The Texas Tax Lawyer

February 2008
Vol. 35, No.1
www.texastaxsection.org

2007

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CHAIR'S MESSAGE

I'm back—rockin' and rollin' and ready to tell you about what's shakin' in the Section!

We are having such a good year thanks to all of you that are helping us execute on our goals, programs and projects. I'm going to single out a few folks for some special mention later in this letter, but let's talk about those "goals" for a minute.

Our Statement of Direction (if you'd like to review it again, log onto www.texastaxsection.org and click on "Statement of Direction") provides that our goals are focused on

- Education—Providing world-class education to our members through accessible and relevant CLE
- Better Laws—Working towards improving the substance and administration of state and federal tax laws.
- Pro Bono—Working towards delivering the knowledge and experience of our members to those people who cannot afford the services of tax lawyers
- Enhanced Profile—Working towards enhancing the profile of our members within the tax community, including Treasury, the Internal Revenue Service, the Comptroller and practitioners, so as to benefit Section members by furthering the national respect for, and credibility of, Texas tax lawyers
- Having Fun

On the *Education* front, under the dynamic leadership of Tina Green we continue to deliver two Webcasts per month on various tax topics, all available at extremely competitive prices and delivered straight to your PC. In addition, our special programs—the Texas Federal Tax Institute, the Advanced Tax Program, the International Tax Symposium and others—provide wonderful opportunities to obtain live CLE and to mix and mingle with our fellow members and many tax luminaries. Finally, our thrice yearly publication of articles, forms and other items in *The Texas Tax Lawyer*, under the able guidance of Alyson Outenreath, provides timely articles on a variety of topics, both in hard copy and now in an e-mailed version.

Regarding *Better Laws*, Mary McNulty is raising the volume and quality of our administrative comments and legislative input to a level matched only by the New York State Bar and the American Bar Association Section of Taxation. Since last I wrote to you, we have submitted additional comments on the proposed reportable transactions regulations that bear on patented transactions and have had very significant involvement in helping the Comptroller address the cost of goods sold definition under the new Texas margin tax rules. I will be traveling to Washington later this month to testify regarding the former matter, and we are very close to issuing detailed comments on the carried interest proposed legislation, the zero basis proposed regulations and proposed regulations regarding the merger of defined benefit plans.

Our *Pro Bono* activities continue to grow, both in our continued funding of Texas C-Bar and our efforts to provide representation to taxpayers who find themselves before to the United States Tax Court. As with so many duties she has handled for the Section, Elizabeth Copeland is doing a stellar job with these and other projects designed to help our community. In addition, with the guidance of Professor Bill Streng and under the leadership of Bob Griffo, we are once again reaching out to students at our Texas law schools to show them the joys and challenges of a career as a tax lawyer. This is an especially rewarding activity, and if you'd like to be involved just e-mail Bob at bgriffo@andrewskurth.com.

There is no better evidence of an *Enhanced Profile* for our Section and its members that the fact that we have received almost three times as many nominations this year for our *Outstanding Texas Tax Lawyer* award as in prior years. I personally believe that the combination of the quality of the prior recipients of that award, the deepening penetration of our Webcast initiative, and the steady input we are providing to Congress, Treasury, the Service and the Comptroller's office in our comment activities has led very directly to this increase in nominations. It appears that being known as an *Outstanding Texas Tax Lawyer* has become an honor worth the effort of nominating worthy candidates. I couldn't be more proud.

And, finally, rest assured we are *Having Fun*. I am convinced that the key to making friends in our busy adult lives is finding something to DO together, and I believe that the deepest of those friendships arise from joint efforts on endeavors of meaning. Notwithstanding what my kids tell me about Internet relationships, you cannot create a true friendship by "friending" someone online. Rather, friendships come from an investment of time and energy in people who will do the same. My very, very best friends made since college days are those people—like you—that I have worked with in religious and community endeavors, and particularly in focused, meaningful Bar work at the local, state and national level. If you haven't experienced that in Section of Taxation work, then I invite you to do so.

Because we still need more laborers in the vineyard. There is even more we do on the CLE, COGS and pro bono front, but we can't do it without more of you showing up when the whistle blows.

So be ready—when I send you an e-mail asking for help, don't hesitate. Just say yes!

And be making plans to attend our Annual Meeting in Houston on June 27. It's become a great place to get some quick and valuable CLE and to reconnect over lunch with colleagues from around the state. As a further treat, you can witness my parting oration and help celebrate the dawn of a new administration led by my good friend, and very able Chair-Elect, Dan Micciche. Without Dan, Secretary Tyree Collier and Treasurer Patrick O'Daniel, the many goals we have and are meeting would have remained mere wishes.

You'll only have to put up with me for a few more months and one more issue of this publication. I'll have a lot to report—and even more to say—in my final letter to you.

Your Chair,
Kevin

UNDERSTANDING SECTION 409A OF THE CODE: A LOOK BACK AT ENRON'S NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS

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I. Introduction

Go to nearly any seminar ("***CLE***") on the nonqualified deferred compensation ("***NQDC***") tax rules under section 409A of the Internal Revenue Code of 1986, as amended (the "***Code***"), and there is bound to be a statement about Enron Corp. ("***Enron***"). In this context, the CLE usually begins with a statement crediting (or, more to the point, blaming) Enron as a reason for the enactment of the complicated rules of Code section 409A, as well as the promulgation of regulations and other guidance thereunder (collectively, "***Section 409A***"). This statement is correct, in that Section 409A was a response to the abusive features and activities that were associated with Enron's NQDC arrangements.[2] However, the CLE almost never includes any discussion on what these abuses were (this is probably a function of the complexity of Section 409A and the need of the CLE's speaker to discuss its rules during a limited time period). Given that Section 409A was designed to prevent such abuses from happening again, it would be interesting to know more about the abuses associated with Enron's NQDC arrangements.

As a supplement to those CLEs that make a passing reference to Enron, this article analyzes Section 409A within the context of Enron's primary NQDC program in effect at the time of Enron's collapse, known as the "Enron Corp. 1994 Deferral Plan" (the "***1994 Plan***").[3] Because there are a number of articles which collectively cover most of the details and nuances of Section 409A, this article focuses more on the general rules of Section 409A and how those rules relate to the 1994 Plan. Accordingly, this article is designed to shed more light on the history, intent, operation and effectiveness of Section 409A, rather than add to the articles that already discuss the detailed inner workings of Section 409A.

II. Background

A. Differentiating Between Qualified and Nonqualified Deferred Compensation.

Deferred compensation arises when a payment of compensation is delayed for more than a brief period after the compensation is earned (compensation is earned when the services giving rise to the compensation are performed).[4] Certain deferred compensation arrangements ("***qualified plans***") that are designed to provide retirement income mostly to rank-and-file employees receive tax-favored treatment.[5] Such qualified plans include (among other things) "401(k)" plans, profit sharing plans and defined benefit plans. These plans must meet a series of specific and detailed requirements under Code section 401(a) and the Employee Retirement Income Security Act of 1974, as amended ("***ERISA***").[6] These requirements under the Code and ERISA have the effect of providing a number of protections to plan participants. For instance, under the Code and ERISA, qualified plan benefits must be funded in accordance with detailed funding rules; also, vested benefits must not be subject to forfeiture (i.e., once an employee earns the right to receive the benefit, the right to receive that benefit is permanent and cannot be revoked).[7] The tax-favored treatment for qualified plans (among other things) allows employers to take tax deductions for contributions to qualified plans.[8] Such deductions may be taken for the same taxable year in which the contributions are made to the plan.[9] An employee participating in a qualified plan also receives tax benefits, because employees are not treated as receiving compensation (and taxable income) at the time contributions are made to the trust forming part of the plan.[10] Instead, the employee is considered to receive taxable income at the time such contributions in the trust (and earnings thereon) are distributed to the employee.[11]

NQDC arrangements ("***nonqualified plans***" or "***arrangements***") are simply arrangements that do not constitute qualified plans.[12] Because nonqualified plans are not subject to the requirements affecting qualified plans, the parties to the arrangement have more flexibility with respect to the arrangement's design.[13] Nonetheless, nonqualified plans are usually designed as unfunded, unsecured promises to pay NQDC, such that benefits under the arrangement are paid from the general assets of the employer.[14] In addition, nonqualified plans often provide NQDC benefits to highly compensated employees ("***executives***"), to the exclusion of rank-and-file employees. Since these arrangements do not constitute qualified plans, employers usually take deductions at the time NQDC under the plan is paid to an executive, which is the same time the executive is considered to receive taxable income.[15] Thus, similar to qualified plans, nonqualified plans provide individuals (i.e., employees/executives) with the tax benefit of deferred taxation, which lasts until the time of payment (however, this tax benefit under a nonqualified plan comes without the protections that are afforded to qualified plan participants).

B. A Brief Summary of Section 409A.

Section 409A was enacted on October 22, 2004.[16] Section 409A basically governs how NQDC may be deferred and paid, provided that the NQDC is earned or becomes vested on or after January 1, 2005 (the "***Effective Date***").[17] Basically, an individual's NQDC becomes vested when the executive has a legally enforceable right to receive the NQDC and that right is not subject to a "substantial risk of forfeiture."[18] For these purposes, NQDC is treated as being subject to a substantial risk of forfeiture if the individual's rights to such compensation are conditioned upon the performance of substantial services by the individual.[19]

The Effective Date is important, because a grandfathering rule applies to NQDC that is earned and vested prior to such time. Under this grandfathering rule, NQDC that is earned and vested prior to the Effective Date is not subject to Section 409A, so long as the arrangement is not modified after October 3, 2004, to provide the payee with enhanced benefits, rights or features.[20]

In addition, Section 409A only applies to its definition of NQDC.[21] Under Section 409A, an amount is considered to be NQDC if it is (or may be) earned by the employee during one taxable year and it is (or may be) payable to the employee in a later taxable year.[22] However, for purposes of Section 409A, a deferral of compensation does not occur when the amounts are paid within the same taxable year (or within 2 ½ months after the end of the taxable year) in which the compensation is no longer subject to a "substantial risk of forfeiture."[23]

Section 409A sets forth a series of detailed requirements that apply to the form and operation of nonqualified plans. Because these requirements apply to the form and operation of nonqualified plans, both the actual terms and the operation of those arrangements must comply with Section 409A's requirements.[24] However, pursuant to transitional relief under Section 409A, companies and nonqualified plan participants have until the close of 2008 to correct any terms in arrangements that do not comply with Section 409A (so long as the arrangements are operated in accordance with Section 409A in the meantime).[25] If an arrangement fails to satisfy these requirements (either on an operational basis or after the transitional relief expires), then the NQDC under the arrangement is subject to regular income tax, plus a 20% penalty tax and interest charges (basically, resulting in a 50-60% tax on the deferred compensation), regardless of whether such NQDC is paid to the executive.[26]

Section 409A includes rules on the timing of initial deferral elections, as well as elections to make subsequent changes to the time and form of NQDC payments.[27] Section 409A also includes rules regarding the times and events on which payments of NQDC can be made, and nonqualified plans are required to specify which of those times and/or events will apply to particular awards of deferred compensation.[28] In addition, payments of NQDC generally may not be accelerated to a time prior to the times and/or events that are specified in a nonqualified plan.[29]

III. DISCUSSION

A. Relevant Provisions and Practices under the 1994 Plan.

Accelerated Distributions. After the collapse of Enron in the fall of 2001, certain actions related to Enron's nonqualified deferred compensation programs were scrutinized. These actions generally involved the payment of NQDC ("***accelerated distributions***") to certain Enron executives in the weeks leading up to Enron's collapse. Those accelerated distributions were made at the request of those executives pursuant to the (amended) terms of the 1994 Plan, and the distributions were paid prior to the regularly scheduled times for payment under the plan. During this time period, there were 181 requests for accelerated distributions, and 117 executives received a total of $53 million in accelerated distributions.[30]

The 1994 Plan was amended in 1997 to permit such requests for accelerated distributions (subject to the consent of the committee responsible for administering the plan).[31] Pursuant to this amendment, whenever an executive requested an accelerated distribution, the executive would be required to forfeit 10% of the requested distribution amount (this feature is sometimes referred to as a "***haircut***").[32] Accordingly, 90% of the requested distribution amount would be paid as an accelerated distribution under the 1994 Plan (*e.g.*, if the executive requested a $100,000 accelerated distribution, the executive would receive $90,000, so long as the committee responsible for administering the plan granted the executive's request).[33] In addition, upon the occurrence of such an accelerated distribution, the recipient would not be eligible to participate in the Plan for a 36-month period following the distribution.[34] The 1994 Plan's haircut and participation limitations (as well as Enron's then-perceived financial successes) likely explain why no accelerated distributions were made in 1998, 1999 or 2000.[35]

Accounts, Deferrals and Earnings. The payment of $53 million in accelerated distributions would not have been possible, but for the high amounts of NQDC that was deferred pursuant to the 1994 Plan. Based on the account balances of the Enron executives participating in the 1994 Plan, approximately $154 million in NQDC was deferred pursuant to the 1994 Plan as of the end of 2000.[36] Although there were account balances under the 1994 Plan, these accounts were not funded (although there was a funded "rabbi trust" in place, as discussed below); instead, the accounts were used merely for recordkeeping purposes in order to measure and determine the amount of NQDC to be paid to each participant (and benefits were paid from the general assets of Enron).[37] Accordingly, these recordkeeping accounts reflected the amount of NQDC deferred by each participant ("***deferrals***"), as well as any earnings on those deferrals (1994 plan participants were offered a few deemed investment choices for calculating how earnings would be credited to their deferrals).[38]

Depending on the election made by a participant, such deferrals were comprised of (i) between 25% and 35% of the participant's base salary, (ii) up to 100% of his or her annual bonus and (iii) up to 100% of certain incentive compensation payments.[39] Under the 1994 Plan, participants could make an irrevocable written election to defer these amounts.[40] Plan participants were required to make this election prior to the first day of the calendar year in which these amounts would otherwise be earned and payable.[41] The Plan also permitted certain participants to defer the receipt of shares of Enron stock attributable to the exercise of stock options ("***stock option gains***") and the vesting of restricted stock ("***restricted stock gains***").[42] To defer stock option gains, the participant was required to make an irrevocable written deferral election prior to the year of exercise and at least six months prior to exercise.[43] A similar election was required to defer restricted stock gains based on the vesting date for the restricted stock.[44] Under such elections, the participant specified when the gains were to be paid (i.e., death, disability, retirement or termination of employment).[45]

Distributions. Distributions under the 1994 Plan generally could be made upon a participant's retirement, disability, death or termination of employment. Participants could elect to receive these distributions in a lump sum or in annual installments over a period not exceeding 15 years.[46] The 1994 Plan was amended to allow participants to change these payment elections on both a retroactive and going-forward basis ("***subsequent elections***").[47] These subsequent elections could be made anytime, but would not be effective until one full calendar year after receipt of the applicable subsequent election form.[48] Distributions also were available upon request following a participant's hardship (such as accidents, illness, large theft and fire losses, severe financial reversals and large personal judgments). The committee administering the 1994 Plan had the sole discretion to grant these hardship distribution requests.[49] As the financial situation of Enron began to deteriorate, many participants made hardship distribution requests claiming that Enron's deteriorating financial condition was causing a hardship for the participants (none of those hardship distribution requests were granted).[50]

