The Texas Tax Lawyer

May 2006
Vol. 35, No. 3
www.texastaxsection.org

STATE BAR OF TEXAS
Created in 1939

2006

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CHAIR'S MESSAGE

At the beginning of this year, the Council set the following goals: (i) submit comments to the Treasury on selected Proposed Treasury Regulations; (ii) increase member participation in pro bono projects; and (iii) enhance existing continuing legal education programs. I'm pleased to report that the Section is making substantial progress with all three of these goals.

To date, the Committee on Governmental Submissions (COGS), chaired by Patrick O'Daniel, has delivered comments to the Treasury on two sets of Proposed Regulations, one concerning the issuance of compensatory partnership interests in exchange for services, and the other addressing changes to rules for non-qualified deferred compensation under the American Jobs Creation Act of 2004. The principal drafters of the Section's comments on the latter project, Stephanie Schroepfer and David D'Alessandro, participated in the public hearing with the IRS and Treasury on the Proposed Regulations. Finally, thanks to the efforts of Bob Griffo, COGS is currently reviewing comments to the recent proposed changes under Circular 230.

Regarding pro bono activities, the Section in late 2005 made a $5,000 contribution to the Texas Access to Justice Foundation in support of legal assistance to the poor of Texas affected by Hurricanes Katrina and Rita. Recently, the Council voted to make a $7,500 contribution to Texas Community Building with Attorney Resources (Texas C-BAR). Texas C-BAR matches transactional attorneys with community organizations in need of legal assistance with projects ranging from drafting entity formation documents to applying for tax-exempt status. The Section's Pro Bono Committee, under the guidance of Dan Micciche, has actively participated in projects with Texas C-BAR and with Volunteer Income Tax Assistance (VITA), a program designed to help low-income taxpayers claim the earned income tax credit. To learn more about these programs, please contact Dan Micciche at dmicciche@akingump.com or call (214) 969-2797.

The CLE Committee has completed a study that reviews each of the Section's CLE programs, makes recommendations for new programs and addresses the use of new technology in the delivery of such programs. At a special meeting to consider that study, the members agreed that in order to continue and augment the success of our CLE programs, we need to design and implement new technology by which our CLE can be delivered to our members. Examples of potential new delivery systems include web casts and telephone conferences that allow live or on-demand access for users. At its June meeting, the Council will consider a proposal setting forth the specifications and budget for a state of the art delivery system for all Section CLE programs. Thereafter, the Council will address improving the quality of programs as well as increasing the number and variety of such programs. The study was prepared by Bill Elliot, as Chair of the CLE Committee, and Dan Micciche and will be an invaluable road map for the Council and Officers in planning future CLE programs. I want to thank Bill and Dan for an outstanding job.

Additionally, thanks to the efforts of Mary McNulty, the Section sponsored forums for law school students at The University of Texas, Southern Methodist University and Texas Tech University. These programs acquaint students with the activities of the Section, provide insight into the practice of tax law, and, hopefully, encourage them to consider a career in tax law and to make active participation in the Section an integral part of their professional development. With more than one-third of the Section having practiced for more than twenty-five years, we need to encourage new practitioners in the field of tax law. The participants in these programs included: (i) Texas Tech: faculty member, Bryan Camp and panelists, Alyson Outenreath, Steve Krier, Sheila Kidwell and Don Williams; (ii) Southern Methodist University faculty members, Christopher Hanna and Larry Jones, and panelists, Todd Welty, Katrina Welch, Michael Threet and Mary McNulty; and (iii) University of Texas: faculty member, David Montoya, and panelists, Christi Mondrik, Patrick O'Daniel and Tim Carey.

Finally, in accordance with the Section's Bylaws, a duly appointed Nominating Committee consisting of the Chair (as an *ex-officio* member), Robert Gibson, Willie Hornberger, and Jack Taylor, has nominated the following persons for the indicated offices: Kevin Thomason – Chair Elect, Dan Micciche – Secretary, and Tyree Collier – Treasurer. Also, the Nominating Committee has nominated the following persons for a three-year Council term beginning at the Section's annual meeting in June: James Howard, Bob Griffo, and Ron Adzgery. Following the procedures set forth in the Bylaws, the Council will vote on the slate of Officers at the Council meeting in May and the slate of candidates for the Council will be presented for a vote by members of the Section at the Annual Meeting in June.

REPORT OF NOMINATING COMMITTEE

The Nominating Committee of the Section of Taxation of the State Bar of Texas for the year 2005/2006 consisted of the Chair, as an *ex officio* member, Jack Taylor, Robert Gibson and Willie Hornberger. This Committee, at a meeting held on February 27, 2006, reviewed all of the nominations that it had received for Officers and Council members. After such review, this Committee nominated the following persons for the offices set forth opposite their names:

Kevin Thomason – Chair Elect

Dan Micciche – Secretary

Tyree Collier - Treasurer

Also, this Committee nominated the following persons for a three-year Council term:

James Howard

Bob Griffo

Ron Adzgery

On March 3, 2006, these names were submitted by this Committee to the Council, which will vote on the Officer nominations at its May meeting. The nominees to the Council will be voted upon at the Annual Meeting of the Section to be held in Austin, Texas, on June 16, 2006.

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2005-2006 CALENDAR

July	
13	New Chair/Treasurer Orientation - Texas Law Center, Austin
15	Quarterly dues check mailed to Section Treasurer
24	Chair: Appoint Nominating Committee
29-30	SBOT Bar Leaders Conference - Omni Mandalay, Las Colinas
August	
1	SBOT Board Advisors: Reminder to committee/section chairs action requiring Board approval for September 23, 2005 Board meeting is due September 9, 2005
10	Texas Bar Foundation grant application deadline
12	Deadline for submitting articles for the October 2005 issue of the Texas Tax Lawyer
12	Chair: Submit names of Nominating Committee members for publication in Texas Tax Lawyer
31	Deadline for SBOT Dues, Texas Occupation Tax and Legal Services Fee
September	
1	Chair: Select Annual Meeting program chair and inform State Bar Annual Meeting coordinator
9	Deadline for receipt of data included in packets for September 23 SBOT Board of Directors meeting
16	Council of Chairs Meeting - Texas Law Center, Austin
15-17	ABA Section of Taxation Fall Meeting - San Francisco, CA
23	10:30 a.m. – 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
23	SBOT Board of Directors Meeting - Ambassador Hotel, Amarillo
29-30	23rd Annual Advanced Tax Law Course - Dallas
October	
2	Annual Meeting program chair: Select program and proposed speakers for SBOT Annual Meeting in 2006

15	Quarterly dues check mailed to Section Treasurer
27-28	23rd Annual Advanced Tax Law Course (Video) - Houston
November	
18	10:30 A.M. - 12:30 P.M. Council Meeting Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
21	New Lawyer's Induction Ceremony - Frank Erwin Center, Austin
December	
9	Deadline for submitting articles for the February 2006 issue of the Texas Tax Lawyer
12	Chair: Prepare section mid-year report (due Jan. 6)
January	
6	Deadline for receipt of data for January 20 SBOT Board of Directors meeting
13	Council of Chairs Meeting - Texas Law Center, Austin
15	Quarterly dues check mailed to Section Treasurer
19-21	ABA Section of Taxation Midyear Meeting – New Orleans, LA
20	SBOT Board of Directors Meeting – Icon Hotel, Houston
27	10:30 a.m. – 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
March	
1	Filing deadline for nominating petitions for SBOT and TYLA Director and President—elect positions
1	Deadline for receipt of nominations for Presidents' Award
3	Nominating Committee: Present nominations to the Council
3	10:30 A.M. - 12:00 P.M. Council Meeting Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000

12	Nominating Committee: Publish nominations for Council members in the Texas Tax Lawyer
12	Deadline for submitting articles for the May 2006 issue of the Texas Tax Lawyer
27	Annual Meeting program chairs: Send information to State Bar for promotional Section flyers and Annual Meeting registration form
April	
1	Annual Meeting program chair: Annual Meeting hotel arrangements for guest speakers due
3	Deadline for SBOT Annual Meeting resolutions
7	Deadline of receipt of data to be included for April 21 Board of Directors meeting
14	Council of Chairs Meeting – Texas Law Center, Austin
15	Quarterly dues check mailed to Section Treasurer
15	Chair: Prepare section end-of-the year report for publication in July Bar Journal
21	SBOT Board of Directors Meeting – Sheraton Four Points Hotel, Brownsville
May	
1	Annual SBOT due statements mailed
4-6	ABA Section of Taxation May Meeting – Washington, D.C.
12	Council: Elect Chair-Elect, Secretary and Treasurer for 2006/2007 fiscal year
12	10:30 a.m. – 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
22	New Lawyers' Induction Ceremony – Frank Erwin Center, Austin
June	
1	Due date for 2006 SBOT Dues, Texas Occupation Tax and Legal Services Fee
2	Deadline for receipt of data for June 14-15 SBOT Board of Directors meeting
8-9	Texas Tax Institute – San Antonio
9	Council of Chairs Meeting – Texas Law Center, Austin
14-15	SBOT Board of Directors Meeting – Austin
14-17	SBOT Annual Meeting, Austin

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Planning Issues Under the New Section 752 Regulations
– Blake D. Rubin

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FEATURED FRIDAY LUNCH SPEAKER:

Eric Solomon — Acting Deputy Assistant Secretary of the Treasury (Tax Policy), U.S. Treasury Department

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NOTICE OF ANNUAL MEETING

The Council Members and Officers

of the State Bar of Texas Tax Section

cordially invite

the Members of the Tax Section

to attend the Section's Annual Meeting

to be held at the

AUSTIN CONVENTION CENTER

on

Friday, June 16, 2006 from 10:00 a.m. to 11:30 a.m.

