAYER IS MANDATORY UNDER THE PROPERTY TAX CODE.

Aaron Rents, Inc. v. Travis Central Appraisal District, No. 03-05-00171-CV (Tex. App. –Austin, September 8, 2006, no pet. h.). (to be published).

Appraisal district sent omitted property notice after taxpayer filed belated amnesty rendition. Taxpayer claimed on summary judgment that no property had been omitted, only value and that the valuation was illegal. The district court granted the motion for summary judgment but denied the taxpayer's claim for attorney's fees. The court of appeals held that a taxpayer may not recover attorney's fees under the Declaratory Judgment Act in an appeal of an appraisal review board determination because the Property Tax Code provides a remedy for such matters. However, a taxpayer may recover fees under the Act if the taxpayer is challenging the constitutionality of a statute or rule or claiming that the appraisal district or appraisal review board is exercising powers reserved to another entity. The court held that the award of attorney's fees to a prevailing taxpayer, in a valuation or equity dispute, is mandatory under the Property Tax Code.

ENDNOTES

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FLIGHT RISK: TEXAS TAX ISSUES IN BUSINESS AND PRIVATE AVIATION

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Introduction

A variety of practical, economic and other factors have contributed to a worldwide increase in business and private aviation. These factors include its relative convenience and flexibility, security issues, delays in major airports, the availability of smaller business airports and hubs, and the recent introduction of a new class of lower-cost entry level "very light jet" by some aircraft manufacturers.

At the same time, the legal and tax aspects of private aircraft ownership, management and flight operations have become increasingly complex. These issues are governed by laws and different agencies, jurisdictions and other concerns with distinct, and sometimes inconsistent, underlying policies, rules and duties.

The following will provide an overview of basic Texas tax rules governing aircraft as well as some selected recent developments affecting this area.

Regulatory Overview

For aircraft owners, the choice of ownership structure and operations requires knowledge and analysis of Federal Aviation Administration ("FAA") and Department of Transportation ("DOT") regulatory considerations, for which noncompliance may bring severe sanctions. The FAA's rules and policies generally focus on ownership, maintenance, operational control, safety, training, and other issues designed to identify and ensure regulation and oversight of the operator and the safe operation of aircraft. The DOT's rules and policies generally address economic, truth-in-advertising and insurance concerns. In addition, however, the owner and his advisors must also assess many other liability, economic, privacy and insurance issues and concerns that are not all directly within the purview of the FAA and DOT rules.

Aircraft ownership and operation also involve significant federal tax considerations. Federal law imposes an excise tax on the commercial transportation of persons or property."[2] Federal tax laws also impose significant limitations on or that may affect the deductibility of operating expenses and depreciation deductions of private aircraft for income tax purposes, including the passive loss limitations of Section 469 of the Internal Revenue Code[3], the hobby loss/profit objective rules of Section 183[4], and limitations on the personal use of business aircraft by family members.[5] While a full discussion of these limitations is beyond the scope of this article, it can be said that securing and maximizing current business deductions for private and business aircraft can be problematic in many situations, especially for owner-pilots who desire to use the aircraft in recreational or personal travel or who intend to transfer operational control of the aircraft to a charter operator by lease.

Finally, many states impose state and local sales, use, property and business taxes or registration fees and fuels taxes on, or indirectly affecting, aircraft and their ownership, maintenance, repair and operations. Because aircraft are by definition moveable property, and their owners often have flight operations or contacts in more than one place, the tax analysis often can involve more than one jurisdiction. The states, and even localities, vary widely in their tax treatment of aircraft, aviation, and related activities such as repair and maintenance. Some states are more "aviation-friendly" in their

treatment of aircraft ownership and operation than are others. For example, a few states exempt aircraft from sales taxes altogether or cap the taxes at a low rate, while others generally treat aircraft in a manner similar to all other tangible property with few special rules.

The stakes are high because the cost of even the most inexpensive private aircraft can result in a significant and sometimes unexpected state or local tax exposure. Many aircraft brokers and some aircraft manufacturers may not have an office or claim sufficient "nexus" in Texas as an ultimate destination state to be required to collect its sales or use taxes. Aircraft owners and their advisers often must address these issues directly with the taxing authorities when taxes are not collected at the time of an aircraft purchase and no exemption applies. Further, aircraft owners may move aircraft to Texas or establish locations in Texas that may change hangar and maintenance needs.