Funding of Distributions. The accelerated distributions were paid from the general assets of Enron, rather than from a trust (the "***Trust***") which was established to cover some of Enron's liabilities for the benefits provided under the 1994 Plan.[51] Accordingly, none of the Trust's assets (worth between $25 and $31 million at that time) were used to pay the $53 million in accelerated distributions.[52] The Trust was funded with life insurance policies which Enron purchased on the lives of 100 Plan participants.[53] Both the 1994 Plan and the Trust required that the Trust's assets remain subject to the claims of Enron's creditors, even in the event of Enron's insolvency and bankruptcy (this feature caused the Trust to be treated as a "***rabbi trust***").[54] The Trust also included a provision that would trigger the full funding of the Trust in the event of Enron's change in control, such that Enron would be required to contribute assets to the Trust which would then be sufficient to cover all of Enron's liabilities under the 1994 Plan.[55]

B. Brief Summary of the Relevant Pre-Section 409A NQDC Law.

<u>In General</u>. By the fall of 2001, a variety of tax principles and Code provisions were used to determine when amounts deferred under a nonqualified plan should be subject to taxation.[56] These principles and Code provisions were used to formulate certain tax doctrines, such as the constructive receipt and economic benefit doctrine in order to explain when amounts should be treated as giving rise to taxable income.[57] Under the constructive receipt doctrine, income that is not actually received by an individual still may be constructively received (and therefore, be taxable to the individual), if such income is made available to the individual, such that he or she could draw upon the income or receive such income upon request.[58] However, income is not constructively received if the individual's control over the receipt of such income is subject to substantial limitations or restrictions.[59] Under the economic benefit doctrine, benefits that are made available to an individual at a future date may be taxable to the individual to the extent the benefits are otherwise secured (in that the benefits are set aside in an escrow account or trust whose assets are not available to the creditors of the employer).[60]

Under the foregoing rules, the primary factor for determining when NQDC was taxable to the individual depended on whether the arrangement was funded or unfunded.[61] If the arrangement was funded, then the NQDC was taxable when the individual's rights became transferable or ceased being subject to a substantial risk of forfeiture (this basically was an application of the constructive receipt doctrine).[62] If the arrangement was unfunded, the NQDC was taxable once the income was actually received or received pursuant to the constructive receipt doctrine.[63]

<u>Constructive Receipt, Subsequent Elections and Accelerated Distributions</u>. With respect to the constructive receipt, the Internal Revenue Service was on the losing end of a number of constructive receipt cases dating back to the 1940s.[64] After losing a few of these cases, the Internal Revenue Service began issuing rulings on the constructive receipt doctrine. Revenue Ruling 60-31 is the principal ruling on the issue of constructive receipt.[65] Revenue Ruling 60-31 basically provides that NQDC will not be constructively received (i) when the deferral of the NQDC takes place before the individual earned the income; (ii) the arrangement specifies when the NQDC will be paid; and (iii) the NQDC is not otherwise held in a trust or escrow account (beyond the reach of creditors) for the benefit of such individual.[66] In Revenue Ruling 71-19, the Internal Revenue Service indicated that subsequent elections (i.e., elections made after the initial deferral election and after the individual began earning the NQDC subject to the subsequent elections) were permissible.[67] The penalty tax rules that applied to early distributions from qualified plans formed the basis for the use of haircut features in nonqualified plans. Under those rules a 10% penalty was imposed on the amount of early distributions from qualified plans, and this 10% penalty formed the basis (by analogy) for when income is subject to substantial limitations or restrictions and therefore, not constructively received.[68] Accordingly, many practitioners believed that constructive receipt would not be triggered if a nonqualified plan required a 10% forfeiture of the amount of any accelerated distribution, though some opted for more severe sanctions.[69]

By the late 1970s, however, the Internal Revenue Service had decided that elective deferrals of compensation should be taxed at the time of deferral, and proposed regulations were going to be issued to that effect.[70] However, Congress stepped in and passed a law that prohibited the Internal Revenue Service from changing the constructive receipt rules that were in effect at the time (with respect to taxable entities), which effectively stopped the issuance of the proposed regulations.[71] Accordingly, practitioners relied on the foregoing rules for the proposition that the constructive receipt doctrine would not be triggered with respect to bona fide, unfunded deferred compensation arrangements with subsequent election and adequate haircut features, so long as the initial deferral of compensation was made in a timely manner (e.g., the initial deferral in this case is usually made prior to the year in which services were performed).[72]

<u>Deferrals of Stock Option and Restricted Stock Gains</u>. In the fall of 2001, the rationale for permitting the deferral of stock option and restricted stock gains was based on Code section 83 and a ruling by the Internal Revenue Service. In Private Letter Ruling 199901006, the Internal Revenue Service ruled that constructive receipt did not arise merely because employees were provided an opportunity to surrender their stock options for NQDC.[73] As indicated above, Code section 83 deals with the payment of property in exchange for services, and, under the rules of Code section 83, a payment of property does not occur when an individual is provided an unfunded right to receive property in exchange for his or her services.[74] By combining the foregoing principles, practitioners took the position that deferrals of stock option gains and restricted stock gains constituted an unfunded right to receive property in the future, thereby precluding the application of constructive receipt and delaying the taxation of the gains.[75]

C. Relevant Conclusions in the Enron Report.

As indicated in the endnotes, the Joint Committee on Taxation (the "Committee") described the features of the 1994 Plan in its "*Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations Volume I: Report*" (JCS-3-03), February 2003 ("***Enron Report***"). The Enron Report included the Committee's conclusions with respect to certain features in the 1994 Plan, including the features relating to subsequent elections, accelerated distributions and stock option and restricted stock gains.

<u>Subsequent Elections</u>. The Committee noted in the Enron Report that, given the applicable law on subsequent elections, there was support for the position that constructive receipt would not be triggered by including a subsequent election provision in a nonqualified plan.[76] The Committee recognized that it was not uncommon for nonqualified plans to provide for some form of subsequent elections.[77] Notwithstanding this case law and common practice, the Committee concluded in the Enron Report that the ability to make subsequent elections arguably should result in constructive receipt, because subsequent elections enable

individuals "to control the timing and form of payment, which is the basis for the general principle of constructive receipt."[78]

Accelerated Distributions. With respect to accelerated distributions, the Committee stated that a requirement of surrender or forfeiture of a valuable right was a sufficient restriction to preclude constructive receipt of income.[79] The Committee recognized that many nonqualified plans utilized a 10% haircut feature as the restriction to preclude constructive receipt.[80] However, the Committee determined that the 10% haircut feature did not stop many Enron executives from requesting accelerated distributions under the 1994 Plan, which called into question whether a 10% haircut really was a sufficient enough restriction to preclude constructive receipt of income.[81] As a result, the Committee determined that provisions allowing for accelerated distributions at the request of a participant should result in constructive receipt (except in situations involving retirement, disability, death, unforeseeable emergencies, etc).[82]

Stock Option and Restricted Stock Gains. With respect to the deferral of stock option and restricted stock gains, the Committee recognized that such deferrals were commonly used.[83] However, the Committee was not comfortable that these deferrals were being made by combining the constructive receipt rules and Code section 83.[84] The Committee saw the combination of these rules as manipulative, resulting in what it called "an unintended and inappropriate result for taxpayers."[85] As a result, the Committee concluded that it is inappropriate to allow for the deferral of stock option and restricted stock gains.[86]

IV. APPLICATION AND CONCLUSIONS

A. Relevant Provisions of Section 409A and Their Effect on the 1994 Plan.

Permissible Distribution Events and the Bar on Accelerated Payments. As indicated above, Section 409A sets forth a series of requirements that apply to the form and operation of nonqualified plans. Among the many requirements of Section 409A is a requirement that NQDC payments be made on (i) a set date (or schedule) or (ii) the occurrence of certain specified events under the rules.[87] Such specified events include the employee's separation from service, death, disability and unforeseeable emergency, as well as the employer's change in control.[88] Section 409A also requires for certain officers of publicly traded companies (known as "***specified employees***") a six-month delay for a payment that would otherwise be made upon the specified employee's separation from service (the "***6-Month Rule***").[89]

With the exception of death, the specified events described above all have detailed definitions under Section 409A, and the nonqualified plan must describe which set date(s) and/or specified event(s) will result in a NQDC payment.[90] These detailed definitions are designed to ensure that payments are made at times and/or events that are objectively determinable, which is further intended to limit the ability to manipulate the timing of a payment under the arrangement.[91] For instance, without a specific definition of "separation from service," the parties to an arrangement could manipulate the arrangement by having the employee continue to provide the same level of services as an independent contractor (rather than as an employee), in order to cause a payment upon his or her separation from service.[92]

In addition, except in limited circumstances, payments of such NQDC cannot be accelerated to a time prior to the set dates (or schedule) and/or specified events described in the arrangement.[93] With respect to these limited circumstances, Section 409A permits an acceleration upon an employer's termination of a nonqualified plan (or, in some cases, a termination of all the employer's nonqualified plans).[94] Sometimes, the termination must occur in connection with a particular business event, such as a corporate liquidation, bankruptcy (with bankruptcy court approval) or change in control.[95] In other cases, certain business events must not be occurring at the time of the arrangement's termination.[96] For instance, when the employer is not subject to a corporate liquidation, bankruptcy or change in control, the payment acceleration will not be permitted in connection with the termination of the employer's arrangements, if the acceleration occurs "proximate to a downturn in the financial health of the [employer]."[97]

If Section 409A's accelerated distribution rules applied to the 1994 Plan, the rules would have impacted the payment of accelerated distributions to Enron's executives, regardless of the fact that those accelerated distributions were coupled with a 10% haircut. Such a 10% haircut provision would have been a per se violation of Section 409A and would have triggered Section 409A's tax, penalty and interest provisions well before any accelerated distribution requests were made. Moreover, even if such a 10% haircut provision was not included in the 1994 Plan, Section 409A would have been violated if accelerated distributions were made during the fall of 2001 (assuming that Enron's nonqualified plans were terminated in connection with the accelerated distributions), because the accelerated distributions would have occurred proximate to a downturn in the financial condition of Enron.[98] That said, some Enron executives could have received NQDC payments in the fall of 2001 (depending on the payout provisions of their arrangements) by simply retiring or otherwise terminating their employment; however, the 6-Month Rule under would have limited other executives, who were "specified employees," from receiving a payment until after Enron's December 2001 bankruptcy filing (at which point any such payment would have required bankruptcy court approval).

Subsequent Elections. As indicated above, Section 409A includes rules on when subsequent elections can be made to change the time and/or form of payments of NQDC (when permitted by the terms of the nonqualified plan). Any such subsequent election must delay payment for at least five years and the election, itself, must be made at least a year before the payment is otherwise scheduled to occur (or commence, in the case of installment payments). In addition, Section 409A requires that the subsequent election not be effective for a year after the election is made.[99]

If Section 409A's subsequent election rules applied to the 1994 Plan, the rules likely would have limited the degree to which Enron's executives made subsequent elections. Since subsequent elections under Section 409A must defer the payment of NQDC for at least five years, executives would not be able to decide each year whether they wanted a NQDC payment in the following year. Such subsequent elections under Section 409A would have forced the executives to give up a significant degree of control over the timing of their NQDC payments. To the extent any such elections did not defer payment for at least five years, the elections would have violated Section 409A and triggered its taxes, penalties and interest provisions. Accordingly, it is less likely that executives would have made such subsequent elections, which would have reduced the amount of NQDC deferred under the 1994 Plan, because more NQDC would have been paid under the plan's normal payment provisions. With less NQDC in the plan during the weeks leading up to Enron's collapse, a lower amount of accelerated distributions would have been paid at that time.[100]

Exemptions from Section 409A. As indicated above, Section 409A only applies to amounts that fall within its definition of nonqualified deferred compensation. For instance, Section 409A does not apply to certain forms of equity compensation. In this regard, Section 409A does not apply to stock options (in employer stock) with an exercise price that can never be less than the underlying stock's fair market value at the time of grant.[101] However, if the option includes any "deferral features" (within the meaning of Section 409A), the option will be subject to Section 409A.[102] For instance, if the option includes a feature that would allow for compensation to be deferred beyond the date of exercise, the option will have a deferral feature and the option will be subject to Section 409A.[103] Similarly, while Section 409A does not apply to awards of restricted stock that are subject to taxation under Code section 83, the addition of deferral features to such restricted stock also would cause it to be subject to Section 409A.[104]

If the foregoing rules under Section 409A applied to the 1994 Plan, the rules would have limited Enron's practice of permitting the deferral of stock option and restricted stock gains under the plan. The 1994 Plan feature that permitted the deferral of such gains would have caused the options and restricted stock to be subject to Section 409A, because compensation could be deferred past the exercise date of the option and the compensation attributable to the restricted stock would be delayed past the stock's vesting date. Once subject to Section 409A, the options and restricted stock would have violated Section 409A's requirement that amounts must be paid on permissible distribution events that are set forth in the arrangement (as discussed above). No permissible distribution event could be specified for such options and restricted stock until an election was made to defer their stock gains (such an election also would need to comply with the subsequent election provisions discussed above). At that point, the taxes, penalties and interest of Section 409A would have already applied to such options and restricted stock.

B. The Effectiveness of Section 409A.

As indicated above, the rules of Section 409A effectively prevent the types of accelerated distributions, subsequent elections and deferral of stock option and restricted stock gains that were prevalent under the 1994 Plan. With respect to amounts subject to Section 409A, it is now impermissible to couple an accelerated distribution with a haircut or to briefly delay payment by making repeated subsequent elections without triggering current taxation and other substantial penalty taxes and interest charges. Whether Section 409A will prevent another large payout of NQDC shortly before a major company's collapse remains to be seen, especially in light of the fact that (i) an Enron-type collapse is an infrequent occurrence, (ii) the Section 409A rules are fairly new and (iii) companies are just starting to implement the rules in their nonqualified plans. The activities and features in the 1994 Plan that were considered abusive resulted from the application of the NQDC rules in effect at the time, which had developed over several decades. As arrangements are developed based on subsequent interpretations of Section 409A, techniques may develop to avoid the application of its rules (just as techniques were developed to avoid the application of constructive receipt). Over the next few decades it would not be surprising that particular combinations of reasonable Section 409A interpretations could lead to a large payout of NQDC shortly before a major company's collapse.