Ticketed Lunch will be from 11:30 a.m. to 1:00 p.m.

Agenda items will include the Members' election of officers and three council members

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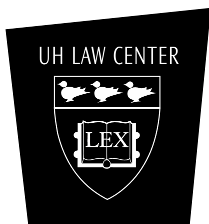

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William Streng
Vinson & Elkins Professor of Law

Ira B. Shepard
Professor of Law

Johnny Rex Buckles
Assistant Professor of Law

Christine L. Agnew
Assistant Professor of Law

TEXAS TAX LAW UPDATE: AN OVERVIEW OF RECENT ADMINISTRATIVE AND JUDICIAL DECISIONS

David E. Colmenero[1]

The following article provides an overview of recent judicial and administrative decisions relating to franchise tax, sales and use tax, and unclaimed property tax, all of which represent taxes administered by the Texas Comptroller of Public Accounts.[2] The period covered is from August 15, 2005 to March 15, 2006.[3]

Within the survey period, the Texas Court of Appeals in Austin, Texas issued decisions addressing the taxability of paper bags and plastic sacks sold to grocers, convenience stores and others for sales and use tax purposes, the constitutionality of the State's failure to pay interest on unclaimed property and the liability of a corporation for unclaimed payroll checks of a sister corporation. The Comptroller issued franchise tax decisions addressing the treatment of negative retained earnings of a subsidiary for taxable capital purposes, the liability of an S corporation for the earned surplus portion of the Texas franchise tax where the S corporation's sole shareholder was exempt for federal income tax purposes, and the treatment of recourse and estimated freight charge accounts for taxable capital purposes. The Comptroller also issued several rulings addressing sales and use tax issues relating to contractors, the manufacturing exemption, taxable services, the fraud penalty, and the effect of a bankruptcy confirmation order on a taxpayer's sales tax liability. These cases and rulings are discussed below.

<u>Franchise Tax</u>

<u>Hearing 41,710</u>: Accumulated Pre-Acquisition Negative Retained Earnings Of A Subsidiary May Not Be Included In Determining Taxable Capital Component Of Franchise Tax.

In *Hearing No. 41,710* (Sept. 9, 2005), Administrative Law Judge Alvin Stoll considered an issue regarding the proper method for valuing a subsidiary acquired as part of a reorganization in determining the taxable capital portion of the franchise tax. Petitioner in this case was a manufacturer and distributor of industrial chemicals that, in 1996, became the parent of a two-tier subsidiary structure as part of a larger corporate reorganization. Each of the two subsidiaries had negative retained earnings at the time they were contributed to Petitioner.

Citing to Section 171.109(h) of the Texas Tax Code, Petitioner argued that it should be permitted to reduce its investment in the two subsidiaries by the amount of the accumulated pre-acquisition retained earnings of those subsidiaries in determining its taxable capital for franchise tax purposes. Section 171.109(h) provides in relevant part as follows:

> A parent or investor corporation must use the cost method of accounting in reporting and calculating the franchise tax on its investments in subsidiary corporations or other investees. The retained earnings of a subsidiary corporation before acquisition by the parent or investor corporation may not be excluded from the cost of the subsidiary corporation or investee to the parent or investor corporation and must be included by the parent or investor incorporation in calculating its surplus.[4]

Petitioner essentially argued that the phrase "may not be excluded from the cost" means that retained earnings must be added to the cost of the subsidiary in valuing the asset for purposes of the taxable capital component of the franchise tax. The Tax Division countered that this phrase means that an amount equal to pre-acquisition retained earnings may not be subtracted from the cost of a subsidiary otherwise determined under the cost method of accounting.

According to the ALJ, the purpose for Section 171.109(h) was to reverse the holding in *State v. Sun Ref. & Mktg., Inc.*, 740 S.W.2d 552 (Tex. App. – Austin 1987, writ denied), wherein the court held that the investment value of a subsidiary for franchise tax purposes must be reduced by an amount equal to the undistributed earnings of a subsidiary prior to acquisition. The ALJ ruled that the language chosen by the Legislature in Section 171.109(h) simply mirrors the language in *Sun Refining* and makes clear that an investment in a subsidiary is to be determined on a cost basis without any reduction or subtraction for pre-acquisition retained earnings.

The ALJ also ruled that petitioner's interpretation of Section 171.109(h) was inconsistent with the requirement in the same section that the cost method be used to determine an investment in a subsidiary. Petitioner's construction of this section amounted to, in effect, a pooling of interests between the acquiring corporation and the acquired corporation, according to the ALJ, and did not represent a cost method of accounting.

ALJ Stoll also found Petitioner's interpretation to be contrary to Section 171.109(a)(1), which defines surplus to include any write down of assets, except for certain specified reserves and accounts, as well as other statutory and regulatory provisions requiring that surplus, assets and debts be computed in accordance with generally accepted accounting principals. Petitioner sought to distinguish its facts on the basis that it had acquired the subsidiaries by contribution rather than through a purchase transaction. The ALJ did not find this distinction significant. According to the ALJ, "[w]hen a subsidiary is acquired through a contribution from an entity under common control, the cost method of accounting requires that the investment of subsidiaries is determined by reference to historical cost."

Petitioner raised an alternative argument that focused on the subsequent sale of stock in the second-tier subsidiary. Petitioner argued that the value of its investment in the first-tier subsidiary should be measured by the sales price of the second-tier subsidiary noting that, following the sale, the first-tier subsidiary became inactive. The ALJ rejected this argument citing to the Comptroller's rule that a permanent decline in value with respect to a subsidiary is recognized only upon the disposition of a subsidiary. According to the ALJ, it is impossible to predict whether future events might cause the subsidiary to again have value where it remains in existence. Because Petitioner's first-tier subsidiary remained in existence after the sale of the second-tier subsidiary stock, the ALJ determined that Petitioner's alternative contention must be denied.

***Hearing No. 45,598*: S Corporation was Liable for Franchise Tax Despite Tax-Exempt Nature of its Sole Shareholder.**

In *Hearing No. 45,598* (Dec. 1, 2005) Chief Administrative Law Judge Eleanor Kim determined that an S corporation with a tax-exempt shareholder was subject to the earned surplus portion of the franchise tax. Petitioner was an S corporation for federal income tax purposes whose sole shareholder was a tax-exempt Employee Stock Ownership Plan ("ESOP"). Petitioner argued that it was not subject to the earned surplus portion of franchise tax because it had no reportable federal taxable income. Petitioner cited to § 171.110(d) of the Texas Tax Code, which defines "reportable federal taxable income" as "the corporation's federal taxable income after Schedule C special deductions and before net operating loss deductions as computed under the Internal Revenue Code, except that an S corporation's reportable income is the amount of the income reportable to the Internal Revenue Service as taxable to the corporation's shareholders." Because Petitioner's sole shareholder was tax-exempt for federal income tax purposes, Petitioner argued that no part of its income was "taxable to the corporation's shareholders," which meant that Petitioner had no reportable federal taxable income for Texas franchise tax purposes.

The ALJ disagreed with Petitioner's literal reading of § 171.110(d). According to the ALJ, Texas courts have rejected the notion that the " plain reading" statutory construction rule should control over other rules of statutory construction on the basis that such approach is too narrow and rigid. Citing to other applicable rules of statutory construction, the ALJ determined that §171.110(d) reflects the Legislature's approach to establishing the amount that should be used as a starting point for determining an S corporation's tax base. By enacting §171.110(d), the Texas legislature intended for an S corporation to report the income that it reports to the Internal Revenue Service as the amount of reportable federal taxable income for franchise tax purposes. The ALJ also concluded that, because the purpose of §171.110(d) is to determine the amount of an S corporation's income, neither the shareholders' responsibility to pay federal income tax nor their eligibility to claim a federal tax exemption is relevant for franchise tax purposes.

***Hearing No. 44,982*: Recourse Accounts for Uncollectible Sales Unsupported By Corresponding Accounts Receivable Accounts and Estimated Freight Charge Accounts May Not Reduce Net Taxable Capital.**

The Petitioner in *Hearing No. 44,982* (Jan. 5, 2006) sold equipment to customers who could obtain financing from lenders. Petitioner had an arrangement with the financing lenders where Petitioner would purchase a loan from the lender if a customer of Petitioner defaulted on the loan. As part of its accounting methodology, Petitioner accrued two percent of the outstanding loan volume to cover future losses attributable to customer defaults. Petitioner argued that these recourse accounts reflected allowances for uncollectible sales and should be excluded from surplus under Section 171.109(i)(1).