Texas is among the states that do not currently impose registration fees on aircraft, and there are several specific, but relatively narrow, aviation-related statutory provisions and administrative interpretations that are favorable to some taxpayers. Nonetheless, the generally applicable sales and use tax, ad valorem/property tax and business margin tax each may still affect the aircraft owner in significant ways, depending on the form of ownership structure, the nature of operation and use and the situs of the aircraft.

Terminology

It is helpful first to provide a few definitions, concepts and distinctions that are used in business aviation and by aircraft owners.

As used in this discussion, "aircraft" will include any device intended for flight in the air, and includes not only fixed wing aircraft, but helicopters unless indicated otherwise. If an aircraft is to be used in private aviation without carrying persons or property for compensation or hire, that is often referred to as a "Part 91" operation, from the FAA regulations governing those operations. The typical example would be use by an individual of his own aircraft for recreation, personal travel, or travel connected with the individual's own business or investment. It could also include use by a corporation or other business entity of its own aircraft for reasons connected with the business of the corporation or its owners.

An aircraft may also be operated for purposes of charter, i.e., the transportation of persons or property for compensation or hire, or leased by the aircraft owner to another party who will use the aircraft for that purpose. For a "corporate sized" aircraft, this is typically referred to as a "Part 135" charter operation, again, in reference to the applicable FAA regulations. These regulations impose additional and generally more stringent duties and responsibilities, and a Part 135 certification of both the aircraft and the charter operator by the FAA is required.

Finally, scheduled US commercial air carriers, using aircraft such as Fokker 100s and larger, are governed by Part 121 of the FAA regulations. This article will not address scheduled commercial air carriers in detail. It is important to note, however, that both Part 121 and Part 135 operations generally are subject to the federal excise tax on transportation. Similarly, under the Texas sales tax laws, discussed more fully below, certain exemptions apply only to a "licensed and certificated carrier of persons or property." This concept is defined to include not only Part 121 commercial carriers but also Part 135 charter operators, as under the applicable FAA statute and rules, both types of operators are in fact specifically defined as "air carriers" certificated by the DOT to conduct commercial operations (see 49 USC § 40102).

While there are other FAA classifications and provisions applicable to special activities such as crop dusting, tours, emergency medical flights, flight simulation, training and instruction and the like, some of which are subject to special tax rules in Texas and other states, most private aircraft purchasers will generally intend to fall within Part 91 or Part 135 operations.

Another important—and frequently misunderstood—definition in the aviation industry segment deals with leasing operations. The FAA's rules define a "wet lease" (in part) as "any leasing arrangement whereby a person agrees to provide an entire aircraft and at least one crewmember." [6](The definition, unfortunately, has nothing to do with whether or not the aircraft is leased with fuel, which leads to much of the industry confusion on this point.) Conversely, a "dry lease" is the lease of an aircraft without a crew member of any kind. The significance of these definitions is that, as a general rule, the presumption under the FAA's rules is that a wet lease is a commercial operation that must be conducted under Part 135, while a dry lease is presumed to be a non-commercial operation, and therefore may be operated under Part 91.

Aircraft are unique assets in that their ownership generally must be registered with the FAA. Unlike automobiles, which typically are registered in one state, ownership changes of aircraft, wherever title may pass, generally must be registered centrally with the FAA's aeronautical center in Oklahoma City. This information is accessible to the public and to all taxing authorities who may be interested in the ownership of a particular aircraft bearing a certain unique and visible six-character "tail number" such as N999XY. For that reason, aircraft owners sometimes may wish to have record ownership of aircraft in a special purpose entity, or in an equipment trust treated as a grantor trust for federal tax purposes for privacy reasons.