That said, there is a short-term metric of the effectiveness of Section 409A that can be considered as well. As indicated above, it is worth noting that the "abuses" attributed to the 1994 Plan were the result of plan activities and features that were not uncommon in 2001.[105] In 2001, the requests by Enron's executives for accelerated distributions coupled with haircuts were out of the ordinary. One of the main purposes of accelerated distribution/haircut provisions was to enable executives to get paid once their companies began to experience financial difficulties.[106] Accordingly, Enron's executives likely had a strong argument that their receipt of accelerated distributions did not trigger any sort of constructive receipt under the NQDC rules which were in place in 2001 (and remain in place today to supplement Section 409A). Thus, it appears that the abuses associated with the 1994 Plan were not the result of an overly aggressive interpretation of the constructive receipt rules. Instead, it was the amount of accelerated distributions that was considered to be abusive, not that accelerated distributions were made. As indicated above, the reason that $53 million in accelerated distributions could be paid from the 1994 Plan was a function of over $154 million being deferred under the 1994 Plan in earlier years. In that sense, the abuses associated with the 1994 Plan, which Section 409A seeks to remedy, arguably involve excessive deferral of executive compensation through nonqualified plans. The Committee stated as much when it suggested that changes to the pre-Section 409A deferred compensation laws would reduce the amount of income deferred through nonqualified deferred compensation programs.[107] Accordingly, the real effectiveness of Section 409A might be based on whether it reduces the amounts of income being deferred through nonqualified plans.

ENDNOTES

1 While Baker Botts, L.L.P. has served, and continues to serve, as counsel to various benefit plans sponsored by Enron Creditors Recovery Corp. (f/ka Enron Corp.), no material for this article was obtained (or otherwise derived) from that representation; instead, such material was obtained from the various public sources cited herein.

2 House Report to H.R. 4520, Rep. No. 108-548 Part 1, 108th Cong. 2d. Sess. 2004, at p. 343 fn. 453.

3 Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations Volume I: Report* (JCX-3-03), February 2003 ("***Enron Report***"), at p. 603.

4 Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-29-02), April 17, 2002, at p. 2.

5 *See* IRS Pub. 4118 at p. 2.

6 *See generally*, Code § 401 and ERISA Title I.

7 *See* Code §§ 411 & 412 and ERISA §§ 203 & 302.

8 Code § 404(a)(1)(A).

9 *Id.*

10 Code §§ 402(a) & (b).

11 *Id.*

12 Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-29-02), April 17, 2002, at p. 2.

13 *Id* at pp. 2-3.

14 *Id* at p 2.

15 There are exceptions for nonqualified plans that are funded with a secular trust, but the use of secular trusts is rare and beyond the scope of this memorandum, especially in light of the fact that a secular trust was not used to fund the 1994 Plan.

16 American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

17 Notice 2005-1 §, Q&A 16(a).

18 Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-39-06), September 5, 2006, at p. 19.

19 Treas. Reg. § 1.409A-1(d).

20 Notice 2005-1 § Q&A 16(a) & 18(a).

21 Treas. Reg. § 1.409A-1(a).

22 Treas. Reg. § 1.409A-1(b)(1).

23 Treas. Reg. § 1.409A-1(b)(4).

24 Notice 2007-86 § 3.01.

25 *Id.*

26 Code § 409A(a)(1).

27 *See* Code § 409A.

28 Code § 409A(a)(2).

29 Code § 409A(a)(3).

30 Enron Report at p. 622 and 627.

31 *Id.* at 608.

32 *Id.*

33 *Id.*

34 *Id.* at 609.

35 *See id* at 622 (the value of Enron's stock was increasing during this time period, and many awards under the 1994 Plan were based on that value).

36 *Id.* at 604.

37 *Id.* at 615.

38 *Id* at 606.

39 *Id.*

40 *Id.*

41 *Id.*

42 *Id.* at 610.

43 *Id.*

44 *Id.* at 611.

45 *Id.*

46 *Id.* at 608.

47 *Id.*

48 *Id.*

49 *Id.*

50 *Id.* at 625.

51 *Id.* at 604 and 624.

52 *Id.* at 615.

53 *Id.* at 612.

54 *Id.*

55 *Id.* at 614.

56 Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005 ("***Blue Book***") at p. 467.

57 *Id.*

58 *See* Treas. Reg. § 1.451-2(a).

59 *Id.*

60 *See Comm'r v. Smith*, 324 U.S. 177 (1945); *Sproull v. Comm'r*, 194 F.2d 541 (6th Cir. 1952).

61 Blue Book at p. 467.

62 *Id.*

63 *Id.*

64 *Veit v. Comm'r*, 8 T.C. 809 (1947); *Veit v. Comm'r*, 8 T.C.M 919 (1949); *Comm'r v. Oates*, 207 F.2d 711 (7th Cir. 1953); *Robinson v. Comm'r*, 44 T.C. 20 (1965).

65 Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-39-06), September 5, 2006, at p. 11 fn. 16.

66 Rev. Rul. 60-31.

67 Rev. Rul. 71-19.

68 Enron Report at p. 629.

69 Brisendine, Veal & Drigotas, *385-4th T.M. Deferred Compensation Arrangements* ("***DCA***"), at p. A-27 (2002).

70 DCA at p. A-22.

71 *Id.*

72 Enron Report at p. 629.

73 Priv. Ltr. Rul. 199901006 (Sept. 28, 1998).

74 Treas. Reg. § 1.83-3(e).

75 Enron Report at p. 632.

76 *Id.* at 630.

77 *Id.* at 597.

78 *Id.* at 630.

79 *Id.* at 636.

80 *Id.* at 629.

81 *Id.* (it is worth noting that the converse of the Committee's statement could apply with respect to the years preceding 2001, in that, because no accelerated distributions under the 1994 Plan occurred in 1998 - 2001, the 10% haircut feature imposed a significant enough restriction to prevent participants from requesting an accelerated distribution).

82 *Id.* at 636.

83 *Id.* at 632.

84 *Id.*

85 *Id.* at 637.

86 *Id.*

87 Code § 409A(a)(2)(A).

88 Code § 409A(a)(2)(A).

89 Code § 409A(a)(2)(B).

90 *See* Treas. Reg. §§ 1.409A-1(h) and 1.409A-3(i).

91 *See* Preamble to Final Regulations ("***Preamble***"), 72 Fed. Reg. 19234, Part VII.C.1.a.

92 Preamble at Part VII.C.2.a.

93 Code § 409A(a)(3).

94 Treas. Reg. § 1.409A-3(j)(4)(ix).

95 Treas. Reg. §§ 1.409A-3(j)(ix)(A) & (B).

96 Treas. Reg. § 1.409A-3(j)(ix)(C).

97 Treas. Reg. § 1.409A-3(j)(ix)(C)(1).

98 If the arrangements did not include a 10% haircut provision, and Enron made an accelerated payment to its executives in violation of Section 409A, the penalties and interest charges associated with Section 409A could be thought of as having the same effect as a haircut, except a higher percentage (over 20%) of the payout would be forfeited (this time to the Internal Revenue Service).

99 Code § 409A(a)(4)(C).

100 The committee administering the 1994 Plan granted fewer accelerated distribution requests for inactive plan participants as compared to active plan participants, which may affect the conclusion above. Enron Report at p. 623.

101 *See* H.R. Conf. Rep. No. 108-755, at 735 (a similar rule applies to stock appreciation rights, due to the economic similarities between options and stock appreciation rights).

102 Treas. Reg. § 1.409A-1(b)(5)(i)(A).

103 Treas. Reg. § 1.409A-1(b)(5)(i)(D).

104 Treas. Reg. § 1.409A-1(b)(6).

105 Enron Report at p. 628.

106 DCA at p. A-22.

107 Enron Report at p. 40.

U.S. FEDERAL INCOME TAXATION OF INTERNATIONAL PARTNERSHIPS

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I. Introduction

The use of partnerships, including other entities and arrangements taxed as partnerships, in both inbound and outbound ventures has increased significantly since the issuance of the check-the-box regulations more than ten years ago. This increase is a result of several factors, including, *inter alia*, the ability of partnerships to specially allocate items of income and loss among its partners, the flow of losses through a partnership to its partners, and the ability to distribute appreciated assets out of a partnership without triggering taxable gain. As one would expect, the use of partnerships in international ventures implicates both the partnership and international provisions of the Code,[2] which are two of the more complicated areas of U.S. federal income taxation. This article discusses some of the primary U.S. federal income tax issues that arise when U.S. persons invest in partnerships with foreign activities or foreign persons invest in partnerships with U.S. activities. With respect to foreign partnerships with U.S. partners, these issues include sourcing of income from partnership operations and dispositions, and the U.S. foreign tax credit and Subpart F rules. With respect to U.S. partnerships with foreign partners, these issues include the U.S. federal income taxation of foreign partners and U.S. withholding obligations of the U.S. partnership.

II . Foreign Partnerships with U.S. Partners

A. Entity Classification

As in the case of domestic entities, the classification of non-U.S. entities starts with the question of whether or not the entity is a "business entity."[3] This question can be somewhat complicated in the international context because entity classification rules vary by country.

As a starting point, the so-called "check-the-box regulations" set forth a list of foreign entities that will be treated as corporations for U.S. federal income tax purposes and are not eligible to elect to be treated otherwise.[4] If a foreign business entity is not classified as a *per se* corporation under the check-the-box regulations, the entity characteristics must be analyzed in a manner very similar to that used to analyze domestic unincorporated business entities, except that the default classification is generally that of a corporation.[5] In other words, a foreign entity that is not a *per se* corporation (a "foreign eligible entity") may elect to be treated for U.S. federal income tax purposes as either a disregarded business entity or a partnership, depending upon whether the entity has one owner or more than one owner. If the liability of all owners is limited, the default classification for a foreign business entity is as a corporation.[6] If the liability of any owner of the entity is not limited, the default classification of the entity is either as a disregarded entity, if the entity has only one owner, or as a partnership, if the entity has more than one owner.[7] Like domestic disregarded business entities and partnerships, such foreign entities may elect to be treated as corporations for U.S. federal income tax purposes.[8]

For U.S. taxpayers, the availability of an entity classification election has a different meaning in the context of a foreign partnership than it does in regard to a domestic partnership. In the context of a domestic partnership, the choice is generally between the flow-through treatment of Subchapter K of the Code or the entity level tax treatment of Subchapter C of the Code. In the context of a foreign partnership, the choice may be between the flow-through treatment of Subchapter K, the quasi-flow-through treatment of Subpart F (*i.e.*, the controlled foreign corporation ("CFC") rules) or the elective flow-through treatment provided for qualified electing funds under Section[9] 1295.

A "foreign" partnership is a partnership that is not created or organized in the U.S. or under the laws of the U.S. or any state thereof.[10] A business entity that is created or organized both in the U.S. and in a foreign jurisdiction is a domestic entity.[11] If an entity is created or organized in more than one jurisdiction and the regulations would classify the entity as a corporation as a result of its formation in any one of the jurisdictions in which it is created or organized, the entity is treated as a corporation for U.S. federal income tax purposes.[12]

B. Contributions of Property

1. Overview

In general, a partner's contribution of assets to a partnership does not trigger recognition of gain or loss under Section 721. In most circumstances, this nonrecognition rule is equally applicable to contributions of property by a U.S. partner to a foreign partnership.

Notwithstanding the general rule, the Treasury has statutory authority in the international context under two separate Code sections to issue regulations that would require a U.S. taxpayer to recognize gain or otherwise take amounts into income if such taxpayer transfers property to a partnership. In addition, if a taxpayer has an overall foreign loss ("OFL"), such taxpayer could recognize gain on the contribution of certain property to a partnership.

2. Section 721(c)

The Treasury has statutory authority under Section 721(c) to issue regulations requiring gain to be recognized by a U.S. person on the transfer of property by such person to a partnership if such gain, when recognized, would be includible in the gross income of a non-U.S. person. Section 721(c) is not currently operative because the Treasury has not promulgated any regulations implementing this provision. Moreover, any regulations promulgated under Section 721(c) would be somewhat redundant given that Section 704(c) generally would operate to allocate any built-in gain in property contributed by a U.S. person to a foreign partnership to the contributing U.S. partner.[13] Accordingly, regulations under Section 721(c) should be limited to situations where Section 704(c) would fail to allocate any such built-in gain to the contributing U.S. partner.

3. Section 367(d)(3)

The Treasury also has statutory authority to issue regulations that would treat the transfer of intangible property by a U.S. person to a foreign partnership consistent with a transfer of intangible property by a U.S. person to a foreign corporation.[14] A U.S. person that transfers intangible property to a foreign corporation generally is treated as having sold the intangible property to the foreign corporation in exchange for a stream of annual royalty payments contingent on the productivity, use and disposition of such property.[15] Regulations have also not been promulgated under Section 367(d)(3), and the section is therefore not currently operative.

4. Section 904(f)(3)

A U.S. partner that has an OFL may also recognize gain on the contribution of property to a partnership under Section 904(f)(3). Although a complete discussion of the OFL rules is beyond the scope of this article, a taxpayer generally sustains an OFL in any taxable year in which its gross income from foreign sources is exceeded by the sum of deductions allocated and apportioned thereto.[16] A taxpayer must compute its OFL separately with respect to each foreign tax credit limitation basket.[17]

If a U.S. taxpayer realizes gain on a disposition of property used predominantly in a trade or business outside of the U.S., such gain can trigger the recapture of an OFL, even if the gain would not otherwise be recognizable.[18] For these purposes, a contribution of property to a partnership is treated as a disposition of such property.[19] As a result, if a U.S. taxpayer has an OFL and contributes property used in a trade or business outside the U.S. to a partnership, the U.S. taxpayer generally would recognize gain in an amount equal to the lesser of the gain realized on the contribution or the taxpayer's OFL.[20]

C. Foreign Tax Credit Issues

1. Overview

Subject to some limitations, the U.S. allows a tax credit in regard to any taxes based on income, war profits or excess profits paid or accrued during a taxable year to any foreign country or possession of the U.S.[21] A domestic corporation may also be eligible to claim a foreign tax credit for taxes paid by a foreign corporation (a "deemed paid credit") if the domestic corporation owns 10 percent or more of the voting stock of such foreign corporation.[22] In general, a domestic corporation that owns 10 percent or more of a foreign corporation is deemed to have paid the same proportion of such foreign corporation's post-1986 foreign income taxes as the amount of dividends from such foreign corporation bears to such foreign corporation's post-1986 undistributed earnings.[23] A special rule allows U.S. shareholders in CFCs (discussed in greater detail below) to treat the income inclusions required under the CFC rules as dividends for such purposes.[24]

For a person who is otherwise eligible for a foreign tax credit and is a partner in a partnership, the amount of such partner's proportionate share of the creditable foreign taxes imposed on the partnership will be taken into consideration in determining the partner's foreign tax credit.[25] Similarly, for the purposes of the deemed paid credit, stock owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by its partners.[26] The Treasury is authorized to promulgate rules to determine the proportionate share of partners in the case of special allocations of dividends, credits and other incidents of ownership.[27]

The partnership is not entitled to a deduction for taxes described in Section 901.[28] Rather, each partner takes into account separately his distributive share of the partnership's taxes described in Section 901.[29] Each partner (rather than the partnership) therefore will determine separately the U.S. federal income tax consequences of foreign taxes imposed on and paid by a partnership.