The Administrative Law Judge disagreed with Petitioner's argument citing two reasons. First, the ALJ noted that Petitioner failed to demonstrate that the recourse accounts were recorded in accordance with generally accepted accounting principles, as required by Section 171.109(i). Second, the ALJ noted that a reserve or allowance for uncollectible accounts is an account in which the balance is subtracted from the balance of an associated account in order to establish a more proper amount for the associated account. Petitioner in this case had no associated or corresponding asset account, which made Section 171.109(i)(1) inapplicable to its facts. On the contrary, the ALJ concluded that the recourse account in this case represents reserve or contingent obligations that are expressly included in the computation of surplus under Section 171.109(a)(1).

Petitioner also argued that certain "landing cost accounts" represent debts that should be excluded from surplus under Section 171.109(a). The amount included in these accounts reflected freight charges related to invoices that the taxpayer had not yet received. Petitioner argued that, while it accrued landing costs before its receipt of the freight invoices from suppliers, these amounts were " extremely certain based on reoccurring purchase transactions of the same equipment and parts." The ALJ rejected this argument, citing to Section 171.109(a)(1) and Texas case law for the proposition that all estimates of future liability, even reasonably accurate ones, must be included in surplus.

Sales Tax

***E. de la Garza, Inc. v. Strayhorn*: Paper Bags and Plastic Sacks Sold to Grocers, Convenience Stores, Bakeries and Restaurants Do Not Qualify for Resale Exemption.**

In *E. de la Garza, Inc. v. Strayhorn*, 2005 W.L. 3004138 (Tex. App.–Austin, Nov. 10, 2005, no pet. h.), the Austin Court of Appeals held that paper bags and plastic sacks sold to grocers, convenience stores, bakeries, and restaurants do not qualify for the sale for resale exemption for Texas sales tax purposes. At issue was Section 151.302(c) of the Texas Tax Code, which provides, "[i]nternal or external wrapping, packing, and packaging supplies used by a person in wrapping, packing, or packaging tangible personal property or in the performance of a service for the purpose of furthering the sale of the tangible personal property or the service may not be purchased by the person for resale." That same section defines the term "wrapping," "packing," and "packaging supplies" to include, among other things, "bags." De la Garza argued that this term applied only to items used by manufactures to transport product and not to grocery bags and sacks sold to retailers. De la Garza also argued (i) it was not notified when the Comptroller changed its interpretation of the tax law to include grocery bags and sacks within the definition of taxable packaging supplies, (ii) it collected sales tax on bags from customers who did not have a resale certificate, and (iii) it accepted resale certificates in good faith.

The Court rejected de la Garza's first argument holding that the Comptroller's construction of Section 151.302(c)-(d) is reasonable and does not contradict the plain language of the statute. The Court also rejected de la Garza's additional arguments on the basis that de la Garza failed to include support in the record for its claim that it collected sales tax on bags sold to customers without resale certificates and that it accepted previously valid resale certificates in good faith. The Court also noted the Comptroller's ruling that resale certificates that become facially invalid after a change in the law cannot be accepted in good faith.

***Combined Hearing No. 40,433 and Hearing No. 43,434*: Contracts with Out-Of-State Service Providers Were Not Tax-Included Contracts Where Contracts Did Not Specifically Mention Texas Sales Tax.**

In combined Hearing No. 40,433 and Hearing No. 43,434 (Apr. 15, 2005,) Chief Administrative Law Judge Eleanor Kim

considered an argument regarding the “tax included” nature of contracts with out-of-state service providers. During the audit period, Petitioner purchased repair and remodeling services that it agreed represented taxable services for Texas sales and use tax purposes, but argued that tax was included under the terms of the contract with its vendors. Petitioner presented certain field work orders which included a statement that the sales price included tax. The Tax Division agreed that the field work orders represented tax included contracts with respect to transactions with Texas vendors, but argued that the language was insufficient to create a tax-included contract with respect to out-of-state vendors. The Tax Division cited Comptroller’s Rule 3.286(d)(3) which states that “out-of-state sellers must identify the tax as Texas tax” in order for a contract with the out-of-state vendor to qualify as a tax-included contract. Petitioner responded that this rule should be limited to sellers of tangible personal property arguing that a service provider physically present in Texas is not an “out-of-state vendor.”

The ALJ agreed with the Tax Division, concluding that the requirement in Rule 3.286(d)(3) allows the Comptroller to determine with certainty that an out-of-state seller has, in fact, collected Texas use tax rather than the tax of the seller’s domicile state. The ALJ also concluded that Rule 3.286(d)(3) did not support Petitioner’s distinction between sellers of tangible personal property and sellers of services. According to the ALJ, a service provider’s physical presence in Texas may establish nexus and require a seller to hold a sales and use tax permit and collect use tax, but it does not make the seller an in-state seller for tax collection purposes. Because the evidence established that the service provider was an out-of-state seller, and no evidence demonstrated identification of Texas tax in the contracts, the transactions were properly scheduled in Petitioner’s audits.

***Hearing No. 43,983*: Teleconferencing Services Held Subject to Sales Tax For Calls Both Originating and Terminating in Texas**

Hearing No. 43,983 (July 14, 2005) addressed the taxability of teleconferencing services by a provider located in Texas that specialized in providing audio teleconferencing services to customers throughout the United States. The Claimant contracted with customers to arrange conference calls. After making the necessary arrangements, Claimant had the participants dial a toll-free number and enter a pass code in order to be connected with other participants. Claimant paid sales tax for all conference calls that involved any Texas participants. The amount of sales tax was based on a percentage of the participants located in Texas. Claimant sought a refund of sales tax for calls where invoices were sent out-of-state.

Citing to Section 151.323(1), Claimant argued that “its teleconferencing services are subject to Texas sales tax only if both (1) a call originates from a telephone number, or billing or service address within Texas and (2) the [customer] to whom the bill is sent is located or billed within Texas.” Section 151.323(1) exempts “long-distance telecommunications services that are not both originated from and billed to a telephone number or billing or service address within Texas.” In cases where Claimant’s customer was located outside of Texas, Claimant argued that no sales tax was due even with respect to participants calling into a conference call from within Texas.

The ALJ disagreed with Claimant’s contentions. Section 151.323(1) only applies to interstate calls and is not intended to exempt intra-state calls, which have been subject to sales and use tax since October 1, 1985, according to the ALJ. Because the calls at issue both originated and terminated within Texas, they were subject to sales and use tax.

***Hearing No. 44,577*: Raw Materials and Printed Materials Incorporated into Telephone Directories Outside Texas Were Not Subject to Texas Use Tax**

Hearing No. 44,577 (July 28, 2005) provides needed guidance for printers who purchase raw materials outside of Texas that is incorporated into printed material before being brought into the State. *Hearing No. 44,577* confirms that these raw materials continue to be excluded from use tax.

At issue in this hearing was the purchase of raw materials and certain printed materials that were purchased by a Texas company and delivered to an out-of-state printing company, which in turn used the materials to produce telephone directories that were then shipped to Texas recipients. Claimant argued that it was entitled to a refund of tax paid on the purchase of the raw materials and printed materials delivered to the out-of-state printer on the basis of *Sharp v. Morton Buildings, Inc.*, 953 S.W.2d 300 (Tex. App.—Austin 1997, pet. denied). The Tax Division argued that both the printing charges and the raw materials were subject to use tax, citing to *May Dept. Stores Co. v. Strayhorn*, 2004 Tex. App. Lexis 7681 (Tex. App. Austin, August 26, 2004).

In *Morton Buildings*, the Texas Court of Appeals held that certain raw materials purchased outside Texas and manufactured into building components outside Texas were not subject to Texas use tax. The Court reasoned that use tax was not due because the raw materials lost their identity when they were transformed into building components. As such, the raw materials were actually used outside the State for use tax purposes. In *May Department Stores*, the same court held that printed items purchased outside the state and delivered to in-state residents at the direction of the purchaser were subject to use tax. The Court in *May Department Stores* determined that, by directing the delivery of a taxable item to a Texas recipient, the purchaser’s use fell within the definition of a taxable use for use tax purposes.

The ALJ determined that the facts of this case fall within the scope of *Morton Buildings* rather than *May Department Stores*. The Claimant in this case purchased printing outside of Texas and further processed the purchased items into different items outside the State. Therefore, Claimant’s purchases were not subject to Texas use tax.

The Comptroller’s decision in this case helps clarify the Comptroller’s current policy regarding the treatment of taxable items purchased outside the state of Texas. In 2003, the Texas legislature amended the definition of a taxable use in Section 151.011(a) of the Texas Tax Code to include “the exercise of a right or power incidental to the ownership of tangible property *other than printed material* that has been processed, fabricated, or manufactured into other property or attached to or incorporated into other property transported into this state.” Tex. Tax Code §151.011(a) (emphasis added). This amendment was intended to and does overrule *Morton Buildings*, but with the narrow exclusion highlighted. There was some uncertainty as to how broadly the Comptroller would construe the term “printed material.” Particularly, would this exclusion apply only to printed material incorporated into other property (*e.g.*, other printed material) outside the state or would it also be construed to exclude from taxable use raw materials incorporated into printed materials outside the

State as was the Comptroller's prior policy? This opinion confirms that the exclusion continues to apply in both cases under the Comptroller's current policy.