A number of different and unique ownership structures and agreements have been developed to address the sometimes competing objectives of those involved in business and private aviation and their regulators and insurers. For example, one such form of ownership is "fractional ownership." As specifically defined and regulated under the FAA's rules, fractional ownership programs involve multiple aircraft co-owners who contract with a management company to maintain and manage the aircraft and who share expenses and are entitled to certain usage of the plane under various interconnected agreements. The FAA, Internal Revenue Service, and state taxing authorities have not treated these arrangements in a uniform manner for regulatory, excise tax and state tax purposes.

Texas Sales and Use Tax-General Rules.

In general, aircraft are tangible personal property. The sale of an aircraft in Texas accordingly is subject to the Texas sales tax unless another generally applicable or specific exemption applies. This is in contrast to certain other transportation property, such as locomotives, rolling stock, and vessels in excess of eight tons displacement, which are specifically exempted by statute from the Texas sales and use tax.[7] As with other assets, the tax applies to the purchase price of aircraft, but does not include the value of any aircraft taken as a trade-in. Thus, if a Texas individual or entity

purchases an aircraft in Texas, hangars it in Texas, and intends to use the aircraft in Part 91 operations, the Texas sales tax, which is up to a total of 8.25% in state and local components, generally applies to the transaction.

If an aircraft is purchased out of state, but brought into Texas within one year of purchase, the Texas compensating use tax still applies to the transaction. Many states have sales tax exemptions for aircraft purchased in a state and removed within a certain period of time, sometimes informally referred to as “fly away” exemptions.[8] If an aircraft is purchased in another state under a fly away exemption and removed from the state within the applicable period of time, no sales tax generally should be due to in the state of purchase or delivery. If, however, an aircraft purchased under a fly away exemption is then moved into and hangared in Texas, the Texas use tax is due. If not collected by the seller, as often is the case when the seller is a nonresident broker or manufacturer or the aircraft is delivered out of state, the aircraft buyer remains responsible for reporting and remitting the tax. If sales tax was lawfully paid to another state, credit may be given against the Texas tax for the other state’s tax.

In most cases, labor charges to repair, remodel, maintain or restore a “private aircraft” (i.e, one other than a certificated carrier as discussed below) are not taxable, and a non-separated lump sum charge for labor and parts is not taxable. Separately stated parts charges are, however, generally taxable.[9]

As moveable property, issues sometimes arise as to whether an aircraft is subject to Texas use tax. For example, Texas owners also may for various reasons elect to hangar their aircraft outside Texas. The Comptroller’s rules provide that an aircraft purchased outside of Texas is subject to Texas use tax (unless another exemption applies) if it is hangared in Texas, or if it used more than 50% inside Texas.[10] All flight logs and records may be examined for this purpose. In determining whether an aircraft is “hangared” in Texas, the Comptroller may consider where the aircraft is rendered for property tax purposes, declarations made to the FAA and other taxing authorities, and whether the owner owns or leases hangar space in Texas.[11] Moreover, simply purchasing and holding an aircraft in a non-Texas entity but then bringing and using the aircraft within the state for a sufficient period of time may also trigger the requirement to pay the use tax. Conversely, however, Texas tax is not due on aircraft sold to a person for use and registration in another state or nation before any use (other than training or flying the aircraft out of Texas) in Texas.[12]

Similarly, the lease of an aircraft is generally subject to Texas sales tax, unless another exemption, such as the exemption for “certificated carriers”, discussed below, applies. If an aircraft is provided with a pilot, however, as would generally be the case in a wet lease, this is generally considered a nontaxable transportation service for Texas sales tax purposes. This is a specific application of the general principle that equipment transferred or leased with an operator is not subject to tax but is the provision of a nontaxable service.[13] Thus, for example, if a charter operator provides an aircraft and crew to a user in a Part 135 operation, sales tax is not normally due. As noted above, however, the provision of transportation service by the Part 135 operator generally is subject to the federal excise tax on transportation services.

Aircraft are also not per se excluded, however, from any of the generally applicable exemptions from the sales and use tax, such as the “sale for resale”[14] and occasional sale[15] exemptions. Thus, if an aircraft is purchased for resale by a person holding a valid sales tax permit for resale, or re-lease, to others in the ordinary course of business, the purchaser may claim a resale exemption on its purchase of the aircraft. The lease payments may or may not be taxable, as discussed above. Aircraft may also be exempt as an occasional sale of the operating assets of a business or identifiable segment of a business.