2. Foreign Tax Credit Limitation

a. Overview

The amount of credits provided under Sections 901 and 902 that a taxpayer may utilize is subject to a limitation set forth in Section 904. The overall limit set forth in Section 904(a) limits the foreign tax credit that a taxpayer may claim to the amount of U.S. federal income tax against which such credit is claimed multiplied by a fraction, the numerator of which is the taxpayer's foreign source income and the denominator of which is the taxpayer's worldwide income. Accordingly, a taxpayer must determine the source (i.e., foreign or domestic) of each item of its income and deduction for purposes of applying the foreign tax credit limitation. Section 904(d) requires that the limit set forth in Section 904(a) be applied separately to two income categories or "baskets," the passive basket and the general basket.[30] A taxpayer must therefore allocate its income among the passive and general baskets and compute a separate limitation for each basket.[31]

b. Source of Income

(i) Distributive Share

In general, a partner determines the character of an item of partnership income, gain, loss, deduction or credit as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.[32] For purposes of the foreign tax credit limitation, items of partnership income and deduction should therefore be sourced at the partnership level and retain there character as U.S. or foreign source as they are passed through to the partner. There are, however, exceptions to this general rule. For example, Section 865(i)(5) specifically provides that income from a partnership's sale of personal property shall be sourced at the partner level.

(ii) Sale of Partnership Interest

The sale of a partnership interest is generally treated as the sale of a capital asset.[33] Gain on the sale of a capital asset generally is sourced based on the residence of the seller.[34] Accordingly, gain on the sale of a partnership interest likely would be sourced based on the residence of the selling partner.

Notwithstanding the foregoing, there are two situations in which the IRS has sourced gain on the sale of a partnership interest other than based on the residence of the selling partner. First, In P.L.R. 9142032,[35] the IRS ruled that income derived by a domestic limited partner from the sale of an interest in a foreign partnership was foreign source. The IRS attributed the partnership's foreign office to the domestic partner under Section 864(c)(5). The IRS then attributed the gain on the sale of the partnership interest to such foreign office and treated the gain as foreign source under Section 865(e)(1), because the gain was subject to an effective rate of foreign income tax of at least 10%. Second, as discussed in more detail below, the IRS ruled in Rev. Rul. 91-32[36] that a foreign partner's gain or loss from the disposition of an interest in a partnership that is engaged in a trade or business through a fixed place of business in the U.S. will be effectively connected U.S. source income to the extent such gain or loss is attributable to U.S. source effectively connected income property of the partnership.

In addition, some commentators have suggested, based on a literal reading of the Code, that an interest in a partnership should be treated as depreciable personal property for purposes of the sourcing rules.[37] The rationale for this position is based on the statutory definition of "depreciable personal property," which is any property whose basis is adjusted on account of depreciation, amortization or other capital cost recovery with respect to any property owned by any person.[38] Because the basis of a partnership interest is adjusted for partnership depreciation and other deductions,[39] and the partnership is a "person" for purposes of the Code,[40] a partnership interest technically satisfies the definition of depreciable personal property.[41] If a partnership interest were treated as depreciable personal property, the gain on the sale of such interest would be foreign source to the extent of any prior depreciation adjustments that were allocated or apportioned to foreign source income.[42] Any gain in excess of prior depreciation deductions would be sourced as if it were gain from the sale of inventory, which is generally sourced based on the place of sale.[43] The place of sale generally is where right, title and interest to property are transferred to the buyer (the title passage rule), unless the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance.[44] Although this argument is in conformity with a literal reading of the Code, this position has not been adopted by the IRS or the courts in any published guidance or case law.

c. Separate Limitation Baskets

(i) Distributive Share

For purposes of applying Section 904(d), if a partner owns 10 percent or more of an interest in a partnership, the partner generally will determine the appropriate foreign tax credit limitation basket (*i.e.*, general or passive) for income earned by the partnership at the partnership level.[45] If a partner is a limited partner or a corporate general partner and owns less than a 10 percent interest in the partnership, such partner's distributive share will be passive basket income.[46]

(ii) Sale of Partnership Interest

For purposes of applying the separate foreign tax credit limitation categories, Treas. Reg. § 1.904-5(h)(3) provides that income from the sale of a partnership interest is treated as passive basket income. However, the American Jobs Creation Act of 2004 amended Section 954(c) to provide for aggregate treatment in determining the character of gain on the sale of a partnership interest by partners that own at least 25 percent of the capital or profits interest in the partnership for purposes of applying the Subpart F provisions of the Code.[47] "Passive income," for purposes of applying the separate foreign tax credit limitation baskets, is defined by reference to Section 954(c).[48] Therefore, a sale of a partnership interest by a partner that owns 25 percent or more of the capital or profits of such partnership should be treated as a sale of the proportionate share of the partnership's assets for purposes of characterizing any gain resulting from such sale as general or passive basket income, notwithstanding Treas. Reg. § 1.904-5(h)(3).

3. Technical Taxpayer Rule

In August 2006, the Treasury and the IRS issued proposed amendments to the foreign tax credit regulations that clarify who is considered to be the taxpayer (the "Technical Taxpayer") for purposes of the foreign tax credit.[49] The proposed regulations provide that income tax is considered paid for U.S. federal income tax purposes by the person on whom foreign law imposes legal liability for the tax.[50] Foreign law is generally considered to impose legal liability for tax on the person who is required to take the income into account for foreign income tax purposes.[51]

If an entity is treated as a partnership for both U.S. and foreign tax purposes, such that both U.S. and foreign law impose liability for tax on income earned by the entity at the partner level, the partner generally would be considered the Technical Taxpayer and entitled to claim a foreign tax credit for the amount of foreign income tax imposed on such partner. If an entity is treated as a partnership for U.S. federal income tax purposes, but as a corporation for foreign tax purposes (*i.e.*, a hybrid partnership), the entity would be considered the Technical Taxpayer for U.S. federal income tax purposes.[52] As a result, each partner in such entity will be entitled to claim a foreign tax credit in the amount of any creditable foreign tax expense allocated to such partner in accordance with Treas. Reg. § 1.704-1(b)(4)(viii) (discussed below).[53] If an entity is treated as a corporation for U.S. federal income tax purposes, but as a partnership for foreign tax purposes (*i.e.*, a reverse hybrid), the proposed regulations generally provide that the reverse hybrid would be considered to have legal liability under foreign law for foreign taxes imposed on the owners of the reverse hybrid in respect of each owner's share of the reverse hybrid's income.[54] For example, if a reverse hybrid is subject to tax in a foreign country and an owner of the reverse hybrid has no other income on which tax is imposed by such foreign country, the entire amount of foreign tax that is imposed on the owner by such foreign country is allocated to and considered paid by the reverse hybrid.[55]

4. Allocation of Foreign Taxes

In October 2006, the Treasury and the IRS issued final regulations on the allocation of foreign source income and related creditable foreign tax expense.[56] These final regulations clarify the application of the Section 704 regulations to foreign taxes paid or accrued by a partnership and eligible for credit under Section 901 ("creditable foreign tax expenditures," or "CFTEs").

The final regulations provide that allocations of CFTEs generally do not satisfy the substantial economic effect safe harbor of Treas. Reg. § 1.704-1(b)(2) and must therefore be allocated in accordance with the partners' interests in the partnership ("PIP").[57] The final regulations adopt a safe harbor test (the "Safe Harbor") providing that a CFTE allocation will be deemed to be in accordance with PIP if (1) the CFTE is allocated and reported on the partnership return in proportion to the distributive shares of income to which the CFTE relates, and (2) allocations of all other partnership items that have a material effect on such allocations are valid.[58] A partnership must follow five steps to satisfy the Safe Harbor.

a. Determine CFTE Categories

The partnership must first determine its CFTE categories. A CFTE category is the U.S. net income attributable to one or more activities of a partnership.[59] Under the general rule, all U.S. net income of a partnership constitutes a single CFTE category.[60] This general rule, however, ceases to apply in the event that partnership income is allocated among the partners in more than one way (*e.g.*, the partnership agreement provides for special allocations of partnership income).[61] A different CFTE category is created for each activity or group of activities of specially allocated partnership net income.[62] Multiple allocations of net income and, thus, multiple CFTE categories, generally result from provisions of the partnership agreement.[63]

Once a partnership determines that it has more than one CFTE category, it must decide how to aggregate or disaggregate the separate partnership activities into each CFTE category. The final regulations require that this grouping/ungrouping of activities, and the determination of the scope of these activities, must be made using a reasonable method taking into account all facts and circumstances.[64] In deciding whether a method is reasonable, the final regulations indicate that the principal consideration is whether or not the proposed determination has the effect of separating CFTEs from the related foreign income.[65] The final regulations list several facts and circumstances that may be helpful in making a grouping/ungrouping determination, including the geographic location of the partnership's business or investment operations, the entities or branches through which the partnership conducts or invests such business, and whether certain types of income are exempt from foreign tax or subject to preferential foreign tax treatment.[66] Absent a material change in circumstances, a partnership must determine which activities should be aggregated on a consistent basis from year to year.[67]

b. Determine Net Income in Each CFTE Category

Second, the partnership must determine the net income, for U.S. federal income tax purposes, in each CFTE category. Net income in a CFTE category is the net income, for U.S. federal income tax purposes (as opposed to foreign purposes), taking into account all items attributable to the activities in a given CFTE category (including any allocations under Section 704(c)).[68] In determining the gross income in each CFTE category, a partnership must use a consistent, reasonable method given the facts and circumstances[69] Only gross income recognized for U.S. federal income tax purposes is taken into account.[70] On the other hand, items of expense, loss or other deduction must be apportioned to the gross income in a given CFTE category using the rules of Treas. Reg. §§ 1.861-8 and -8T.[71]

c. Determine Distributive Shares of Net Income in Each CFTE Category

In the third step, the partnership must determine each partner's distributive share of net income in each CFTE category. For purposes of the Safe Harbor, a partner's distributive share of income in a given CFTE category equals the net income allocated to such partner by the partnership agreement for such category.[72] If multiple partners are allocated net income and more than one other partner is allocated a net loss, resulting in net income allocations in excess of the overall net income in the CFTE category, the distributive share of income of each partner that receives a positive income allocation is limited to each partner's positive income allocation attributable to the CFTE category, divided by the aggregate positive income allocations attributable to the CFTE category, multiplied by the net income in the CFTE category.[73]

In the event that a partnership does not have any net income, for U.S. federal income tax purposes, in a CFTE category in a year foreign taxes are paid, the partnership can still satisfy the Safe Harbor by equating the CFTE category net income for such year to the net CFTE category income in the CFTE category for the prior three years.[74] In determining each partner's distributive share of income, the CFTEs are allocated among the partners for the CFTE category in proportion to how the aggregate net income was allocated among the partners in the three prior years.[75] As such, the aggregate net income of the partnership over the prior three years will control allocation of the current year's CFTEs to the partners. If a CFTE category has neither income in the current year nor in the prior three years, a partnership must allocate CFTEs in a manner that the partnership reasonably believes will reflect how the partnership's aggregate net income will be allocated among the partners in the succeeding three year period.[76] If none of the above rules apply, CFTE category income must be allocated according to the partners' outstanding capital contributions.[77]

e. Allocate and Apportion CFTEs Among CFTE Categories

Fourth, the partnership must allocate and apportion CFTEs to the CFTE category containing the net income, recognized for foreign tax purposes, on which the CFTE is imposed. CFTEs are allocated and apportioned to CFTE categories in accordance with the principles of Treas. Reg. § 1.904-6.[78] Under these principles, a CFTE is related to income in a CFTE category if the income is included in the base upon which the foreign tax is imposed.[79] If the foreign tax base includes income in more than one CFTE category, the CFTEs are apportioned among the CFTE categories based on the relative amounts of taxable income computed under foreign law in each CFTE category.[80] A foreign tax imposed on an item that would be income under U.S. tax principles in another year (*i.e.*, a timing difference) is allocated to the CFTE category that would include the income if the income were recognized for U.S. federal income tax purposes in the year in which the foreign tax is imposed.[81] A foreign tax imposed on an item that would not constitute income under U.S. tax principles in any year (*i.e.*, a base difference) is allocated to the CFTE category that includes the partnership items attributable to the activity with respect to which the foreign tax is imposed.[82]

e. Allocate CFTEs Among Partners

In the final step, the partnership must allocate CFTEs in each CFTE category among its partners in proportion to each partner's distributive share of income in the CFTE category to which the CFTEs relate.[83]

D. CFCs as Partners

1. Overview

A CFC is a foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock, or more than 50 percent of the total value of the stock, of the corporation is held by U.S. shareholders.[84] A "U.S. shareholder" for these purposes is a shareholder that owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock of the relevant foreign corporation.[85]

U.S. shareholders of a CFC are generally required to include in their gross income their pro rata share of certain types of income ("Subpart F Income") of the CFC in the year such income is earned, whether or not such income is distributed to the U.S. shareholder.[86] The income required to be included in the U.S. shareholder's income includes (among other things) foreign personal holding company income, foreign base company service income and foreign base company sales income.

In general, a CFC's distributive share of an item of a partnership's income is Subpart F Income if the item would have been Subpart F Income if received by the CFC directly.[87]

2. Foreign Personal Holding Company Income

Foreign personal holding company income includes (among other things) dividends, interest, royalties, rents and annuities and the excess of gains over losses from the sale or exchange of property (i) which gives rise to dividends, interest, royalties, rents and annuities, (ii) which is an interest in a trust, partnership or REMIC or (iii) which does not give rise to any income.[88] Certain types of income, such as rents and royalties, are excluded from the definition of foreign personal holding company income if such income is earned in the active conduct of a trade or business.[89] In determining whether a CFC's distributive share of an item of income of a partnership qualifies for this exception, only the activities of, and property owned by, the partnership, and not the separate activities or property of the CFC, are taken into account.[90] In the case of any sale by a CFC of an interest in a partnership with respect to which such corporation is a 25 percent owner of an interest in the capital or profits of the partnership, such corporation is treated as selling the proportionate share of the assets of the partnership attributable to such interest.[91]

The Treasury has proposed regulations that would treat the non-Subpart F Income of a CFC as Subpart F Income under certain circumstances if a hybrid branch payment is made that reduces a foreign tax and falls within a category of foreign personal holding company income.[92] A hybrid branch payment means the gross amount of any payment (including an accrual) that under the tax laws of any foreign jurisdiction to which the payor is subject is regarded as a payment between two separate entities, but is regarded under U.S. federal income tax rules as not income to the recipient because the payment is treated as being made between two parts of a single entity.[93] The rules relating to hybrid branches may also apply to payments between a partnership and a hybrid branch under certain circumstances.[94]

3. Foreign Base Company Services Income

"Foreign base company services income" means income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which are performed on behalf of any related person, and are performed outside the country in which the CFC is organized.[95] As mentioned above, a CFC's distributive share of any item of partnership income must be included in the income of a U.S. shareholder if the income would have been required to be included in the U.S. shareholder's income if the income had been received directly by the CFC.[96]

A CFC's distributive share of a partnership's services income will be deemed to be derived from services performed for or on behalf of a related person, and thus foreign base company services income, if (a) the partnership is a related person with respect to the CFC under Section 954(d)(3), and

(b) in connection with the services performed by the partnership, the CFC, or a person that is related with respect to the CFC, provides assistance that would have constituted substantial assistance contributing to the performance of such services under Treas. Reg. § 1.954-4(b)(2)(ii) if furnished to the CFC by a related person.