Hearing No. 42,906: Contract Not Required to Prove that Sales Tax is Paid Separately

Hearing No. 42,906 (Aug. 26, 2005) examines the language included in certain new construction contracts to determine if tax was collected on the sales price. The Tax Division agreed with Petitioner that the contracts at issue represented contracts for new construction services for which the labor is not subject to sales tax. They disagreed however on the question of whether tax was collected on any part of the sales price. The Tax Division argued that Petitioner had collected sales tax on materials because its contracts included the following provision: "STATE SALES TAX BASED UPON GRAND TOTAL OF CONTRACT; INCLUDING MATERIALS, LABOR, GENERAL CONDITIONS AND CONTRACTOR'S PROFITS AND OVERHEAD AS REQUIRED BY STATE OF TEXAS."

The Administrative law Judge ruled that this language did not suffice to establish that tax was collected on the sales price. Rule 3.286(d)(3) requires the "[t]he amount of the sales tax must be separately stated on the bill, contract or invoice to the customer or there must be a written statement to the customer that the stated price includes sales and use taxes." If a particular provision does not satisfy this requirement, the seller is presumed not to have collected sales tax. The ALJ also cited the Comptroller's long-standing policy that an agreement between a seller and a buyer to the effect that the seller's price includes sales tax must be unconditional and explicit. The language relied on by the Tax Division above did not meet this requirement.

The ALJ also considered language included in purchase orders that suggested Petitioner was collecting sales tax on materials from its customers. Petitioner's purchase orders contained the following language: "New const: Sales tax for materials only on this C.P.O." However, the ALJ noted that a separate document called the "Application and Certification of Payments" and the attached continuation sheet indicated that the line item "tax on materials" on the continuation sheet represented tax paid by Petitioner on its purchase of materials rather than tax collected by Petitioner from its customers.[5]

Combined Hearing No. 43,230 and 39,357A (Aug. 31, 2005): Residential Remodeling Services not Taxable Despite Subsequent Conversion of Residential Property to Commercial Use

In combined *Hearing No. 43,230 and Hearing No. 39,357A* (Aug. 31, 2005), Administrative Law Judge Roy Scudday addressed the taxability of remodeling services to residential property where the residential property was subsequently converted to commercial use. Petitioner argued that the project at issue represented a residential rather than a commercial project because, at the time the project began in 1996, many apartment units were occupied by residential tenants, and the project was merely intended to upgrade the residential apartments. The Tax Division countered that the project involved commercial remodeling services because Petitioner changed its intent from retaining the project as apartments to marketing them as condominiums or timeshares with rights to be placed in a rental pool. The Tax Division further noted that, in 1999, units in the building were placed in the resort rental pool and the buildings became commercial buildings. Petitioners responded that the subsequent commercial use should not retroactively determine the taxability of the remodeling contract.

The ALJ agreed with Petitioners. The ALJ observed that, at the time the project began, there was no question that the use of the buildings was residential, and that, upon completion of the project, no different use was made of the buildings. The ALJ also stated that, if the commercial use had occurred within a reasonable time after completion of the remodeling project, the project would be viewed as a commercial remodeling project because actual use manifests the intent of the parties to the remodeling project. In this case, the buildings were placed into the rental pool almost a year after completion of the renovations. The ALJ concluded that, without other evidence establishing that the parties intended to convert the residential buildings into commercial buildings, the commercial use of the buildings nearly twelve months after the remodeling project was completed did not establish the taxability of the project.

Hearing No. 44,553: Packaging Supplies, Including Business Forms Attached to Packaging Supplies, are Subject to Texas Use Tax Even if Shipped Outside the State

The Claimant in *Hearing 44,553* (Sept. 8, 2005) sought a refund of tax paid on certain packaging supplies and business forms attached to the packaging materials. Claimant operated a freight forwarding and packaging business. As part of its operations, Claimant shipped packages both domestically and internationally. For its international shipments, Chief Administrative Law Judge Eleanor Kim rejected Claimant's request for refund on the basis that it failed to provide adequate documentation establishing the percentage of its packaging supplies and business forms that were used to package goods exported outside of the United States. The ALJ also rejected Claimant's request for refund on business forms for out-of-state shipments within the United States.

Claimant argued that business forms on out-of-state shipments but within the U.S. were exempt from Texas tax under the exclusion provided for in Section 151.011(f)(2), which provides that keeping or retaining tangible personal property for the purpose of attaching the property into other property for transport outside the state does not constitute use or storage for Texas tax purposes. Claimant argued that, because the forms were attached to packages that were shipped outside the state, no taxable use or storage occurred within Texas. The ALJ disagreed citing to Comptroller's Decision No. 38,620 (2002) in which the Comptroller ruled that packaging supplies do not fall within the exclusion of Section 151.011(f)(2) because they do not become attached to property in the sense contemplated by the Texas legislature. In other words, stated the ALJ, "[p]ackaging supplies are used or stored in this state by the purchaser, even if the packaged items are shipped outside the state." For this reason, claimant was not entitled to the refund sought.

Hearing No. 43,792: Manufacturing Exemption Available only for the Sale of Qualifying Equipment used by Manufacturer that Purchased the Equipment

In *Hearing No. 43,792* (Sept. 12, 2005), Chief Administrative Law Judge Eleanor Kim concluded that certain equipment does not qualify for the manufacturing exemption where the purchaser does not use the equipment in its own manufacturing operations, notwithstanding that the

equipment is used to perform activities that otherwise constitute manufacturing under Section 151.318(a)(2). The Claimant in this ruling is engaged in the manufacturing, marketing and distribution of non-alcoholic beverages, concentrates, and syrups. It sought a refund of sales tax paid on the purchase of fountain drink machines and replacement parts, and repair services performed on those items. As part of an agreement with its customers, claimant provided fountain drink machines to its customers who then used the machines to manufacture and sell soft drinks. Claimant argued that the fountain drink machines qualified for the manufacturing exemption under a 1999 amendment to Section 151.318(a), which reads that items enumerated in Section 151.318 "are exempted from the taxes imposed by this chapter sold, leased, or rented to, or stored, used or consumed by a manufacturer." The Tax Division countered that the manufacturing exemption did not apply to the fountain drink machines because Claimant did not use the machines in its own manufacturing operations.

According to the ALJ, language in the 1999 amendment simply tracks or parallels the imposition statutes for sales and use tax: sales tax is imposed on each sale of a taxable item in the state whereas use tax is imposed on the storage, use, or other consumption of the taxable item in this state. The ALJ concluded that this statutory language, when viewed in the context of the transactional nature of the sales and use tax, indicates that the Texas legislature intended Section 151.318(a) to cover purchases made by a manufacturer that are subject to either sales tax or use tax, but to exempt from sales and use tax any equipment purchases used in a manner qualifying under Section 151.318(a)(2). In short, the 1999 amendment did nothing more than clarify that the manufacturing exemption applies to "sales tax" and "use tax." The ALJ found further support for her conclusion in the Texas legislature's statement that the 1999 changes to Section 151.318 represent a "clarification of existing law and does not imply that existing law may be construed as inconsistent with the law as amended by this Act." For these reasons, the ALJ determined that claimant's contention should be rejected.

The ALJ also determined that Comptroller's Decision No. 39,295 (2000), which Claimant cited to in support of its argument, had been overruled by a later decision of the Comptroller in Comptroller Decision No. 39,695 (2002). Having concluded that the fountain drink machines did not qualify for the manufacturing exemption, the ALJ also determined that the services performed on those machines likewise did not qualify for the exemption provided in Section 151.3111.[6]

<u>Hearing No. 45,163</u>: Separate Charge for Table Dances at Gentlemen's Club Held Not Taxable as Entertainment Services

Hearing No. 45,163 (Sept. 12, 2005) addresses the taxability of fees paid for table dances at a gentlemen's club. The taxpayer operated a gentleman's club where female dancers performed on stage. The taxpayer would sometimes charge an admission fee to the club. For an additional fee negotiated by the dancer, a customer could purchase a personal table dance. These table dances were conducted in the club's general area in view of other customers. The taxpayer paid sales tax on the admission fees to the club, but did not do so on fees paid for table dances. An audit was conducted with the auditor concluding that tax was due on the table dance fees because they were amusement services.

Although the taxpayer recognized that he was an amusement service provider, he contended that the table dance fees were not taxable because they did not represent the "collection of an admission fee" under Section 151.005(3). The taxpayer noted that the dances were done out in the open, in an area that customers had already been admitted to, making the fees payment for a service instead of admission. In support of this argument, the taxpayer pointed to taxability memos and letters where the Comptroller determined that hiring a piano player, clown, or magician were not taxable because the taxpayer was purchasing personal services, whereas a fee charged to the general public to view these entertainers would be taxable. In response, the Tax Division relied on a taxability letter stating that fees for services that take place inside a place of amusement are taxable as sales of amusement services.