The principal aircraft-specific exemption in Texas sales tax law is found in Section 151.328 of the Texas Tax Code.[16] That section exempts aircraft “sold [or leased] to a person using the aircraft as a licensed or certificated carrier of persons or property.” The exemption also applies to parts incorporated into a carrier. An administrative rule provides that this term includes “a person authorized by the appropriate United States agency . . . to operate an aircraft . . . as a common or contract carrier transporting persons or property for hire in the regular course of business.”[17] Thus, in most cases a sale or lease of an aircraft to a certificated carrier, as would be the case for a Part 135 charter operator, would be exempt. Similarly, a purchase of an aircraft for immediate resale or release to a certificated carrier prior to any divergent use of the aircraft, should be exempt as a sale for resale, followed by an exempt lease to a carrier.[18]

As with all tax exemptions, the certificated carrier exemption is narrowly construed and caution should be taken to insure compliance. For example, in Quorum Sales, Inc. v. Sharp[19], a Texas law firm purchased an aircraft and represented to the seller that it would be used “for charter under FAA Part 135” and no sales or use tax was paid. Several months later, the law firm did in fact enter into an agreement with a charter operator and placed the aircraft on the charter operator’s certificate. Nonetheless, the court held that the original sale was not exempt because the law firm did not hold Part 135 status based on its intent to place the aircraft with the charter operator and it was not itself a certified carrier. While this result may conceivably be avoided with proper use of the resale exemption, sometimes charter certification is a time-consuming process.

Texas Sales and Use Tax-Current Developments

As noted above, one unique form of aircraft ownership is fractional ownership. In a 2000 tax policy memorandum[20], the Comptroller considered an aircraft fractional ownership arrangement in which a management company would oversee a pool of aircraft. The company administered the aircraft on behalf of all participants, including all administrative details and maintenance, hiring of crew and operation, under interconnected agreements. The memorandum noted that the FAA has treated fractional ownership as non-commercial transportation, but the Internal Revenue Service has ruled that for excise tax purposes are more in the nature of commercial transportation because the owners have surrendered possession, command and control of the aircraft. The memorandum concluded that under the facts stated, the participants were contracting for a nontaxable service, and that the arrangement did not constitute a taxable sale or lease to the participants, even if the charges for a pilot or other labor were separately stated. The reasoning of the fractional ownership policy would not, however, apply to all forms of aircraft co-ownership, and the Comptroller has indicated that tax is due if the co-owners fly the aircraft themselves or directly hire or fire the flight crew.[21]

The Comptroller of Public Accounts recently released a significant policy statement regarding the use of so-called “transitory entities” to avoid Texas sales tax on aircraft

purchases (or other types of personal property as well), attempting to impose a business purpose test in some cases, and revoking an earlier policy that had appeared to support such transactions.[22] The letter expresses concern that some taxpayers would form a single purpose transitory entity to acquire an aircraft tax free outside Texas, but then quickly would liquidate or merge the entity and bring the aircraft into Texas, taking the position that no sales or use tax is due. The letter concludes that "[i]f the method of transfer(s) of an aircraft, or other tangible personal property, does not have a business purpose other than tax avoidance, then the transitory entity should be ignored and use tax should be assessed accordingly." The letter did provide a transition or grandfather-type provision by stating that this analysis would be applied only to transactions that had not been completed before December 1, 2006.

Property Tax

As is the case with the sales and use tax, aircraft are not specifically exempted from property taxes as a class of asset. Personal property held or used for the production of income must be rendered annually to the applicable appraisal district. Aircraft are subject to property taxation if they are held or used for the production of income. Even if they are not held for use in the production of income, local jurisdictions may tax even personal non-business aircraft on a local option basis.[23] Relatively few local jurisdictions (and none of the state's largest cities), however, do so as of this writing.