4. Foreign Base Company Sales Income

"Foreign base company sales income" means income derived in connection with (i) the purchase of personal property from a related person and its sale to any person, (ii) the sale of personal property to any person on behalf of a related person, (iii) the purchase of personal property from any person and its sale to a related person, or (iv) the purchase of personal property from any person on behalf of a related person, if the property so purchased or sold was not manufactured in the country in which the CFC is organized and the property is purchased or sold for use, consumption, or disposition outside of the country in which the CFC is organized.[97]

As mentioned above, a CFC's distributive share of any item of partnership income must be included in the income of a U.S. shareholder if the income would have been required to be included in the U.S. shareholder's income if the income had been received directly by the CFC.[98] In determining whether an item of income would have been Subpart F Income if received by a CFC directly, the tests for whether an entity is a related person or whether an activity takes place in or outside the country under the laws of which the CFC is organized are applied at the CFC-partner level, rather than the partnership level.[99]

Also for purposes of determining whether an item of income would have been Subpart F Income if received by a CFC directly, the Regulations provide two situations where sale and purchase transactions between a partnership and a CFC will be treated as transactions between related persons. First, a sale to or purchase from a partnership by a CFC will be treated as a transaction with a related entity if the CFC purchases the property from or sells the property to a person that is related to the CFC other than the partnership.[100]

> *Example.* CFC, a CFC organized in Country A, is an 80 percent partner in MJK Partnership, a Country B partnership. CFC purchased goods from J Corp, a Country C corporation that is a related person with respect to CFC. CFC sold the goods to MJK Partnership. In turn, MJK Partnership sold the goods to P Corp, a Country D corporation that is unrelated to CFC. The goods were manufactured in Country C by persons unrelated to J Corp. CFC's distributive share of the income of MJK Partnership from the sale of goods to P Corp will be treated as income from the sale of goods purchased from a related person for purposes of Section 954(d)(1) because CFC purchased the goods from J Corp, a related person. Because the goods were both manufactured and sold for use outside of Country A, CFC's distributive share of the income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to MJK Partnership will also be foreign base company sales income.[101]

Second, a transaction will be treated as being made with a related entity in the case where the partnership purchases personal property from (or sells personal property on behalf of) the CFC and the branch rule of Section 954(d)(2) applies to treat the income of the CFC from selling personal property that the CFC has manufactured to the partnership (or a third party) as foreign base company income.[102]

In general, foreign base company sales income does not include income of a CFC derived in connection with the sale of personal property manufactured, produced or constructed by such CFC in whole or in part from personal property which it has purchased.[103] For purposes of applying this exception, property sold by a partnership will be considered to be manufactured by a CFC-partner only if the manufacturing exception would have applied to exclude the income from foreign base company sales income if the CFC had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the CFC.[104]

> *Example.* CFC, a CFC organized under the laws of Country A, is an 80 percent partner in Partnership X, a partnership organized under the laws of Country B. Partnership X performs activities in Country B that would constitute the manufacture of Product O, if performed directly by CFC. Partnership X, through its sales offices in Country B, then sells Product O to Corp D, a corporation that is a related person with respect to CFC, within the meaning of Section 954(d)(3), for use within Country B. CFC's distributive share of Partnership X's sales income is not foreign base company sales income because the manufacturing exception of Treas. Reg. § 1.954-3(a)(4) would have applied to exclude the income from foreign base company sales income if CFC had earned the income directly.[105]

In some circumstances, branches of CFCs may be treated as separate corporations. If a CFC conducts sales or purchasing activity outside its country of organization through a branch, and the use of such branch has substantially the same effect as the use of a separate corporation, the branch is treated as if it were a separate corporation.[106] There is no authority addressing whether or the extent to which the branch rule may apply to a CFC's interest in a partnership that conducts activities outside the CFC's country of organization.

5. Investments in U.S. Property

If a CFC has investments in "U.S. property" at the end of any quarter, its U.S. shareholders may be required to include in income a proportionate part of the CFC's earnings and profits that would not otherwise be required to be included in such shareholders' income. The amount of earnings and profits that may be so included in the U.S. shareholders' income is limited to their pro rata shares of the CFC's investment in U.S. property.[107] In general, "U.S. property" includes tangible property located in the U.S., stock of a U.S. corporation, an obligation of a U.S. person and any right to use certain intangible property within the U.S.[108] For the purposes of determining whether a CFC has an investment in U.S. property, if a CFC is a partner in a partnership that owns property that would be U.S. property if owned directly by the CFC, the CFC is treated as holding an interest in the property equal to its interest in the partnership and such interest is treated as an interest in U.S. property.[109]

E. The Tax Treaty Hybrid Entity Rules

Treaties between the U.S. and other jurisdictions may reduce the U.S. federal income tax imposed on certain types of income earned and/or received by a resident of a treaty jurisdiction. With respect to an entity that is fiscally transparent under the laws of the U.S. and/or any other jurisdiction, income of such entity is eligible for a reduction of U.S. federal income tax under the terms of a U.S. tax treaty only if the item of income is derived by a resident of the applicable treaty jurisdiction.[110] For these purposes, an entity is treated as being fiscally transparent if a holder of an equity interest in the entity is required to take into account the income of the entity on a current basis (whether or not the income is distributed) and the character and source of the income is determined as if the income were realized directly by the interest holder.[111] An item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity, or both.[112] An item of income is considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity's jurisdiction.[113] An item of income paid to the entity is considered to be derived by the interest holder in the entity only if the interest holder is not fiscally transparent in its jurisdiction.[114]

An income tax treaty may not apply to reduce the amount of U.S. federal income tax on U.S. source payments received by a domestic reverse hybrid entity.[115] A domestic reverse hybrid entity is a domestic entity that is treated as not fiscally transparent for U.S. federal income tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction, with respect to the item of income received by the domestic entity.[116] The foreign interest holders of a domestic reverse hybrid entity are not entitled to the benefits of a reduction of U.S. federal income tax under a tax treaty on items of income received from U.S. sources by such entity.[117]

Similarly, subject to some exceptions, an item of income paid by a domestic reverse hybrid entity to an interest holder in such entity has the character of such item of income under U.S. law.[118] Such income is considered to be derived by the interest holder, provided the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income.[119] In determining whether the interest holder is fiscally transparent with respect to the item of income, the determination is made based on the treatment that would have resulted had the item of income been paid by an entity that is not fiscally transparent with respect to any item of income under the laws of the interest holder's jurisdiction.[120]
U.S. Partnerships with Foreign Partners

III. General Rules Relating to U.S. Taxation of Foreign Persons

1. FDAP

The U.S. taxes the income of nonresident foreign persons if the income is fixed, determinable, annual or periodic ("FDAP Income") from U.S. sources or is effectively connected with the conducted of a trade or business in the U.S.[121] FDAP Income includes (among other things) interest, dividends and rents.[122] Capital gains of nonresident foreign individuals (other than from the disposition of a U.S. real property interest) are taxed in the U.S. only if the person is in the U.S. for 183 days or more or if the gains are effectively connected with a U.S. trade or business.[123]

U.S. FDAP Income is generally subject to tax at a rate of 30% of the gross amount of the payment.[124] However, the amount of the tax is subject to change by any applicable tax treaty, and a number of items have independent exceptions that may cause FDAP Income to be excluded from U.S. federal income tax. For example, although interest earned by a foreign person is nominally subject to a 30% tax, interest (other than effectively connected interest) is generally excluded from U.S. federal income tax by the exceptions available for portfolio debt investments. Interest that is effectively connected to a U.S. trade or business is subject to tax at the regular graduated tax rates.[125]

2. Income Effectively Connected with a U.S. Trade or Business

a. Overview

Foreign persons engaged in a U.S. trade or business are generally taxable on the taxable income (as opposed to gross income) effectively connected with the U.S. trade or business at the graduated rates provided in Sections 1 and 11.[126] In general, a foreign person generally will not be engaged in a U.S. trade or business unless its activities in the U.S. are "considerable, continuous, and regular."[127] Additionally, courts have held that to give rise to a U.S. trade or business, a foreign person's activities in the U.S. must be directly related to the income rather than merely "incidental, ministerial, or clerical in nature."[128] Thus, the determination of whether a foreign person is engaged in a U.S. trade or business involves an analysis of both quantitative and qualitative components. If a foreign person is a partner in a partnership that is engaged in a U.S. trade or business, the foreign person will also be viewed as being engaged in a U.S. trade or business.[129]

b. Effect of Tax Treaties

Tax treaties may also exclude from U.S. federal income tax the income of a foreign person that is effectively connected to a U.S. trade or business. However, these treaty exclusions will generally apply only if the foreign person does not have a permanent establishment in the U.S., such as an office or other fixed place of business. For these purposes, the permanent establishment of a partnership in the U.S. is attributable to foreign partners.[130]

B. Withholding Obligations

1. Partnership FDAP Income

U.S. partnerships are required to withhold 30 percent of the gross amount of a nonresident foreign partner's distributive share of FDAP Income, whether or not such income is distributed, unless the partner qualifies for a specific exception.[131] Such withholding is not required in respect of income to the extent such income is exempt from withholding or subject to reduced withholding because of a treaty.[132]

2. Partnership Income Effectively Connected with a U.S. Trade or Business

In general, Section 1446 requires a partnership that has income that is effectively connected with a U.S. trade or business to withhold on the portion of such income that is allocable to any foreign partner. The withholding obligation applies to any income that is treated as effectively connected income, including partnership income subject to a partner's election under Section 871(d) or Section 882(d) to treat real property income as effectively connected with a U.S. trade or business, or income from the disposition of interests in U.S. real property.[133]

A foreign partner's allocable share of partnership effectively connected income does not include income or gain that is excluded from U.S. federal income tax by reason of a provision of the Code.[134] Similarly, withholding under Section 1446 does not apply to income or gain that is exempt from U.S. federal income tax by operation of any U.S. tax treaty or reciprocal agreement. In calculating a foreign partner's share of effectively connected income for purposes of determining the withholding obligation of the partnership, certain deductions, losses and credits ordinarily allowable are not included or are required to be recalculated.[135] For example, oil and gas depletion allowances are required to be recalculated, and charitable deductions, net operating losses, capital loss carryovers, personal exemptions and partnership credits are not included in the calculation of the withholding obligation.

The Code provides that the withholding on effectively connected income of foreign partners will be applied at the highest rate specified in Section 1 or Section 11, as applicable.[136] The regulations interpret this requirement to generally permit the partnership to apply the highest rate of tax applicable to a particular type of income or gain.[137] A partnership is only allowed to take into consideration rates that depend upon the corporate or noncorporate status of the recipient if the partnership has documentation establishing such status. The partnership is required to pay such withholding on a quarterly basis.[138] The payment of the tax is treated as an advance against the foreign partner's share of partnership profits.[139] Although Section 1445 normally applies to withholding on the amount realized from dispositions of U.S. real property, the Regulations provide that a U.S. partnership that satisfies its withholding obligations under Section 1446 will be deemed to have also satisfied its obligations under Section 1445.[140]

In general, where a partnership (a "lower tier partnership") that has effectively connected income has a partner that is itself treated as a partnership for U.S. federal income tax purposes (an "upper tier partnership"), the lower tier partnership is not required to withhold tax with respect to the upper tier partnership's allocable share of net income if the upper tier partnership is domestic, regardless of whether the upper tier domestic partnership's partners are foreign.[141] If the upper tier partnership is foreign, the lower tier partnership generally computes its withholding obligation based upon documentation provided to it relating to the identity and nationality of the partners of the upper tier partnership.[142] Such look-through rules do not apply, however, if the upper tier partnership is publicly traded.[143]

As discussed above, a partnership normally only takes into account certain specified partnership level deductions and losses in calculating partnership effectively connected taxable income.[144] Under certain circumstances, a partnership may also consider partner level deductions and losses in computing its Section 1446 tax obligation.[145] This procedure is not available to publicly traded partnerships.[146] A partnership may only consider such partner level deductions and losses if (i) a foreign partner has submitted valid documentation as to the partner's identity and (ii) the foreign partner submits a certificate to the partnership that sets forth the deductions and losses that such partner reasonably expects to be available for the partner's taxable year to reduce the partner's U.S. federal income tax liability on the partner's allocable share of effectively connected income or gain from the partnership.[147] A foreign partner must submit a separate certificate for each partnership taxable year.[148] The foreign partner against whose share the tax has been withheld is entitled to apply the withholding tax as a credit against the partner's other U.S. federal income tax liabilities.[149]

C. Branch Profits Tax

As discussed above, foreign corporations are subject to U.S. federal income tax on income that is effectively connected with the conduct of a U.S. trade or business. In addition, foreign corporations engaged in a U.S. trade or business may also be subject to a "branch profits tax" under Section 884. Generally, the branch profits tax is a tax imposed on a foreign corporation's post-1987 U.S. business profits that are not reinvested in U.S. branch operations. The tax is imposed at 30 percent of a calculated "dividend equivalent amount."[150] In effect, the branch profits tax is a substitute for a tax on dividends that would be imposed if the U.S. branch were a separately incorporated domestic subsidiary. A U.S. tax treaty may apply to reduce the rate of the branch profits tax applied to qualified residents of the country whose treaty is applied.[151] A foreign corporation is exempt from the branch profits tax for the taxable year in which it completely terminates all of its U.S. trade or business.[152]

A foreign corporation's ownership of an interest in a domestic partnership is treated as a U.S. asset for the purposes of calculating the branch profits tax.[153] Calculation of the branch profits tax requires, among other things, a determination of the partnership's items of income, gain, loss, and deduction.[154]

D. Disposition of Interests in U.S. Partnerships by Non-U.S. Persons

In general, the disposition of a partnership interest results in gain or loss treated as gain or loss from the sale or exchange of a capital asset, except as provided in Section 751, relating to unrealized receivables and inventory items.[155] Gain or loss recognized by a nonresident foreign person on the sale of a capital asset is generally not subject to tax in the U.S. unless the gain is effectively connected with a U.S. trade or business.[156] This rule is subject to some exceptions. For example, foreign individuals who are present in the U.S. 183 days or more are subject to U.S. federal income tax on U.S. source gains.[157]

The IRS has ruled that a foreign partner's gain or loss from the disposition of an interest in a partnership that is engaged in a trade or business through a fixed place of business in the U.S. will be effectively connected income (U.S. source) gain or loss to the extent such gain or loss is attributable to effectively connected income (U.S. source) property of the partnership.[158] The rule established by Rev. Rul. 91-32 does not apply to effectively connected property that is a U.S. real property interest. Dispositions of partnerships that hold U.S. real property interests are governed by Section 897(g).[159] The gain or loss attributable to the effectively connected income property of the partnership is an amount that bears the same ratio to the gain or loss realized by the foreign partner from the disposition of its partnership interest as the foreign partner's distributive share of partnership net effectively connected income gain or loss would have borne to the foreign partner's distributive share of partnership net gain or loss if the partnership had itself disposed of all of its assets at fair market value at the time the foreign partner disposes of its partnership interest. In computing the foreign partner's distributive share of net gain or loss of the partnership, net effectively connected income gain or loss and net non-effectively connected gain or loss are computed independently of one another. Thus, net non-effectively connected loss will not offset effectively connected gain, nor will net effectively connected loss offset net non-effectively connected gain.