The ALJ rejected the Tax Division's argument stating that neither the statute nor the Comptroller's rules require amusement services to be taxed on the basis of where they are performed. According to the ALJ, the taxable service is not the performance, as the Tax Division argued, but instead the service of allowing a person to view the performance. Thus, the ALJ found for the taxpayer, holding that the lap dances were not taxable as an entertainment service.

<u>Hearing No.42,916</u>: Server Racks and Workstation Tables Do Not Qualify Under Manufacturing Exemption

In *Hearing No. 42,916* (Sept. 16, 2005), the Comptroller considered whether a seller of telecommunications equipment could exempt chrome steel server racks and workstation tables under the manufacturing equipment exemption. Taxpayer purchased the racks and tables to hold servers used by its engineers in compiling software codes. The taxpayer argued that the purchase was exempt from sales tax under Rule 3.300(d)(4) which exempts "accessories that are used to power, supply, support, or control" equipment qualifying as manufacturing equipment.

The ALJ rejected this argument, stating that the server racks and workstation tables did not qualify under Rule 3.300(d)(4) because they were not a component part of the manufacturing equipment. The ALJ agreed with the Tax Division that the exemption does not apply to items that merely prop up manufacturing equipment such as racks and tables.

<u>Hearing No. 42,902 and Hearing No. 44,571</u>: Fraud Penalty Upheld For Gross Under- Reporting of Sales Tax

Hearing Nos. 42,902 and *44,571* continue the trend of Comptroller's administrative decisions, upholding the fraud penalty where there has been a "gross underreporting of taxable sales," which is generally defined as an underreporting rate of 25% or more. The Comptroller continues to find that this error rate, along with other factors, or no plausible explanation provided by the taxpayer, establishes the requisite element of intent for civil fraud penalty purposes.

In *Hearing No. 42,902* (Sept. 19, 2005), Administrative Law Judge Alvin Stoll considered the applicability of the 50% fraud penalty against a convenience-store owner and its qualification for insolvency relief. Petitioner in this case owned and operated two stores that sold beer, tobacco, and snacks. The auditor found that the taxpayer's records were incomplete, forcing the auditor to use estimating methods to determine taxable sales. From these procedures, the auditor found that the taxpayer had an error rate of 69.5% and assessed tax, interest, a ten-percent penalty, and an additional 50% penalty for fraud.

The ALJ first stated that the auditor correctly estimated tax based on the available facts and then went on to address the taxpayer's contention that the 50% penalty should not have been applied. Relying on previous Comptroller decisions, the ALJ determined that the 50% penalty may be applied when there is gross underreporting of taxable sales with no other plausible explanation for the underpayment of tax other than an attempt to evade tax. Gross underreporting is defined as an error rate of 25% or greater. Petitioner's error rate of 69.5% exceeded this rate. Another factor supporting the penalty was the lack of complete records, which the ALJ also determined to reflect an indication of intent to evade tax. The ALJ found that these factors, along with the lack of an explanation for the discrepancy, and his operational control over the stores, showed that the 50% fraud penalty was warranted.

In response to Petitioner's request for insolvency relief, the ALJ stated that, while the Comptroller may settle an audit liability if paying it would make the taxpayer insolvent, this is generally not done when fraud is involved. For this reason, the ALJ determined that insolvency relief should not be granted.

In *Hearing No. 44,571* (Sept. 2, 2005), Administrative Law Judge Roy Scudday also upheld imposition of the fraud penalty against a taxpayer. Based on an estimated tax audit, the contract auditor determined that Petitioner either collected and did not remit or should have, but did not collect an undisclosed amount of sales tax, which resulted in an overall audit error rate of 42.47%. Citing to prior Comptroller decisions stating that "gross underreporting of taxable sales (along with other factors or no plausible explanation), is sufficiently indicative of intent to evade the tax," the ALJ found that Petitioner provided no plausible explanation for the error rate and, therefore, upheld the fraud penalty.

***Hearing No. 42,188*: Vouchers and Schedule of Payments Were Sufficient to Prove that Work Done on Generators was Nontaxable Scheduled Maintenance**

The Claimant in *Hearing No. 42,188* (Sept. 26, 2005) was a provider of telephone and communications services who had purchased electric-power generators to provide backup energy in the case of a power failure. The Claimant contended that sales tax accrued on charges for regularly scheduled and periodic maintenance of the generators should be refunded. The Tax Division disagreed on the basis that Claimant did not provide the contract to show that the services at issue were tax-free maintenance instead of taxable repair work.

To prove the services were scheduled and periodic maintenance, Claimant provided evidence showing that the vendor typically entered into preventative maintenance agreements with its customers for the generators. Claimant also provided a voucher and schedule of payments showing that the taxpayer authorized and consistently paid for recurring monthly payments for a three-year period. Claimant was unable to provide a copy of the contract. The ALJ found that, despite the lack of a contract, this evidence was sufficient to prove that the services were non-taxable scheduled maintenance.

The Tax Division also argued that the monthly charges could have included repair charges. Citing Rule 3.357(a)(9) the ALJ noted that minor repair work performed during scheduled maintenance is not taxable. Relying on a repair invoice which showed that repairs were paid and authorized separately from scheduled maintenance, the ALJ determined that the monthly charges did not include such repair charges.

***Hearing No. 45,110*: Forklift used to Crush Items Does Not Qualify for Manufacturing Exemption Where Crushed Items Were Not Subsequently Sold.**

In *Hearing No. 45,110* (Oct. 18, 2005), Chief Administrative Law Judge Eleanor Kim addressed the applicability of the manufacturing exemption to a forklift used in the process of crushing automobiles. Petitioner was in the business of operating used automotive parts yards in several states, including Texas. It purchased used automobiles and sold dismantled automotive parts. At issue was the taxability of a forklift used to prepare junk vehicles for crushing. The forklift was used to dent car doors and carry the junked vehicles from one location to another. Petitioner argued that the forklift qualified for the manufacturing exemption because it caused a physical change and was used in conjunction with the crusher.

The ALJ disagreed, arguing that Petitioner had failed to establish that it was a manufacturer. To be eligible for the manufacturing exemption, stated the ALJ, petitioner must establish that it was a manufacturer (*i.e.*, that it manufactures, processes or fabricates tangible personal property for ultimate sale). While the crushing and selling of used vehicles to third parties would constitute manufacturing, there was no evidence to establish that petitioner actually sold the crushed vehicles.

The ALJ also ruled that, even if Petitioner did sell the crushed vehicles, it would still not qualify for the manufacturing exemption under the specific facts of this case. Because the forklift was used to carry junk vehicles from one location to another, it constituted "intraplant transportation equipment" which is specifically excluded from the manufacturing exemption under Section 151.318(c)(1).

***Hearing No. 45,247*: Rental Payments Not Covered by a Specific Lease Term do Not Qualify for the One-Year Lease Sales Tax Exemption**

Hearing No. 45,247 (Nov. 29, 2005) involved a lessee of gas compressor equipment for use in manufacturing. The taxpayer entered into a 12-month lease agreement with an effective date of May 25, 2000. The agreement provided that, after the 12-month term expired, the agreement would continue on a month-to-month basis until notice of termination was given. After twelve months, the taxpayer remained in possession of the equipment and continued to make monthly payments. Another 12-month lease was eventually entered into on June 6, 2002, with an effective date of July 1, 2000.

The taxpayer, who had paid been paying sales tax on the rental payments, asked for a refund of those amounts. The taxpayer relied on Section 151.318(a)(2), which exempts property directly used in manufacturing. The Tax Division cited Section 151.318(e), which states that the exemption does not apply to property leased for less than one year. The Comptroller had previously agreed to allow a refund for the two twelve-month periods covered by the contracts, but not for the month-to-month period between the two.

The taxpayer argued that the month-to-month period should also be considered exempt because the first

agreement had an open-ended termination date and did not end until the second agreement was entered into. The ALJ, relying on Comptroller letter rulings, disagreed with the taxpayer and held that the actual term of the lease was the determining factor. Thus, when the contract ended and the taxpayer was allowed to retain the equipment on a month-to-month basis, the equipment became taxable.

***Letter Ruling 200509266L*: Information Provided to Excavators and Others Regarding Location of Power Lines Not Subject to Tax Where Information and Consideration Provided by Utility Operators.**

In *Letter Ruling 200509266L* (Sept. 19, 2005), the Comptroller determined that certain information provided by a "notification center" is not subject to Texas sales and use tax. The notification center was established under the Texas Utility Code to provide information about the location of power lines to potential excavators. The notification center provided the information to excavators at no charge. Instead, the utility operators were charged a fee on a per call basis. In addition, information regarding the location of lines was provided to the notification center by the utility operators.