As with other types of personal property, issues sometimes arise as to whether an aircraft has taxable "situs" in a particular taxing jurisdiction. It is clear that an aircraft may have taxable "situs" in a county even if it is not physically present in the county on January 1.[24] As with other tangible property, Texas has jurisdiction to tax aircraft if it (i) located in the state for more than a temporary period, (ii) temporarily located outside this state and the owner resides in Texas or (iii) used continually, whether regularly or irregularly in this state.[25] If an aircraft is regularly hangared in a county, for example, it generally will be subject to tax in that jurisdiction.

Given the cost and significant fair market value of private aircraft, the annual property tax can be significant. An annual tax on 100% of an aircraft's value annually without any apportionment could be cost prohibitive for many owners. This factor alone may encourage some individual aircraft owners to claim that an aircraft is not held or used for the production of income, even if it means loss of federal tax deductions based on business usage.

Sections 21.055 and 21.05 of the Tax Code[26], now do permit an allocation of the value of aircraft based on the ratio of Texas departures to total departures, which may help reduce the total tax on business aircraft. Section 21.055, which applies to "business aircraft," and Section 21.05, which applies to "commercial aircraft", contain different formulas and mechanisms for this allocation, so great attention should be paid to which of these two rules applies to the operator and aircraft and to obtaining the necessary allocation with applicable local appraisal districts.

Franchise/Margin Tax

While it is not specifically directed at aviation, the new Texas franchise or margin tax[27] adds another level of analysis to planning for aircraft ownership. If an aircraft is to be owned by a taxable entity other than an individual, or the other limited types of entities exempt from the tax, and the entity is chartered in or doing business in Texas, the entity may be subject to the margin tax at applicable rates on its gross revenues allocated to Texas. Further, aircraft leasing or operations, even if conducted at an operating or federal income tax loss, as they sometimes are, may still generate significant gross revenues, and thus potential margin tax exposure. It is not unusual, for example, for the lease payments in a dry lease structure to reflect the debt service on the purchase financing for the aircraft.

Many special purpose or closely held entities owning aircraft will be not be subject to margin tax liability if their annual revenues are less than $300,000[28], but others, either in isolation, or as a member of an affiliated group required to file a consolidated margin tax return, will be subject to the tax on the revenues from aircraft leasing or flight operations. The effect of margin tax exposure should be considered and monitored for all aircraft-owning entities chartered in or otherwise doing business in Texas and receiving revenue.

Conclusion

The trend toward increased private and business aviation is expected to continue, and along with it a specialized and sometimes complicated regulatory and business environment. Federal and state tax factors make aircraft ownership planning more complex.

While owning a business aircraft in a special purpose entity and leasing it to a charter operator or related entity sometimes may be advantageous for liability and sales tax reasons, it may not necessarily be the best result for federal income tax purposes. For example, while an aircraft purchaser may be able to claim a resale exemption on purchase of the aircraft for sales tax purposes, and possibly eliminate tax on the lease payments under the certificated carrier exemption if the lessee is a Part 135 operator, it may cause the losses associated with the depreciation and expenses of the aircraft to become "passive losses" for federal income tax purposes under Section 469 of the Internal Revenue Code as the rental of tangible personal property. In addition, such a structure can still create regulatory issues. Another common structure adopted by some owners with the goal of limiting liability and providing favorable tax treatment is to simply own and operate the aircraft through a sole or special purpose entity. However, such a structure, while sometimes advantageous from a tax or liability perspective, can raise significant regulatory and civil liability concerns.[29]

Careful advisors should examine the full matrix of these issues and balance the trade-offs involved to achieve desired objectives with a minimum of surprises where possible. Federal and state tax obligations should also be considered and their economic and reporting obligations be addressed in contractual agreements governing aircraft operations. There is no "one size fits all" structure when it comes to business and private aviation.

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2 I.R.C § 4261.