If the consideration received on the disposition of a partnership interest is attributable to a U.S. real property interest, the consideration may be considered as an amount received in exchange for the U.S. real property interest.[160] Regulations provide that if 50 percent or more of the value of an interest in a partnership is attributable to U.S. real property interests, the partnership interest will be treated as being entirely a U.S. real property interest solely for withholding purposes under Section 1445.[161]

ENDNOTES

1 Associate, Baker & McKenzie LLP, Houston, Texas.

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

3 *See* Treas. Reg. § 301.7701-2(a).

4 *See* Treas. Reg. § 301.7701-2(b)(8)(i).

5 *See* Treas. Reg. §§ 301.7701-2 and -3.

6 *See* Treas. Reg. § 301.7701-3(b)(2)(i)(B).

7 *See* Treas. Reg. § 301.7701-3(b)(2).

8 *See* Treas. Reg. § 301.7701-3(a).

9 Unless otherwise indicated, all references to "Section" are to provisions of the Code.

10 *See* Section 7701(a)(5).

11 *See* Treas. Reg. § 301.7701-5(a).

12 *See* Treas. Reg. § 301.7701-2(b)(9).

13 *See* Section 704(c). A detailed discussion of Section 704(c) is beyond the scope of this article.

14 *See* Section 367(d)(3).

15 *See* Section 367(d)(2).

16 *See* Treas. Reg. § 1.904(f)-1(c)(1).

17 *Id*.

18 *See* Treas. Reg. § 1.904(f)-2(d).

19 *See* Treas. Reg. § 1.904(f)-2(d)(5)(i).

20 *See* Treas. Reg. § 1.904(f)-2(d)(4).

21 *See* Section 901(a) and (b).

22 *See* Section 902(a).

23 *Id*.

24 *See* Section 960(a)(1).

25 *See* Section 901(b)(5).

26 *See* Section 902(c)(7).

27 *Id*.

28 *See* Section 703(a)(2)(B).

29 *See* Section 702(a)(6)

30 *See* Section 904(d)(1).

31 *See* Treas. Reg. § 1.904-4(a).

32 *See* Section 702(b).

33 *See* Section 741.

34 *See* Section 865(a)(1).

35 July 23, 1991

36 *See* 1991-1 C.B. 107

37 *See* Davis and Lainoff, "U.S. Taxation of Foreign Joint Ventures," 46 Tax L. Rev. 165, 285 (1991).

38 *See* Section 865(c)(4).

39 *See* Section 705(a).

40 *See* Section 7701(a)(1).

41 *See* also, Kuntz and Peroni, *U.S. International Taxation* (Warren, Gorham & Lamont, 1996), ¶A2.03[9][e], [k][i] (making a similar argument with respect to sales of corporate stock where the seller's adjusted basis in the stock reflects "depreciation adjustments" allowed with respect to other property (i.e., the seller's adjusted basis in the stock is determined by reference to the adjusted basis of property as to which depreciation was allowed)).

42 *See* Section 865(c)(1).

43 *See* Section 865(c)(2); Treas. Reg. § 1.861-7(a).

44 *See* Treas. Reg. § 1.861-7(c).

45 *See* Treas. Reg. § 1.904-5(h)(1).

46 *See* Treas. Reg. § 1.904-5(h)(2).

47 *See* Section 954(c)(4).

48 *See* Section 904(d)(2)(B)(i).

49 Notice of Proposed Rulemaking, Fed. Reg. Vol. 71, No. 150, p. 44240 (8/4/2006).

50 *See* Prop. Reg. § 1.901-2(f)(1)(i).

51 *Id*.

52 *See* Prop. Reg. § 1.901-2(f)(3)(i).

53 *Id*.

54 *See* Prop. Reg. § 1.901-2(f)(2)(iii).

55 *Id*.

56 *See* T.D. 9292 (Oct. 19, 2006).

57 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(a).

58 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(a).

59 *See* reas. Reg. § 1.704-1(b)(4)(viii)(c)(2)(i).

60 *Id*.

61 *Id*.

62 *Id*.

63 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(c)(2)(ii).

64 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(c)(2)(iii).

65 *Id.*

66 *Id.*

67 *Id.*

68 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(i).

69 *Id.*

70 *Id.*

71 *Id.*

72 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(c)(4).

73 *Id.*.

74 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(5).

75 *Id.*.

76 *Id.*.

77 *Id.*.

78 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(d)(1).

79 *Id.*.

80 *Id.*

81 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(d)(2).

82 *Id.*

83 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(a)(1).

84 *See* Section 957(a).

85 *See* Section 951(b).

86 *See* Section 951.

87 *See* Treas. Reg. § 1.952-1(g)(1)

88 *See* Section 954(c)(1).

89 *See* Section 954(c)(2).

90 *See* Treas. Reg. § 1.954-2(a)(5)(ii)(A).

91 *See* Section 954(c)(4)(A).

92 *See* Prop.Treas.Reg. § 1.954-9(a).

93 *See* Prop. Treas. Reg. § 1.954-9(a)(6).

94 *See* Prop. Treas. Reg. § 1.954-9(a)(2)(ii).

95 *See* Section 954(e).

96 *See* Treas. Reg. § 1.952-1(g)(1).

97 *See* Section 954(d)(1).

98 *See* Treas. Reg. § 1.952-1(g)(1).

99 *Id.*

100 *See* Treas. Reg. § 1.954-1(g)(2)(i).

101 *See* Treas. Reg. § 1.954-1(g)(3), Example 3.

102 *See* Treas. Reg. § 1.954-1(g)(2)(ii).

103 *See* Treas. Reg. § 1.954-3(a)(4)(i).

104 *See* Treas. Reg. § 1.954-3(a)(6).

105 *See* Treas. Reg. § 1.954-3(a)(6)(ii).

106 *See* Section 954(d)(2).

107 *See* Section 956(a).

108 *See* Section 956(c)(1).

109 *See* Treas. Reg. § 1.956-2(a)(3); Rev. Rul. 90-112, 1990-2 C.B. 186.

110 *See* Treas. Reg. § 1.894-1(d)(1).

111 *See* Treas. Reg. § 1.894-1(d)(3)(ii)(A).

112 *See* Treas. Reg. § 1.894-1(d)(1).

113 *Id.*

114 *Id*

115 *See* Treas. Reg. § 1.894-1(d)(2)(i).

116 *Id*

117 *Id*

118 *See* Treas. Reg. § 1.894-1(d)(2)(ii)(A).

119 *Id*

120 *Id*

121 *See* Sections 871, 881, 882.

122 *See* Sections 871(a), 881(a).

123 *See* Section 871(a)(2).

124 *See* Sections 871(a), 881(a).

125 *See* Sections 871(h), 881(c).

126 *See* Sections 871(b), 882.

127 *See e.g.*, Spermacet Whaling & Shipping Co. v. Comm'r, 30 T.C. 618 (1958), aff'd, 281 F.2d 646 (1960); Linen Thread Co., Ltd. v. Comm'r, 14 T.C. 725 (1950).

128 *See* Scottish American Investment Co., Ltd. v. Comm'r, 12 T.C. 49 (1949).

129 *See* Section 875.

130 *See* Donroy, Ltd. v. U.S., 301 F.2d 200 (9th Cir. 1962).

131 *See* Treas. Reg. § 1.1441-5(b)(2).

132 *See* Treas. Reg. § 1.1441-6.

133 *See* Treas. Reg. § 1.1446-2(b)(2)(ii)

134 *See* Treas. Reg. § 1.1446-2(b)(2)(iii).

135 *See* Treas. Reg. § 1.1446-2(b)(3) and (4).

136 *See* Section 1446(b).

137 *See* Treas. Reg. § 1.1446-3(a)(2).

138 *See* Treas. Reg. § 1.1446-3(b)(1).

139 *See* Treas. Reg. § 1.1446-3(d)(2)(v).

140 *See* Treas. Reg. § 1.1446-3(c)(2)(i).

141 *See* Treas. Reg. § 1.1446-5(a).

142 *See* Treas. Reg. § 1.1446-5(c).

143 *See* Treas. Reg. § 1.1446-5(d)(1).

144 *See* Treas. Reg. § 1.1446-2(b).

145 *See* Treas. Reg. § 1.1446-6T(a).

146 *See* Treas. Reg. § 1.1446-6T(b)(1).

147 *See* Treas. Reg. § 1.1446-6T(a) and (b).

148 *See* Treas. Reg. § 1.1446-6T(a).

149 *See* Section 1446(d)(1).

150 *See* Section 884(a).

151 *See* Section 884(e).

152 *See* Treas. Reg. § 1.884-2T(a).

153 *See* Treas. Reg. § 1.884-1(d)(3)(i).

154 *See* Treas. Reg. § 1.884-1(d)(6)(iii).

155 *See* Section 741.

156 *See* Sections 871, 881.

157 *See* Section 871(a)(2).

158 *See* Rev. Rul. 91-32, 1991-1 C.B. 107.

159 *Id.*

160 *See* Section 897(g).

161 *See* Treas. Reg. § 1.897-7T.

SECTION OF TAXATION
State Bar of Texas

December 21, 2007

The Honorable Eric Solomon
Assistant Secretary for Tax Policy
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Linda E. Stiff
Acting Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

RE: Comments on Proposed Treasury Regulations under Section 6011 and Section 6111 (REG-129916-07).

Dear Assistant Secretary Solomon and Acting Commissioner Stiff:

On September 25, 2007, the Department of Treasury (the "Treasury") and the Internal Revenue Service (the "Service") issued a notice of proposed rulemaking regarding sections 6011 and 6111 of the Internal Revenue Code (the "Code"). The Treasury and the Service requested comments on the regulations proposed in that notice by December 26, 2007, and the following comments are submitted in response to that request. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed comments concerning those proposed regulations.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Department of the Treasury and the Internal Revenue Service for providing guidance in this area, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Kevin Thomason

Kevin Thomason
Chair, Section of Taxation
State Bar of Texas

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Internal Revenue Service
CC:PA:LPD:PR (REG-129916-07)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

COMMENTS ON PROPOSED TREASURY REGULATIONS UNDER SECTIONS 6011, 6111 AND 6112

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

These comments were prepared by individual members of the Section's Tax Controversy Committee (the "Committee"). Principal responsibility was exercised by the Chair of the Committee, M. Todd Welty, and by two other members of the Section, Patrick L. O'Daniel and Stephen A. Beck. The Comments were reviewed by Paul Asofsky, a member of the Section's Committee on Government Submissions, and by the Chair of the Section, Kevin Thomason.

Although many of the people who participated in preparing, reviewing and approving these comments have clients who will be affected by the federal tax law principles addressed by these comments and frequently advise clients on the application of such principles, none of the participants (or the firms or organizations to which such participants belong) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the subject matter of these comments.

Contact Person: M. Todd Welty
Phone: (214) 744-3700
Email: twelty@meadowscollier.com

Date: December 21, 2007

I. EXECUTIVE SUMMARY.

The following comments are submitted in response to a request for comments made by the Department of Treasury (the "Treasury") and the Internal Revenue Service (the "Service") in the notice of proposed rulemaking issued on September 25, 2007 regarding sections 6011 and 6111 of the Internal Revenue Code (the "Code"). The Treasury and the Service requested comments by December 26, 2007.

The following is a summary of our comments.

We generally agree with the approach taken by the Treasury and the Service in requiring disclosure of patented tax strategies. However, we have two comments regarding the scope of "participation" under section 1.6011-4(c)(3)(i)(F) of the proposed regulations.

First, we suggest that a taxpayer paying a fee for the right to use the tax strategy should not be considered as having participated in the patented transaction merely by reason of deducting such fees because those deductions represent true economic, out-of-pocket costs incurred by the taxpayer and do not result from the implementation of the patented tax strategy. Requiring disclosure solely because of the deduction of fees could cause some taxpayers to be subject to the disclosure requirement even though they ultimately decide not to report any tax benefits from the patented tax strategy.

Second, we suggest that a patent holder should be considered as having participated in the patented transaction merely from the filing of the patent application, regardless of whether the patent holder deducted any expenses incurred in the process of obtaining the patent. This would prevent unnecessary delay in the government's ability to examine the merits of a transaction that could otherwise be caused by the patent holder simply choosing not to claim any deductions from the patent application process.

II. BACKGROUND.

On November 1, 2006, the Treasury and the Service issued a notice of proposed rulemaking and temporary and final regulations under Code sections 6011, 6111, 6112. In the preamble to the proposed regulations, the Treasury Department and the Service expressed concern regarding the patenting of tax strategies and requested comments regarding the appropriate treatment of patented tax strategies under the reportable transaction rules, including whether a new category of reportable transaction should be created to address patented tax strategies.

The Section of Taxation of the State Bar of Texas submitted comments suggesting that disclosure be required under Code section 6011 for every process involving the application of federal tax law that is the subject of an application for a patent or granted patent. In addition, those comments suggested that every party who files an application for a patent, or for whom a patent is granted, with regard to a process involving the application of federal tax law be considered a material advisor, thereby requiring such party to file a disclosure statement and investor list with respect to that process.

On September 25, 2007, the Treasury and the Service issued a notice of proposed rulemaking containing proposed regulations under Code sections 6011 and 6111 that would create a new category of reportable transactions under Code section 6011 for certain "patented transactions" and would define which parties are material advisors, and therefore subject to the list maintenance requirements, with respect to such transactions.

In this notice of proposed rulemaking, the Treasury and the Service requested comments with regard to the proposed regulations and, in particular, on the clarity of the proposed rules, how they could be made easier to understand, and the administrability of the rules in the proposed regulations.

III. COMMENTS.

We commend the Treasury and the Service for its thoughtful and appropriate response to the issue of patented tax strategies. The required disclosure of patented tax strategies is an important mechanism for ensuring that the Treasury and the Service receive information regarding transactions that could potentially be mass-marketed to the public under the false representation that the propriety of the underlying tax strategy has been approved by the government.