The Comptroller determined that this service was not taxable because the persons receiving the information were not required to pay for it. According to the Comptroller, an information service is taxable if there is an exchange of the type of information covered by the statute or rule for consideration. Citing to Letter Ruling No. 9710199L (1997), the Comptroller noted that the person receiving the information must also pay for it for the service to be taxable. The Comptroller also cited to Letter Ruling 9204L1166A01 (1992) as consistent with its decision, but noted that Letter Ruling No. 9311L1271F13 (1993) concluded that charges to utility companies for free information provided to excavators constituted a taxable information service. The Comptroller determined that the 1993 Letter Ruling was incorrect.

***Hearing 43,047*: Confirmation Order Not Appealed Represents Final Determination of Tax Liability Barring Further Claim for Refund**

In *Hearing No. 43,047* (Sept. 9, 2005), Chief Administrative Law Judge Eleanor Kim determined that a bankruptcy confirmation order represents a final determination of tax liability for sales tax purposes. The bankrupt taxpayer was denied a claim for refund notwithstanding the Comptroller's apparent agreement that it had erroneously paid sales tax to the state.

Hearing No. 43,047 involved a Claimant that engaged in certain sale-leaseback financing arrangements. Claimant's typical transactions consisted of purchasing consumer appliances, electronic devices, and similar items from its customers. For the period at issue, Claimant would rent the tangible personal property back to its customers and collect sales tax on the rental charges. At the end of the lease term, Claimant's customer would have the option of purchasing the property from Claimant or renewing the lease. The Comptroller's auditor assessed tax on the sale of the property from Claimant to its customers.

Prior to receiving its Texas Notification of Audit Results, Claimant filed for bankruptcy protection under Chapter 11 of the United States Code. At the bankruptcy proceeding, Claimant asserted certain challenges to the auditor's tax adjustments, but did not challenge the taxability of its transactions. Sometime after Claimant filed for Chapter 11 bankruptcy protection, but before the reorganization was confirmed, the Comptroller issued Letter Ruling No. 200001019L (Jan. 31, 2000) in which it determined that the inquirer's specific facts presented a financing arrangement. The Bankruptcy Court confirmed Claimant's reorganization plan on November 20, 2000.

Claimant thereafter filed two claims for refund arguing that his sale-leaseback transactions represented a financing transaction similar to the transaction that the Comptroller determined was not taxable in Letter Ruling No. 200001019L. The Comptroller granted Claimant's request for refund for taxes reported after the confirmation date, but denied Claimant's refund claim for taxes reported prior to the confirmation date. The Tax Division argued that the refund denial was proper because the confirmation order rendered that tax adjustment a final determination.

The ALJ agreed with the Tax Division, citing to *Republic Supply v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987), in which the court held that a confirmed plan that is not appealed represents a final judgment on the merits. The ALJ rejected Claimant's argument that his refund claim was not included in the confirmation plan under Title 11, Sections 523(a)(1)(A) and 507(a)(8)(c) of the United States Code, which provide exclusions from a bankruptcy discharge for "tax required to be collected or withheld" by the debtor. According to the ALJ, exceptions to the discharge provision apply only to claims that are not made a part of the bankruptcy proceeding and, therefore, did not apply to Claimant's refund claim for taxes that were expressly included in the confirmation plan and agreed order.

The ALJ likewise rejected Claimant's further argument that its tax liability was not discharged in bankruptcy under Tile 11, Section 523(a)(2)(A) of the United States Code because the money was obtained by the Comptroller under false pretense or false representation. The ALJ disagreed with Claimant finding that Section 523(a)(2)(A) applies to false pretenses or false representations made by the debtor and, therefore, did not apply to the facts of this case. Even more significantly, stated the ALJ, exceptions to discharge provisions apply to claims that are not made part of a bankruptcy.

Claimant also argued that false statements and certifications made by the Comptroller should serve to invalidate the sales tax portion of the confirmation plan, citing to Title 18, Section 152 of the United States Code, which makes it a criminal act for a person to knowingly and fraudulently make false oaths, declarations, certificates, or represent a false claim for proof against the estate of a debtor. Claimant noted that when the Comptroller filed its proof of claim on May 12, 2000, it knew that it had changed its position regarding the taxability of financing arrangements as reflected in Letter Ruling No. 200001019L. The ALJ disagreed with Claimant because no evidence existed establishing that the Comptroller had intentionally made a claim for taxes on transactions that it knew were not taxable. The ALJ also observed that Claimant had treated his sale-leaseback transactions as taxable with respect to the rental charges and never challenged the taxability of these transactions. For this reason, concluded the ALJ, the Comptroller's personnel involved in the bankruptcy proceeding had no reason to question the taxable nature of Claimant's transactions.

Unclaimed Property

Clark v. Strayhorn: The State's Failure to Pay Interest on Unclaimed Property Not an Unconstitutional Taking

In *Clark v. Strayhorn*, 184 S.W.3d 906 (Tex. App.—Austin Feb. 3, 2006, no pet. h.), the Texas Court of Appeals considered whether the Comptroller's failure to pay interest when returning unclaimed property to the owner constitutes an unconstitutional taking. The Appellant claimed that the Texas Unclaimed Property Act implied a trust relationship between the Comptroller and the original owner. He based his argument on Sections 74.304(a) and 74.601 of the Texas Property Code, which respectively state that "the state shall assume custody of the property and responsibility for its safekeeping," and "from time to time invest" the property while "exercis[ing] the judgment and care of a prudent person."

The court rejected this argument stating that, while the Unclaimed Property Act is custodial in nature, the Comptroller invests the property for the benefit of the State, not the owners. The court further distinguished the matter from a Ninth Circuit Court of Appeals case in which the Ninth Circuit held that a custodial trust was created under the language of California's unclaimed property statute. *See Taylor v. Westley*, 402 F.3d 924, 931 (9th Cir. 2005). The court distinguished the *Taylor* case noting that the California statute required the funds to be deposited in a "separate trust fund" while the Texas statute only requires the unclaimed property be deposited in the general revenue fund. Therefore, the Ninth Circuit's opinion in *Taylor* did not control an interpretation of the Texas Unclaimed Property Act.

The court also addressed whether not paying interest on the unclaimed property constitutes an unconstitutional taking. In support of his argument, the Appellant pointed to Supreme Court cases holding that the retention of interest earned on interpleader funds and IOLTA accounts was an unconstitutional taking. However, the court distinguished these cases because interpleader funds and funds deposited into an IOLTA account are held in trust for the owner, and the Texas statute does not create such a trust relationship.

Metromedia Restaurant Services v. Strayhorn: Subsidiary Was Not a Holder of Unclaimed Property by Merely Handling Payroll Responsibilities For a Related Entity and Reporting Unclaimed Wages

Metromedia Restaurant Services v. Strayhorn, No. 03-05-00006-CV, 2006 WL 305223 (Tex. App.—Austin Feb. 10, 2006, no pet. h.) involved a group of affiliated corporations that were assessed a liability for failure to remit unclaimed employee wages. S&A Restaurant Corporation wholly owned Steak & Ale of Texas, Inc. and Metromedia Restaurant Services, Inc. Steak & Ale operated restaurants throughout Texas, and Metromedia provided office administration for both S & A and Steak & Ale. For the period at issue, Steak & Ale and Metromedia would deposit their revenue each day into bank accounts and this money would then be transferred to S&A's bank account at the close of business each day. S&A would then retransfer funds to the subsidiaries' accounts to cover items presented for payment. Metromedia wrote payroll checks for employees of Steak & Ale from its zero-balance account.

When a payroll check written by Metromedia went unclaimed, S&A would take a $15 processing fee out of the check and deliver the rest to the Comptroller. The Comptroller asserted and S&A agreed that the retention of the processing fees was improper. The Comptroller filed a counter-claim to compel delivery of these improperly retained funds from Metromedia in response to Metromedia's action for declaratory relief, but did not file claims against S&A or Steak & Ale. The trial court found Metromedia was a single business enterprise with S&A and Steak & Ale, and that all were holders of the funds, and therefore liable. Metromedia appealed claiming that it was not a holder of the unclaimed property and that the Comptroller failed to plead a corporate veil-piercing theory. S&A and Steak & Ale also appealed claiming that they could not be held liable because they were not parties to the original lawsuit.

The court first addressed whether S & A and Steak & Ale could be held liable. The Comptroller argued that it was not required to name all of the entities in its lawsuit because the jury had found that Metromedia operated as a single business unit with S&A and Steak and Ale. The court rejected this argument, stating that veil-piercing theories do not override the requirements of due process. The court further stated that S & A and Steak & Ale have the right to appear and to be heard on whether they are a single business unit with Metromedia, noting that they might have defenses different from Metromedia. Therefore, the court held that the district court did not have jurisdiction over S & A and Steak & Ale.

The court then examined whether Metromedia was itself a holder of the unclaimed property. Section 72.001 of the Texas Property Code defines a holder as someone in possession of property that belongs to another or someone indebted to another on an obligation. The court found that Metromedia's actions of handling payroll responsibilities and reporting unclaimed wages did not provide evidence that it was either in possession of the wages or indebted to the employees for the wages. Because money was only transferred into Metromedia's account when checks were presented for payment, and the checks at issue were never presented, the wages never entered Metromedia's account. As such, Metromedia was never in possession of the money. Further, the court determined that the mere fact that Metromedia issued some negotiable instruments on its own zero-balance account did not provide evidence that it was indebted to the employees of Steak & Ale for their wages.