3 See Rev. Rul. 2005-64, 2005 I.R.B. 600 (September 26, 2005).
4 See, e.g., *Rabinowitz v. Commissioner*, T.C. Memo. 2005-188.
5 See I.R.S. Notice 2005-45, 2005-24 I.R.B. 1228 (June 13, 2005).
6 14 C.F.R. § 119.3
7 Tex. Tax Code Ann. §§ 151.329 (vessels); 151.331 (locomotives and rolling stock).
8 See. e.g., 68 Oklahoma Statutes §§ 1355, 1357, 6001 and 6002.
9 34 Tex. Admin. Code §3.297(i).
10 Id. § 3.297(c)(3).
11 Id. § 3.297(c)(4).
12 Id. § 3.294(c)(9).
13 Id. § 3.294(c)(2).
14 Tex. Tax Code Ann. § 151.302.
15 Id. § 151.304; see also 34 Tex. Admin. Code § 3.316.
16 Tex. Tax Code Ann. §151.328; see also Tex. Admin. Code §3.297.
17 Tex. Admin Code §3.297(a)(1).
18 For an interesting variation, see Taxability Memorandum 200302754L (February 24, 2003) (Part 135 charter operator owned by two related companies did not make divergent use of aircraft purchased tax-free when the two companies used the aircraft in Part 91 operations where the two companies paid same rates as charter customers).
19 910 S. W. 2d 59 (Tex. App.-Austin 1995, writ denied).
20 Tax Policy Memorandum 200011036L (November 9, 2000).
21 *Aircraft and the Texas Sales and Use Tax*, Texas Comptroller of Public Accounts Publication no. 94-168 (March 2006).
22 Letter to Otis Fields, Manager, Audit Division from Bryant Lomax, Manager, Tax Policy Division, no. 200611755L, November 15, 2006. The letter provides that Letter 9502L1333G03 (February 7, 1995) "and similar documents" are being superseded.
23 Tex. Tax Code Ann. §11.14.
24 See, e.g., *Jet Fleet Corporation v. Dallas County Appraisal District*, 773 S. W. 2d 744 (Tex. App.-Dallas 1989, no writ)
25 Texas Tax Code Ann. § 11.01(c).
26 Id. §§ 21.05, 21.055.
27 Id. § 171.001 et seq.
28 Id. §§ 171.002(d)(2).
29 *See* David T. Norton, *Don't Put Your Client's Shiny New Corporate Jet Into A Sole-Asset L.L.C. (Unless You Really Want to Create an Airline)* 65 Texas Bar Journal 314 (2002).

REPRESENTING INCOME TAX NON-FILERS

E. Rhett Buck[1]

There are important criminal and civil issues facing federal income tax return non-filers, including what to do to avoid criminal liability, and what to do about the large tax debts that usually result from the filing of a group of delinquent returns, or from the IRS's assessment of tax under its own substitute for return (SFR) filing procedures.

Willful Failure to File

Under Internal Revenue Code (IRC) § 7203, the government can prosecute for willful failure to file income tax returns. This type of prosecution is relatively rare. Most non-filer cases are resolved without resort to criminal prosecution. But where there are egregious indications of "willfulness", IRS criminal investigations can lead to indictment, conviction, fine and incarceration.

The three elements of the offense of willful failure to file, each of which must be proven by the government beyond a reasonable doubt, are as follows:

- The defendant was a person required to file a return.
- The defendant failed to file at the time required.
- The failure to file was willful.

The requirement to file an individual income tax return is based on the taxpayer's gross income, so to sustain its burden of proof the government must show that the taxpayer had the requisite amount of gross income.[2] This may be proven by direct or indirect methods, such as analysis of bank deposits, or analysis of the taxpayer's assets, debts, income and expenses.

Clients often do not understand how a criminal liability for their own failure to file could apply to them. Usually, they did not intend purposely, or make an affirmative decision, not to file. Often, they just have not given a priority to filing the returns. Illness, medical problems, emotional difficulties, divorce, alcohol and drug abuse, mental illness, or even just very busy lifestyles and careers intervene, and once they have gotten behind, they may not file subsequent years currently, because they owe returns for the prior years.

However, the facts and circumstances as to why the taxpayer is late in filing do bear on the important question of willfulness. The Internal Revenue Manual (I.R.M. § 4.19.1.6.12.2) lists the factors considered in deciding to make a criminal referral:

- History of nonfiling (3 years or more of unfiled returns).
- Repeated contacts by the Service.
- Indication of knowledge of the filing requirements (i.e., professional with an advanced education, or a person who works directly in the tax field).
- Age and occupation of the taxpayer.
- Substantial tax liability after credits and payments.
- Large number of cash transactions.
- Indications of significant unreported income.