We generally agree with the approach taken by the Treasury and the Service in the proposed regulations and commend the Treasury and the Service for devising a firm, but even-handed, solution for monitoring patented tax strategies. However, we would like to comment on some narrow issues implicated by the proposed regulations. We appreciate this opportunity to comment and hope that our comments prove helpful.

Our comments relate to the proposed scope of "participation" in a patented transaction in section 1.6011-4(c)(3)(i)(F) of the proposed regulations. From the standpoint of a taxpayer who has been sold a patented tax strategy by a promoter, the "participation" concept, as currently drafted, may be overly broad because participation may be triggered merely by the payment of a fee from the taxpayer to the promoter. Thus, an out of pocket, economic cost incurred by the taxpayer can result in such taxpayer being subject to the disclosure requirements, even though the taxpayer's return for that year may not reflect any tax benefits resulting from the implementation of the patented tax strategy. Indeed, disclosure would be required as a result of the payment of the fee even if the taxpayer ultimately decided not to utilize the patented tax strategy and never claimed any tax benefits it.

In contrast, from the standpoint of the patent holder, the "participation" concept, by partially relying on the claiming of tax benefits with respect to the obtaining of the patent, may not be broad enough. The party applying for a patent with regard to a tax strategy may simply not claim any deductions for its expenses incurred in the application process. This would defer the time at which that party would be required to make any disclosures with regard to the underlying tax strategy and would delay the ability of Treasury and the Service to examine the merits of such strategy under the federal tax authorities. This delay could result in additional taxpayers being lured into using inappropriate tax strategies through representations that the patent is an indication of governmental approval of the strategy.

Instead of being tied to the claiming of tax benefits, "participation" should result from the mere filing of an application for a patent for any process involving the application of federal tax law. This would prevent the above described delay in the government's ability to learn of and examine the strategy underlying the patent application.

SECTION OF TAXATION
State Bar of Texas

Texas Society of
CPA Certified Public Accountants

January 11, 2008

Honorable Susan Combs
Texas Comptroller of Public Accounts
P.O. Box 13528
Austin, Texas 78711

Re: 34 TAC §3.588 Margin: Cost of Goods Sold

Dear Comptroller Combs:

The Section of Taxation State Bar of Texas, ("SBT") and the State Tax Committee, Texas Society of Certified Public Accountants ("TSCPA") applaud your efforts and those of your staff as you adopt and enforce rules relating to the revised franchise tax under House Bill 3, 79th Legislature, Third Called Session, 2006 and House Bill 3928, 80th Legislature, 2007.

With respect to the TSCPA, one of the expressed goals of the TSCPA is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The views expressed herein are written on behalf of the State Tax Committee of the TSCPA. The committee has been authorized by the TSCPA Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the TSCPA Board of Directors or Executive Board and should not be construed as representing the views or policy of the TSCPA.

WITH RESPECT TO THE STATE BAR, THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUMBITTED THIS LETTER, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE

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COMMENTS REPRESENT THE VIEWS OF THE SECTION OF TAXATION WHO PREPARED THEM.

Members of the State Tax Committees of the SBT and the TSCPA who have contributed to this letter are as follows: Donna Rutter (Chair, State Tax Committee of the TSCPA), David Colmenero (Chair, State Tax Committee of the SBT), Matt Larsen, Alyson Outenreath, Geoff Polma, Charolette Noel, Ira Lipstet and Christi Mondrik. This letter was also reviewed by Steven Salch of the SBT's Committee on Government Submissions, Mary McNulty, Chair of the SBT's Committee on Government Submissions, and by Kevin Thomason, Chair of the SBT.

If you would like to contact someone to discuss the contents of this letter, please contact either of the persons below:

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

Background

Texas House Bill 3928, 80th Legislature, R.S. (2007) amended Section 171.1012(g) of the Texas Tax Code to allow a taxable entity to elect either to capitalize costs of goods sold in the same manner as the costs are capitalized on the federal income tax return, or to expense those costs, other than costs excluded from the definition of cost of goods sold.[1] The recently issued Comptroller Rule 3.588 states that "[a] taxable entity that elects to capitalize costs on its first report due on or after January 1, 2008, may not include any costs incurred prior to the accounting period upon which the report is based."[2] We disagree with this interpretation of Section 171.1012(g) for the reasons stated below and respectfully request that the Comptroller reconsider its position on this very important issue.

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[1] *See* Tex. H.B. 3928, §15, 80th Leg., R.S. (2007).
[2] 34 Tex. Admin. Code § 3.588(c)(2)(A).

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On August 3, 2007, the Comptroller released a draft version of proposed revised franchise tax administrative rules and requested comments prior to publishing the proposed rules in the Texas Register. The State Tax Committee of the TSCPA submitted comments on August 13, 2007. On September 14, 2007, the Comptroller published proposed versions of the rules in the Texas Register and again requested comments. Both the State Tax Committee of the TSCPA and the State Tax Committee of the SBT provided extensive comments by the date requested. The final versions of the rules were adopted as published in the Texas Register on December 28, 2007, along with explanations from your office addressing the comments submitted by the various interested parties, including the SBT and TSCPA.

We acknowledge and appreciate the challenge your office has undertaken in drafting the rules and procedures for a completely new tax concept—a tax unlike that any other state has implemented. We appreciate the opportunity to work with your staff and review the revised language in 34 TAC §3.588(c)(2)(A).

Taxpayers Were Not Given an Opportunity to Comment on the New Rule

The text of Comptroller Rule 3.588(c)(2)(A) as published in the December 28, 2007, Texas Register was not discussed with us during our exchanges with your staff. Instead, it contains new and different language regarding beginning inventory for cost of goods sold purposes not previously released or published. The language is significant and will affect taxpayers who qualify for a cost of goods sold deduction in a variety of ways and who are required to file reports due in 2008 and thereafter. Unfortunately, no taxpayer or group had an opportunity to review and comment on the adoption of this additional language in the rule before it became final.[3] We believe that, had such an opportunity been provided, the serious issues discussed below might have been averted.

Our first concern therefore is that taxpayers were not given an opportunity to comment on the revised language in Rule 3.588(c)(2)(A) before it became final. We believe that, given the significance of this revision to Rule 3.588(c)(2)(A), taxpayers should have been given the opportunity to comment on it before it became final and that

[3] According to the Texas Legislature, the Texas Register and related administrative procedures reflect the "public policy of this state to provide adequate and proper public notice of proposed state agency rules and state agency actions through publication of a state register."[3] When rules or portions of rules are not posted for public comment prior to adoption, as in this case, the legislative intent of the open government provisions upon which our state government was founded is not carried out. The Texas Supreme Court has held that a key criteria for whether a final rule must be republished is "whether the agency's notice fairly apprises affected parties of the pertinent issues to allow them to comment and participate in the rulemaking process in a meaningful and informed manner." *Tex. Workers' Comp. Comm'n v. Patient Advocates of Tex.*, 136 SW3d 643, 650 (Tex. 2004).

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the result of those comments would have been a Rule that does not have the issues that are now present.

Excluding Beginning Inventory from the Computation of Cost of Goods Sold is Inconsistent with the Texas Tax Code

We have reviewed Texas Tax Code ("TTC") §171.1012 to determine if a statutory basis exists for excluding beginning inventory from the cost of goods sold deduction and find no authority for such an exclusion. Rather, TTC §171.1012(g) confirms that beginning inventory should be included in the computation of cost of goods sold, as it states that a taxable entity that is subject to Section 263A, 460 or 471 may "capitalize that cost *in the same manner and to the same extent* that the taxable entity capitalized that cost on its federal tax return…." (emphasis added).[4] Federal income tax concepts for calculating cost of goods sold clearly require that cost of goods sold be computed by taking into account both beginning and ending inventory. The very first sentence in the federal income tax regulations issued under 26 USC § 471 states, "In order to reflect taxable income correctly, *inventories at the beginning and end of each taxable year are necessary* in every case in which the production, purchase, or sale of merchandise is an income-producing factor."[5] We therefore fail to see how beginning inventory can be excluded from cost of goods on the first reports due on or after January 1, 2008, given that taxpayers are specifically required to capitalize costs in the same manner as they do for federal income tax purposes.

Furthermore, TTC §171.1012(h), as amended by HB 3928, requires that "[a] taxable entity shall determine its cost of goods sold, except as otherwise provided by this section, in accordance with the methods used on the federal income tax return on which the return on which the report under this chapter is based."[6] The federal income tax returns on which a taxable entity's first margin tax report will be based will include beginning inventory computed with reference to costs incurred prior to the accounting period upon which the report is based (*e.g.*, see Schedule A, Form 1120), as required by the entity's federal computation of cost of goods sold. By disallowing beginning inventory, attributable to such costs, Rule 3.588(c)(2)(A) disregards the federal income tax methods used on the federal income tax return on which the first margin tax return is based. Moreover, no other provision of §171.1012 "otherwise provides" for the disallowance of a cost of goods sold deduction for costs incurred prior to the margin tax effective date. Therefore, your office's interpretation not only appears unsupported by the language of TTC §171.1012(g), it also appears directly contradicted by TTC §171.1012(h).

[4] Tex. Tax. Code § 171.1012(g).
[5] Treas. Reg. § 1.471-1 (emphasis added).
[6] Tex. Tax. Code § 171.1012(h).

The sole concept in the Texas Tax Code with the effect of excluding costs incurred prior to the effective date of the tax from the computation of cost of goods sold is the language in Section 171.1012(g) which provides that "[i]f the taxable entity elects to expense a cost of goods sold that may be allowed under this section, a cost incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold."[7] Because of this limitation, a taxable entity that elects to expense cost of goods sold on its first margin tax report would not be able to expense costs incurred prior to the period on which that first report is based. However, this limitation by its terms applies only to taxable entities that elect the "expensing" option on the first or subsequent returns. The language simply cannot be read to prevent taxable entities electing to capitalize the costs of goods from including beginning inventory in the computation.

Moreover, ignoring pre-2008 elements of margin tax computation ignores the rationale of Texas courts as set out in the case of *General Dynamics v. Sharp*.[8] At issue in that case was whether the (then) newly enacted earned surplus component of the Texas franchise tax could be based upon earnings incurred by the taxpayer before the effective date of the relevant tax legislation. The court concluded that the franchise tax was a privilege tax, and that basing post-legislation tax liability on a pre-law change measurement amount was an appropriate approach. As margin tax provisions have not changed the basic concept that the franchise tax is imposed for the privilege of doing business in the state, the *General Dynamics* holding should be applicable in this situation as well.

Excluding Beginning Inventory from the Computation of Cost of Goods Sold Is Inconsistent with Fundamental Accounting Principles.

Inventory serves the critical function of aggregating and tracking the expenses associated with the production and sale of goods so as to match these expenses against the revenue from the goods. Excluding beginning inventory from the computation of cost of goods sold is inconsistent with fundamental accounting principles, which require that revenue from the sale of goods and expenses associated with such goods be matched in the same accounting period. The use of an inventory is central to the effort of matching revenue and expenses. Accounting Revenue Bulletin ("ARB") 43 states: "The term *inventory* is used herein to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale."

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[7] Tex. Tax. Code §171.1012(g).
[8] 919 SW2d 861 (Tex. App.—Austin, 1996, pet. den.).

The term *inventory* encompasses goods awaiting sale, goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). To exclude beginning inventory from the computation of cost of goods sold for purposes of calculating taxable margin is contrary to the concept and basic principles of revenue recognition. The revenue from the sale of items should be properly matched with costs directly associated with the acquisition, production and manufacture of such items. ARB 43 further provides, "In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized ["margin"]. The revised franchise tax is based upon federal income tax methods and specific federal income tax return line items. The federal income tax provisions relating to costs of goods sold are based upon these stated generally accepted accounting principles ("GAAP"). Therefore, the deviation from the standard methods for matching revenue with the costs associated with generating such revenue creates an inequitable calculation of the margin upon which the revised franchise tax is based.

Excluding Beginning Inventory from the Computation of Cost of Goods Sold Raises Significant Constitutional Concerns

In addition, from a state and federal constitutional perspective, Comptroller Rule 3.588(c)(2)(A) raises significant concerns of unequal and non-uniform treatment of similarly situated out-of-state taxpayers who begin doing business in Texas in future years. As the limitation against beginning inventory applies to the taxpayer's "first report due on or after January 1, 2008," companies conducting business outside Texas will be faced with this limitation in future years if they begin doing business in Texas. Although in-state companies formed in 2008 will have the benefit of beginning inventory, similarly situated out-of-state companies will be denied a deduction for beginning inventory when they begin doing business in the state in future years. After report year 2008, the discrimination inherent in the disallowance of beginning inventory for calculating cost of good sold falls on out-of-state companies. This type of interstate discrimination raises significant constitutional concerns.

A tax that has a disproportionate impact among different classes of taxpayers is constitutionally allowed if the tax "legislation is rationally related to a legitimate governmental goal and the system operates equally within each class."[9] A tax classification will be upheld unless it has no rational basis.[10] Where taxpayers are

[9] *See Rylander v. Palais Royal, Inc.*, 81 S.W.3d 909 (Tex.App.--Austin 2002, pet. denied), *cert. denied*, 538 U.S. 1013 (2003); *see also, Rylander v. 3 Beall Bros. 3, Inc.*, 2 S.W.3d 562, 569 (Tex. App.-- Austin 1999, pet. denied) (equal and uniform requires only that all persons falling within the same class be taxed alike), *citing Tandy Corp. v. Sharp*, 872 S.W.2d 814, 818 (Tex.App.-Austin 1994, writ denied).
[10] *3 Beall Bros.*, 2 S.W.3d at 567.

permitted an election among accounting methods or periods, courts have generally permitted separate tax classification.[11]

The U.S. Supreme Court has determined that no legitimate governmental goal can be obtained by discriminating in favor of in-state business and against interstate commerce.[12] Only in rare situations, perhaps limited to health and safety matters, may states discriminate against interstate commerce.[13] Discrimination against interstate commerce is permitted only if it serves an important state goal and there is no less oppressive manner of achieving that goal.[14] Interstate discrimination that is triggered when an out-of-state company begins conducting business in Texas seems unlikely to be sustained in this situation, particularly because the discrimination may be avoided simply by interpreting TTC § 171.1012 to incorporate beginning inventory in the calculation of cost of good sold consistent with the taxpayer's federal method of accounting for inventory.

The Legislature has determined that all taxpayers should have the choice of either expensing or capitalizing inventory for cost of goods sold purposes. Calculations under both methods are designed to determine an appropriate amount of cost of goods sold during the relevant period. Various reasons may cause a taxpayer to choose one of these traditionally acceptable alternative accounting methods. Any differences in tax calculations caused due to the choice of one or the other of such methods are inherent in the taxpayers' choice, which is available to all taxpayers. This justification for a separate tax classification is not available for discrimination against interstate commerce. Accordingly, the constitutional concerns weigh in favor of permitting all taxpayers who capitalize cost of goods sold to utilize beginning inventory in the same manner and to the same extent as allowable in the taxpayer's federal income tax return.