The court then addressed Metromedia's argument that it could not be held responsible for the liabilities of S & A and Steak & Ale on the basis that Metromedia was in a single business enterprise with S&A and Steak & Ale. The court agreed with Metromedia, stating that the Comptroller failed to plead that Metromedia was responsible under a corporate veil-piercing theory for the unclaimed property liability of other holders.

As a final matter, the Court reversed the award of statutory penalties and attorneys' fees in favor of the Comptroller. The Court also remanded the case for a determination of whether attorneys' fees are awardable to either Metromedia or the Comptroller under the Declaratory Judgments Act.

ENDNOTES

1 Meadows, Owens, Collier, Reed, Cousins & Blau, LLP.

2 This article addresses judicial and administrative decisions that the author considers to be among the more significant and is not intended as a comprehensive overview of all judicial and administrative developments.

3 The Court of Appeals decision in *Home Interiors & Gifts, Inc. v. Strayhorn*, No. 03-04-00660-CV, 2005 WL 2313518 (Tex. App.—Austin Sept. 22, 2005, pet. filed) was issued September 22, 2005, and falls within this survey period. It is not addressed in this article, however, because the author provided a comprehensive discussion of this decision in the last Texas Tax Law update, which appeared in the October 2005 edition of the Texas Tax Lawyer.

4 Tex. Tax Code § 171.109(h).

5 The application and certification of payment showed an original contract price of a specified amount, plus a change order amount and a total contract sum. Sales tax was not separately stated. The continuation sheet provided an itemization of work and corresponding values with a grand total amount. Included in that sum was a line item of "tax on materials" of a specified amount.

6 The implications of this ruling are largely mitigated by the fact that the Claimant could have avoided sales tax on its purchase of the fountain drink machines on the basis of the sale for resale exemption by simply selling or leasing the machines to its customers. In this case, claimant did not submit lease agreements or other evidence establishing the arrangements between itself and its customers and therefore did not establish its qualification for the resale exemption.

CORPORATE TAXATION: RECENT DEVELOPMENTS

Samira A. Salman and Glenn T. Leishner[1]

The following is a summary of selected current developments in corporate tax law. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended ("the Code"). The Internal Revenue Service is referred to as the Service.

Acquisition of Target by Holdco is a "reverse acquisition" under Treas. Reg. Section 1.1502-75(d)(3)

In PLR 200603009,[2] the Service ruled that the acquisition of a target corporation qualifies as a reverse acquisition within the meaning of Treas. Reg. Section 1.1502-75(d)(3)(i). Failure to qualify as a reverse acquisition would have terminated the target group and subjected the losses to the separate return limitation year ("SRLY") rules. Accordingly, the parties to the transaction wanted the target group to survive the restructuring. The Service reached this conclusion with little explanation of who the relevant shareholders were and what percentage of the stock was "old and cold."[3]

Facts

T is the common parent of an affiliated group of corporations. T has two classes of outstanding stock. P owns x% of Class A, Shareholders B-H own, in the aggregate, the remaining percentage of Class A, and Shareholder A owns 100% of Class B. T owns all the stock of S1 and S2, which are part of the T consolidated group.

P also has two classes of outstanding stock. Shareholder A owns 100% of Class A and Shareholders B-H own 100% of Class B.

For business reasons (not described in the PLR) the taxpayer proposed the following steps:

- Shareholders A-H will transfer 100% of their T stock to P, in exchange for P stock. P will then own 100% of T.
- P will form Holdco.
- Holdco will acquire 100% of T from P, in exchange for Holdco stock. P will own 100% of Holdco, and Holdco will own 100% of T.

The following representations were made:

- The transfer of T shares to P will qualify under Section 351.
- T will remain in existence as a separate corporate entity controlled by Holdco.
- Holdco's acquisition of T from P will be tax free as a Section 368(a)(1)(B) reorganization or a Section 351 transfer.
- T's shareholders represented (immediately before the acquisition) that they will own more than 50% of the fair market value ("FMV") of the outstanding stock of Holdco (after the acquisition).

Conclusion

The ruling concludes that the acquisition of T by Holdco will qualify as a reverse acquisition within the meaning of Treas. Reg. Section 1.1502-75(d)(3), the T group will remain in existence with Holdco as its common parent, and Holdco will file the consolidated return for the same taxable year as T. The tax attributes of T will survive for consolidated return purposes, the prior taxable years will not be considered SRLY, the net operating loss carryovers ("NOLs") of T will be included in computing the consolidated net operating loss deduction of the affiliated group existing after the date of the transaction, the transaction will qualify as a "group structure change" for purposes of Treas. Reg. Sections 1.1502-31 and 1.1502-33, and the earnings and profits of Holdco will be adjusted to reflect the earnings and profits of Target immediately before Target ceases to be the common parent.[4]

The Service's analysis in reaching this conclusion is unclear for two reasons: First, when is the identification of the relevant Target shareholders made? Is it made before Shareholders A-H transfer their Target stock to Parent, or is it made after Shareholders A-H transfer their Target stock to Parent (so that Parent owns 100% of Target's stock)? Second, do you determine whether or not the relevant Target shareholders will own more than 50% of the FMV of outstanding Holdco stock?

The ruling does not discuss the timing of the relevant Target shareholder determination because the Service expressly relies on the representation that the Target shareholders will own more than 50% of the FMV of the outstanding Holdco stock. The percentage of Target's total stock represented by Parent's "old and cold" Target stock (before the transfer from the other shareholders) is unclear. If, before any of the restructuring steps, Parent owned more than 50% of Target stock, then Parent's exchange of its Target shares for Holdco shares would satisfy the 50% requirement (without regard to Parent's acquired Target shares from Shareholders A-H). But, if Parent owned less than 50% of Target stock before any of the restructuring steps, Parent would not satisfy the 50% requirement solely with its "old and cold" shares, and would have to consider the newly acquired shares (from Shareholders A-H).

Counting the newly acquired shares may disqualify the acquisition as a reverse acquisition because Treas. Reg. Section 1.1502-75(d)(3)(i) requires that all acquisitions or redemptions of the stock of either corporation that are

pursuant to a plan of acquisition are to be "taken into account" for purposes of determining whether the Target shareholders own more than 50% of the Holdco stock by reason of their owning Target stock. The language "taken into account" could mean that Parent's transitory ownership of Shareholders A-H shares will be disregarded (since Shareholders A-H do not receive Holdco stock), in which case Parent will not meet the 50% requirement.

New Parent not considered successor of Old Parent and allowed to file consolidated return before 5-year waiting period

In PLR 200604017[5] the Service found New Parent of a consolidated group was not a successor to Old Parent and therefore was allowed to file its own consolidated return.

Facts

Old Parent wholly owned the stock of Sub, which wholly owned the stock of Sub 1, which wholly owned the stock of each of Sub 2, Sub 3, and Sub 4. The aggregated value of Subs 2, 3, and 4 accounted for less than 5% of the total FMV of Old Parent. This low value may have affected the conclusion of this ruling.

On Date B, Sub 1 formed New Parent and contributed the stock of each of Sub 2, Sub 3, and Sub 4 to New Parent. On Date C (a date after Date B), Old Parent elected under Section 1361 to be treated as an S corporation, effective Date A (a date before Date B). On Date D (a date after Date C), Sub, Sub 1, and certain other subsidiaries, each elected under Section 1361(b)(3) to be treated as a qualified Subchapter S subsidiary of Old Parent, effective Date A (before Date B). New Parent, Sub 2, Sub 3, and Sub 4 did not make qualified Subchapter S subsidiary elections and remained Subchapter C corporations.

New Parent and its includible corporations that satisfy the stock ownership requirements of Section 1504(a)(2) proposed to file a consolidated federal income tax return, with New Parent as common parent of Subs 2, 3, and 4, beginning Date B.

Conclusion

The Service ruled that New Parent will not be considered a successor to Old Parent within the meaning of Section 1504(a)(3)(A). This conclusion allows New Parent and its includible subsidiaries[6] to elect to file a consolidated federal income tax return beginning Date B.

Analysis

Section 1504(a)(3)(A) precludes a consolidated group member from disaffiliating from the group and subsequently rejoining the group's consolidated return before the 61st month beginning after its first taxable year as a disaffiliated corporation. The Secretary may waive the application of this rule to any corporation for any period subject to certain conditions.[7]

This ruling contained little analysis, but one can conclude that the value of the assets, and the timing of the transfer may have affected the outcome. The stock of Subs 2, 3, and 4 constituted less than 5% of the value of Old Parent's assets (determined immediately prior to the transfer) and the transfer consisted of stock, not operating assets. If the transfer constituted a larger value, and was of operating assets, the Service may have reached a different conclusion.