Willfulness

Willfulness is a state of mind. It is a "voluntary, intentional violation of a known legal duty." [3] The IRS does not need to prove an evil motive or a bad purpose, such as intent to cheat or defraud the government.[4] Criminal intent is proved when the government shows that the taxpayer's nonfiling was "voluntary and purposeful and with the specific intent to fail to do that which he knew was required."

Proving willfulness is the biggest challenge facing the government in criminal tax prosecutions. Because taxpayers seldom make clear, unambiguous inculpatory statements about their intent, the IRS must prove intent through indirect evidence.

Tax Evasion

Violations of IRC § 7203 are misdemeanors with a maximum sentence of one year per count. If a taxpayer's willful failure to file returns can be shown to be part of a scheme to evade tax, the government can prosecute for the felony offense of tax evasion under IRC § 7201. The punishment is a $100,000 fine ($500,000 for a corporation) and/or five years imprisonment.

Felony tax evasion can be charged if, in addition to the failure to file itself, the government can prove certain "affirmative

acts." Affirmative acts constituting evidence of tax evasion, which can aggravate a misdemeanor nonfiling case into a felony tax evasion case, include:

- Making of false statements,[5] especially false W-4s reducing or eliminating the withholding of taxes on the defendant's wages.[6]
- Placing assets in others' names.
- Dealing in currency.
- Paying other creditors instead of the government.[7]• Lying to IRS agents.[8]
- Laundering money or moving funds offshore.[9]

Probably the most quoted list of actions evidencing an affirmative, willful attempt to evade tax was presented by the Supreme Court:[10]

> . . . keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal.[11]

Voluntary Disclosure Policy

From time to time a taxpayer will decide to correct his non-filing before he gets caught. This can be safely accomplished under the IRS and Department of Justice "voluntary disclosure" policies. The basic rule is a prosecution will not be pursued if a non-filer (with income from legal sources only) corrects his past mistakes by filing his delinquent returns before investigation by the IRS Criminal Investigation Division.[12]

A voluntary disclosure occurs when the communication is truthful, timely, complete, and:

a. the taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and
b. the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.[13]

The disclosure is not timely if the IRS has already initiated an investigation, or if the taxpayer is aware of some event that is likely to lead to such an investigation.

Note that not paying the tax in full is not an impediment to a voluntary disclosure. It is sufficient if the taxpayer "makes arrangements with the IRS to pay the tax."[14] This could include an installment payment plan agreement, an offer in compromise, or other reasonable and cooperative method to deal with the liability.

Note also that even if it is too late to take advantage of the safe harbor of the voluntary compliance program, it may still be possible to file returns, get in filing and payment compliance, and show the IRS investigators that the facts giving rise to their investigation may be explained or justified in a sufficient way to avoid a criminal referral.

Preparing to Make the Disclosure

The previous discussion makes clear that filing missing returns before the IRS goes after the taxpayer can mean the difference between simply filing the missing returns and dealing with the tax payment problem, or being prosecuted and sent to jail (and/or heavily fined). Therefore, it is of utmost importance to get the voluntary disclosure process moving as soon as possible. Methods to start voluntary disclosure:

1. Request Freedom of Information Act (FOIA) request from local Disclosure Office.
2. Request transcript record of accounts for all possible missing return years and Information Returns of Payers (IRP's) for each missing return year.

In addition to information from the IRS, the practitioner will also need information from the client, and possibly from his employers, banks and brokers. It may also be necessary to rely on reasonable, good faith estimates for some items.

Period of Retroactive Compliance

For its own administrative reasons, the IRS generally will demand tax returns going back only six years. Managerial approval, based on consideration of various factors (history of non-compliance, illegal income, amount of income, time and effort required, and other special circumstances that may apply), is required if an agent wishes to pursue enforcement activity for anything more than a six year retroactive compliance period.[15]

Interest and Penalties

Once the missing returns are prepared, they will show how much tax is owed. Interest and penalties, however, must be calculated so that the full magnitude of the client's problem will be known. Numerous penalties can be asserted against nonfilers, including the late filing penalty, late payment penalty, and civil fraud penalty.