Neither Applicable Tax Statutes and Rulings, Fundamental Accounting Principles Nor Controlling Constitutional Law Support a Wholesale Exclusion of Beginning Inventory from the Computation of Cost of Goods for Texas Franchise Tax Purposes

Based upon the analysis provided herein, we do not believe there is a legal basis or a sustainable accounting position that supports excluding beginning inventory from the

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[11] *See, e.g., 3 Beall Bros.*, 2 S.W.3d at 567-69 (taxpayer allowed to be taxed differently based on its choice to be a fiscal year taxpayer), citing *General Dynamics Corp. v. Sharp,* 919 S.W.2d 861(Tex.App.-Austin 1996, writ denied) (taxpayer allowed to be taxed differently based on an election to utilize the "completed contract" method).

[12] *See, e.g., Boston Stock Exchange v. State Tax Commission,* 429 U.S. 318 (1977); *Halliburton Oil Well Cementing Co., v. Reily,* 373 U.S. 64 (1963); *Northwest States Portland Cement Co. v. Minnesota,* 358 U.S. 450, 457 (1959).

[13] *See, e.g., Maine v. Taylor*, 477 U.S. 131 (1986).

[14] *Hughes v. Oklahoma,* 441 U.S. 322 (1979); *City of Philadelphia v. New Jersey,* 437 U.S. 617 (1978).

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computation of costs of goods sold on the first report due on or after January 1, 2008, so long as the taxable entity elects to capitalize those costs in the same manner as reported on the federal income tax return. While the statute does not explicitly state that beginning inventory is to be included in that computation, such inclusion is required by the federal income tax methods upon which the revised franchise tax is based and which Section 171.1012 specifically references. Moreover, such inclusion is also consistent with the fundamental accounting principles which guide the calculation of taxable margin throughout the revised franchise tax legislation. Finally, and quite significantly, the exclusion of beginning inventory from the computation of cost of goods sold for these purposes raises significant constitutional concerns regarding unequal and non-uniform treatment of similarly situated out-of-state taxpayers who begin doing business in Texas in future years.

We greatly appreciate the opportunity to work with your office on this significant tax issue and hope to provide relevant analysis for your review. Thank you for your consideration.

Very truly yours,

Donna R. Rutter
Chair, State Tax Committee
Texas Society of Certified Public Accountants

Kevin Thomason
Chair, Section of Taxation
State Bar of Texas

cc: Mike Reissig, Texas Comptroller of Public Accounts
William Hamner, Texas Comptroller of Public Accounts
Jerry Oxford, Texas Comptroller Tax Policy Division
Martin Hubert, Deputy Comptroller
David Colmenero, Chair, State Tax Committee, Section of Taxation, State Bar of Texas
Daniel Micciche, Chair-elect Section of Taxation, State Bar of Texas
Geoff Polma, Council Member
Bob Owen, Legislative Liaison, TSCPA
Jim Smith, Chairman of TSCPA
Mary McNulty, Chair, Committee on Government Submissions, Section of Taxation, State Bar of Texas

COMPTROLLER REMINDER: THE FIRST MAJOR FRANCHISE TAX FILING DEADLINE IS UPCOMING

By Susan Combs

Texas Comptroller Susan Combs reminds taxpayers and their representatives that the revised franchise tax is now effective for reports due on or after Jan. 1, 2008, with the first major filing deadline on May 15 of this year. Entities subject to the revised franchise tax include not only corporations and limited liability companies, but certain general partnerships, limited and limited liability partnerships, as well as business trusts and professional associations.

Tax practitioners may want to alert their clients that they will not be receiving a preprinted packet of forms with instructions, as has been done in the past. Taxpayers will now simply receive letters, which are expected to be mailed in early to mid-March, with their assigned taxpayer identification number (ID) and a password. The ID and password will allow taxpayers to log into the Comptroller's Web site where they may electronically file their franchise tax report. Taxpayers will still have the option to print and mail the forms to the Comptroller as well. The revised franchise tax forms and instructions will be available on the Comptroller's Web site in early March.

Extension requests must be properly filed by May 15, 2008. Newly taxable entities and combined groups that include at least one newly taxable entity will not be granted an extension based on payment of 100 percent of the tax reported as due in the previous calendar year. Instead, extension requests for newly taxable entities and combined groups that include at least one newly taxable entity will be granted based only on payment of 90 percent or more of the amount of tax reported as due on the report filed on or before Nov. 15, 2008. Special provisions apply to taxpayers required to file by Electronic Funds Transfer. Please see Comptroller Rule 3.585 for those provisions.

Corporations and limited liability companies that are eligible for the temporary credit provided under Tax Code § 171.111 and Rule 3.594 must preserve their right to take the credit on or before the due date of their first report in 2008. A taxable entity will not be eligible to take the credit at any time if it fails to complete and return the preservation form by the due date or a valid extension date. After a taxpayer makes the initial preservation claim, the amount preserved may be changed only as the result of an audit by the Comptroller or the Internal Revenue Service. Note, however, that if no claim exists at the time the preservation form is due, but a valid claim subsequently arises due to audit results, the credit may be claimed at that time.

Franchise tax policy experts at the agency are hosting a series of Webinars this spring to answer questions and help taxpayers and their representatives understand all the changes to the franchise tax. For more information regarding the Webinars and the revised franchise tax in general, visit the Comptroller's Web site at window.state.tx.us/taxinfo/franchise/index.html. The Web site contains links to relevant statutes, agency rules and other statements of agency policy. You may also call the agency for assistance at (800) 252-1381, or e-mail questions to us at tax.help@cpa.state.tx.us.

TAX CALENDAR 2008

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. HCAD is located at 13013 Northwest Freeway, Houston, TX.

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; 800-252-3439.

IRS Individual: Internal Revenue Service Center, Austin, TX 73301. Business: Ogden UT 84201-0012. Use pre-printed address with payment voucher if provided with return.

IRS-ES Internal Revenue Service Center, P.O. Box 660406, Dallas, TX 75266-0406. Use pre-printed address with payment voucher if provided with return.

IRS-FD Internal Revenue Service Center, Ogden, UT 84201-0048. 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, 2008

IRS-ES Final installment for 2007 individual estimated income taxes (Form 1040-ES). See 3/1/08 for an exception for farmers and fishermen, and 1/31/08 for a file and pay exception for other individuals.

IRS-FD Final installment of 2007 fiduciary estimated tax (Form 1041-ES). See 1/31/08 for an exception.

JANUARY 20, 2008

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, 2007 (Note 3).

JANUARY 31, 2008

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 2007 (Form W-2) wage and withholding statement. Form 1099 due date for payers: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, 2007, (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 2007 (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, 2008.

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

COLL County, HISD and other 2006 property taxes due.

IRS Individuals may file their 2007 income tax returns (Form 1040) and pay tax due in lieu of payment of the final estimate at January 15, 2008.

IRS Trusts, calendar-year estates and certain residuary trusts may file their 2007 income tax returns (Form 1041) and pay tax due in lieu of payment of the final estimate at January 15, 2008.

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

FEBRUARY 15, 2008

Last day for filing Form W-4 by employees who wish to claim exemption from withholding of income tax for 2008.

FEBRUARY 29, 2008

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 2007 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, 2008.

MARCH 1, 2008

Last day for complex trusts to distribute income for 2007 deduction.

Last day to file Form 1041-T.

MARCH 15, 2008

Last day for payment of charitable contributions authorized by the board of directors in 2007 for deductions on calendar year 2007 tax return by accrual basis taxpayers.

BANK Full payment of calendar year 2007 corporation income tax.

IRS Due date for calendar-year corporate 2007 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 2008 (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 2004.

APRIL 1, 2008

Final day for individuals who turned 70½ in 2007 to take first retirement plan distribution. Due date for electronically filed Forms 1099, 1098 and W-2G.

APRIL 15, 2008

Final day to establish or fund 2007 IRA.

Final day for accrual basis, calendar-year employer to make 2007 contributions to employees' trust and make 2007 IRA contributions to individual accounts.

Last day for individuals to file amended income tax returns for calendar year 2004, and for calendar-year partnership to file amended return for 2004.

IRS Individual 2007 income tax returns due and returns of 2006 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 2007 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 2007 income tax return Form 1065, K-1 or Form 7004 six-month extension.

IRS Split-interest trust 2007 information return (Form 5227). Form 2758 for estate extension of time to file.

IRS Gift tax return (Form 709) for taxable gifts made during 2007. Form 4868 for six-month extension.

IRS-ES First installment of 2008 individual estimated income taxes (Form 1040-ES) due.

IRS-FD First installment of 2008 fiduciary estimated tax (Form 1041-ES).

BANK First installment of 2008 calendar-year corporation estimated income taxes (Form 8109).

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

APRIL 20, 2008

COMP Texas state, city and MTA sales and use tax returns including payment of tax in full for the quarter ended March 31, 2008. (Note 1).

APRIL 30, 2008

CAD Final day to file extended property tax rendition form.

APRIL 30, 2008

IRS Employer's quarterly federal tax return (Form 941 or 943) for the quarter ended March 31, 2008. (Note 2).

TWC Texas Unemployment Quarterly Reports (Forms C-3 and C-4) for the quarter ended March 31, 2008.

MAY 15, 2008

IRS Information returns for 2007 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 Margin tax return and Texas public information annual report for year ended in 2007, or Extension to November 15, 2008 (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, 2008

Annual statement to IRS regarding 2007 account balances for IRAs and SEPs (Form 5498).

JUNE 15, 2008

BANK Second installment of 2008 calendar-year corporation estimated income taxes.

INS Texas corporation annual report of non-admitted insurer for 2007.

IRS-ES Second installment of 2008 individual estimated income taxes (Form 1040-ES).

IRS-FD Second installment of 2008 fiduciary estimated tax (Form 1041-ES).

IRS-PHIL 2007 tax returns of U.S. citizens and permanent residents out of the country on April 15, 2008 (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, 2008

Final day for U.S. individuals, corporations, etc., with financial interests in a foreign country to report 2007 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 2007 (Form 3115); Commissioner of Internal Revenue, Washington, D.C. 20224.

JULY 15, 2008

IRS Calendar-year trust 2007 income tax return (Forms 1041 & 1041A) extended by Form 8736. Form 8800 application for additional three-month extension.

JULY 20, 2008

COMP Texas state, city and MTA sales tax and use tax returns including payment of tax in full for the quarter ended June 30, 2008 (Note 3).

JULY 31, 2008

IRS Employee's 2007 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, 2008 (Note 2).

TWC Texas Unemployment Quarterly Reports (Forms C-3 and C-4) for the quarter ended June 30, 2008.

SEPTEMBER 15, 2008

BANK Third installment of 2008 calendar-year corporation estimated income taxes.

IRS-ES Third installment of 2008 individual estimated income taxes (Form 1040-ES).

IRS-FD Third installment of 2008 fiduciary estimated tax (Form 1041-ES).

IR Last day for calendar-year corporate 2007 income tax return (Form 1120, 1120-A, 1120S, 1120S K-1s, etc.) extended by Form 7004.

OCTOBER 15, 2008

IRS Last day for individual 2007 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 2007 income tax return (Form 1041 and 1041A) extended by Form 8736 and Form 8800.

IRS Last day for split interest trust 2007 information return (Form 5227) extended by Form 2758.

IRS Last day calendar-year partnership 2007 income tax return (Form 1065, K-1's) extended by Form 7004.

OCTOBER 20, 2008

COMP Texas state, city and MTA sales and use tax returns including payment of tax in full for the quarter ended September 30, 2008 (Note 1).

NOVEMBER 15, 2008

COMP Last day to file extended Texas corporation franchise Margin returns for year ended in 2007.

NOVEMBER 30, 2008

IRS Employer's quarterly federal tax return (Form 941 or 943) for quarter ended September 30, 2008 (Note 2).

TWC Texas Unemployment Quarterly Reports (Form C-3 and C-4) for the quarter ended September 30, 2008.

IRS Last day for information returns for 2008 for exempt organizations (Form 990, 990-PF, 990-T, etc.) extended by Form 2758.

DECEMBER 15, 2008

BANK Final installment of 2008 calendar-year corporation estimated income taxes.

DECEMBER 24, 2008

Final business day in 2008 to complete securities transactions for a 2008 gain.

DECEMBER 31, 2008

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 2007 contributions. Last day to spend money from Flexible Spending Accounts. Last day to place assets "in-service" for 2007 depreciation.

2008 Federal Legal Holidays:

1/1/08 New Years Day	2/18/08 Washington Birthday
9/1/08 Labor Day	11/11/08 Veterans Day
1/21/08 M.L. King Day	5/26/08 Memorial Day
10/13/08 Columbus Day	11/27/08

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 2008 calendar year and are not adjusted to the next business day for dates falling on weekends and holidays.**

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2007-2008 CALENDAR

July	
August	
17	Deadline for submitting articles for the October 2007 issue of the *Texas Tax Lawyer*
29	Nuts & Bolts of Tax Workshop - Houston
30-31	25th Annual Advanced Tax Law Course - Houston
September	
14	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Thompson & Knight LLP 1700 Pacific, Suite 3300 Dallas, Texas 75201 (214) 969-1700
27-29	ABA Section of Taxation 2007 Joint Fall CLE Meeting - Vancouver, British Columbia
October	
November	
2	10:30 a.m. – 12:30 p.m. Council Meeting Thompson & Knight LLP 1700 Pacific, Suite 3300 Dallas, Texas 75201 (214) 969-1700
7	Nuts & Bolts of Tax Workshop – Dallas (Video)
8-9	25th Annual Advanced Tax Law Course – Dallas (Video)
December	
14	Deadline for submitting articles for the February 2008 issue of the *Texas Tax Lawyer*

January	
17 – 19	ABA Section of Taxation 2008 Midyear Meeting – Lake Las Vegas, Nevada
25	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting Thompson & Knight LLP 1700 Pacific, Suite 3300 Dallas, Texas 75201 (214) 969-1700
February	
March	
14	Deadline for submitting articles for the May 2008 issue of the *Texas Tax Lawyer*
April	
18	10:30 a.m. – 12:30 p.m. Council Meeting Thompson & Knight LLP 1700 Pacific, Suite 3300 Dallas, Texas 75201 (214) 969-1700
May	
8 – 10	ABA Section of Taxation 2008 May Meeting – Washington, DC
June	
5-6	24th Annual Texas Federal Tax Institute – San Antonio
26-28	State Bar of Texas Annual Meeting – Houston
27	Members' Meeting of the Section of Taxation of the State Bar of Texas – Houston
July	**Future Dates - Tentative**
17	Orientation for SBOT Section chairs/vice-chairs, treasurers and Committee chairs/vice-chairs – The Woodlands

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2007-2008
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