However, penalties can be waived by showing that the late filing or late payment was due to "reasonable cause and not willful neglect." It is therefore important to gather and fully document any facts that might support a reasonable cause argument. The greatest problem facing most non-filers in securing relief from the delinquency penalties is their long history of noncompliance.

Filing Status

Determining the appropriate filing status for the returns of married taxpayers requires analysis.

Taxpayers can always amend from separate returns to a joint return, but taxpayers cannot amend the other way. The decision to file married filing jointly is irrevocable. Consideration of the limitations to claim innocent spouse may suggest separate returns. Also, whether the tax is owed jointly or only by one spouse has important consequences when it comes to resolving the liabilities through bankruptcy, an offer in compromise, payment plans, or other collection alternatives, including consideration of IRS collection powers against community property assets and incomes, and protective use of post-nuptial agreements.

Time-Barred Refunds

The taxpayer may be due a refund for at least some of the years for which returns are un-filed, except that these refunds may be time-barred. The IRS cannot issue a refund if a claim

(here, the tax return itself) is not filed by the later of three years from the return due date or two years from the date of payment. This rule prohibits not just a refund check, but also crediting the overpayment against underpayments in other tax years.

Because of the harsh effect of the statute of limitations on refunds, tax professionals should check for any possible statute of limitations bar dates at the initial meeting with the client, and ask that those (usually most recent) returns be filed first, before the bar date.

IRS Substitute for Return Procedures

The IRS focuses on finding non-filers and bringing them back into the tax system, while prosecuting some extreme cases so that the resulting publicity will foster "voluntary compliance." The IRS identifies non-filers primarily by matching W-2s, 1099s and K-1s to taxpayer accounts.

These substitute for return (SFR) procedures are sometimes thought of as the IRS preparing the delinquent taxpayer's returns, although legally-speaking, the SFR may not qualify as a "return." Just as it is best to correct the non-filing before a criminal investigation starts, it is also advisable to file the missing tax returns before an SFR assessment is made. SFR assessments are often wrong. For example, the IRS gives the taxpayer credit for only one personal exemption and the standard deduction. They also take income from 1099's and K-1s, while ignoring expenses or losses. Additionally, the IRS does not have information on substantial itemized deductions, additional personal exemptions, or loss carry-forwards. Moreover, the IRS will often include the income reported by a broker on Form 1099-B, but since the IRS does not know the taxpayer's basis, it will use a cost basis of zero.

Avoiding SFR's can be crucial if the taxpayer later seeks relief in bankruptcy. Under Bankruptcy Code (BC) §523(a), an income tax debt is dischargeable in a Chapter 7 case only if the bankruptcy petition is filed more than two years after the filing of the tax "return" for that year, but a delinquent tax return given to the IRS after an SFR assessment has been made is not considered a tax "return."

Therefore, it is best to file the returns as soon as possible, prior to IRS criminal investigation activity, and before the IRS can prepare SFR's. Typically, the client'

ENDNOTES

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2 *See U.S. v. Wade*, 585 F.2d 573 (5th Cir. 1978).

3 *Cheek v. U.S.*, 498 U.S. 192 (1991).

4 *U.S. v. Moylan*, 417 F.2d 1002 (4th Cir. 1969).

5 *U.S. v. Callanan*, 450 F.2d 145 (4th Cir. 1971).

6 *U.S. v. DiPetto*, 936 F.2d 96 (2d Cir.), *cert. denied* 502 U.S. 866 (1991).

7 U.S. v. Shorter, 809 F.2d 54, 57, (D.C. Cir.), *cert. denied*, 484 U.S. 817 (1987).

8 *U.S. v. Brimberry*, 961 F.2d 1286, 1291 (7th Cir. 1992).

9 *U.S. v. Voorhies*, 658 F.2d 710, 712 (9th Cir. 1981).

10 *Spies v. U.S.*

11 317 U.S. 492,499 (1943).

12 I.R.M. § 9.5.3.3.1.2.1, IRS News Release IR-2002-135.

13 *See Id.*

14 *See Id.*

15 I.R.M. § 9.5.3.3.1.2.1.

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