Date A, the effective date of Old Parent's, Sub's, and Sub 1's Subchapter S election was before Sub 1's transfer of Subs 2, 3, and 4 to New Parent. Accordingly, at the time of the transfer, Subs 2, 3, and 4 were merely direct assets of Old Parent as a Subchapter S corporation. Note the ruling specifically does not express an opinion as to whether Old Parent's S corporation election was properly and timely made, and whether Sub and Sub 1 were considered "qualified Subchapter S subsidiaries" under Section 1361(b)(3)(B).

The Code and Treasury Regulations do not define the term "successor" for purposes of Section 1504(a)(3). And, notwithstanding the fact that New Parent's assets were the only assets held by Old Parent, the Service concluded that New Parent is not considered a successor to Old Parent for purposes of Section 1504(a)(3)(A).

Final Section 368(a)(1)(A) Regulations allow Mergers with Foreign Corporations

The Service issued final regulations defining the term "statutory merger or consolidation" as used in Section 368(a)(1)(A).[8] The primary significance of the final regulations is that a statutory merger or consolidation is no longer limited to a transaction effected under the laws of "the United States or a State or the District of Columbia".[9] Now, a transaction can qualify as a statutory merger or consolidation if it is effected under any statute (or statutes), whether or not the applicable statute(s) are domestic. Thus, foreign corporations can now be parties to statutory merger transactions within the meaning of Section 368(a)(1)(A). The final regulations also clarify that a merger of a corporation into a disregarded entity may qualify as a tax-free reorganization under Section 368(a)(1)(A). The regulations are effective January 23, 2006.

Background

On January 24, 2003, the Treasury Department published temporary regulations.[10] The 2003 temporary regulations provided that a statutory merger or consolidation is a transaction effected pursuant to the laws of the United States or a State or the District of Columbia. Given that many foreign jurisdictions have merger or consolidation statutes that operate in material respects like those of the States, on January 5, 2005, the Treasury Department proposed regulations containing a revised definition of statutory merger or consolidation that allows transactions effected pursuant to the statutes of foreign jurisdictions or of a United States possession to qualify as a statutory merger or consolidation.[11] Simultaneously with the publication of the 2005 proposed regulations, the Treasury Department issued a notice of proposed rulemaking containing amendments to the regulations under Sections 358, 367, and 884. These proposed amendments stated that a transaction involving a foreign entity and a transaction effected pursuant to the laws of a foreign jurisdiction might qualify as a statutory merger or consolidation.[12]

The most significant comments received with respect to the 2003 temporary regulations and the 2005 proposed regulations, and the extent to which these comments have been adopted in the final regulations are discussed below.

State Law Conversions

A number of commentators have questioned whether a stock acquisition followed by a conversion of the target into a disregarded entity[13] would qualify as a statutory merger or consolidation under the 2003 temporary regulations. The final regulations clarify that it will not. The target does not cease its separate legal existence for all purposes. Rather, the target's

state law legal existence continues, but in a different form. Because target's separate legal existence does not cease for all purposes, the transaction does not qualify as a statutory merger or consolidation. This transaction may, however, qualify under a different reorganization provision.

Existence and Composition of the Transferee Unit
The 2003 temporary regulations generally require that, for a transaction to qualify as a statutory merger or consolidation, all of the assets and liabilities of each member of the transferor combining unit become the assets and liabilities of one or more members of one other combining unit (the transferee unit).

One commentator questioned whether the existence and composition of the transferee unit is also tested immediately before the transaction. The commentator believed it was clear that the existence and composition of the transferor unit are tested only immediately before the transaction and that the existence and composition of the transferee unit are tested immediately after the transaction, but it is unclear whether that same testing is required before the transaction.[14] These final regulations include an example[15] that confirms that the existence and composition of the transferee unit is not tested immediately prior to the transaction but is tested only immediately after the transaction.

Consolidations and Amalgamations
Questions have arisen regarding the application of the definition of statutory merger or consolidation to transactions that are effected under state law consolidation statutes and foreign law amalgamation statutes.[16] In a typical state law consolidation and a foreign law amalgamation, two or more corporations combine and continue in the resulting entity, which is a new corporation that is formed in the consolidation transaction.[17]

The Service and Treasury Department believe that the continued existence of the consolidating or amalgamating corporations in the resulting corporation will not prevent a consolidation or amalgamation from qualifying as a statutory merger or consolidation under the final regulations. The final regulations require that the separate legal existence of the target corporation ceases. Even if the governing law provides that the existence of the consolidating or amalgamating entities continues in the resulting corporation, the separate legal existence of the consolidating or amalgamating entities does in fact cease.[18]

Other commentators have questioned whether a consolidation or amalgamation of two operating corporations can involve a reorganization under Section 368(a)(1)(F) with respect to one and a reorganization under Section 368(a)(1)(A) with respect to the other. The Service and Treasury Department intend to further study this issue in connection with their separate study of reorganizations under Section 368(a)(1)(F).[19]

Additionally, the final regulations include an example that illustrates the application of Section 368(a)(2)(D) to a triangular amalgamation.[20]

Final and Temporary Regulations for Basis Determinations in Reorganization Transactions

Effective January 23, 2006, the Service issued final regulations under Section 358 that provide guidance regarding the determination of the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions.[21] At the same time, the Service published temporary regulations under Section 1502 governing certain basis determinations and adjustments of subsidiary stock in certain transactions involving members of a consolidated group. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject.[22]

Background
The proposed regulations were issued on May 3, 2004. In the course of developing the proposed regulations, the Service considered whether a tracing method or an averaging method should be used to determine the basis of stock and securities received in these transactions. The final regulations retain the tracing method of the proposed regulations, but make several modifications to the proposed regulations in response to the comments received. These modifications are discussed below.

Allocation of Consideration Received
For exchanges subject to Sections 354, 355, or 356, the final regulations confirm that if the terms of the exchange specify which shares of stock or securities are received in exchange for a particular share of stock or security (or a particular class of stock or securities), then those terms will control for purposes of determining the basis of the stock or securities received (provided that the terms are economically reasonable).[23] In addition, the final regulations provide that if the terms of the exchange do not specify which shares of stock or securities are received in exchange for a particular share of stock or security (or a particular class of stock or securities), then a pro rata portion of the shares of stock and securities of each class received is treated as received in exchange for each share of stock and security surrendered, based on the FMV of the surrendered stock and securities.

Stockless Reorganizations
Several commentators observed that it is not clear how basis should be determined in reorganizations in which no stock is issued. In a "stockless reorganization," a shareholder or security holder surrenders stock or securities of a target in a transaction under the terms of Sections 354 or 356, and either receives no consideration, or receives consideration with an aggregate fair market value less than the fair market value of the surrendered stock or securities. The final regulations address this situation in Section 1.358-2(a)(iii) by: (i) deeming the acquiring corporation to issue an amount of stock having an aggregate value equal to the value of the surrendered target stock (such fictional shares would have a basis equal to the basis of the surrendered shares); and then (ii) deeming a recapitalization of all of the target shareholder's acquiring shares (fictional shares plus actual shares held) into the acquiring shares actually held. Target shareholder's basis in the acquiring shares deemed received in the recapitalization would be determined under Section 358(a). The Service believes this approach is consistent with the general tracing approach of the proposed regulations.[24]

Single v. Split Basis Approaches
These regulations clarify that a single share of stock may have a split holding period and a split basis.[25] This situation would arise if one share of stock or security is received in exchange for more than one share of stock or security, a fraction of a stock or security, or stock or securities acquired on different dates for different prices.

Coordination with Section 1036
Section 1036 provides that no gain or loss is recognized if common stock is exchanged for common stock in the same

corporation, or if preferred stock is exchanged for preferred stock in the same corporation. These final regulations clarify that the tracing rules do apply to transactions governed by both Sections 1036 and 354 or 356.[26]

Application of Tracing Rules to Section 351 Transactions
The tracing rules do not apply to an exchange described under Section 351. Some practitioners find it undesirable to have different regimes apply to the determination of the basis of stock received in a tax-free reorganization and Section 351 exchanges. The Service is continuing to study this.[27]

Excess Loss Accounts
Treas. Reg. Section 1.1502-19(d) provides that if a member ("P") of a consolidated group has an excess loss account ("ELA") in shares of a class of another member's ("S's") stock at the time of a basis adjustment or determination under the Code with respect to other shares of the same class of S's stock owned by the member, the adjustment or determination is allocated first to equalize and eliminate that member's ELA. The rule reflects a policy of permitting the elimination of ELAs. The application of the rule, however, is sensitive to the form of the transaction and the Service believes that the electivity of the application of the rule is undesirable.[28]

Accordingly, the Service expanded the scope of the application of the rule of Treas. Reg. Section 1.1502-19(d) in the temporary regulations included in this treasury decision. The temporary regulations add an additional rule that provides that (i) if a member would otherwise determine shares of a class of S's stock (a new share) to have an ELA and (ii) such member owns one or more other shares of the same class of S's stock, then the basis of such other shares is allocated to eliminate and equalize any ELA that would otherwise be in the new shares.[29]

Service Revokes Revenue Ruling 74-503

Effective December 20, 2005, the Service revoked a 32-year old revenue ruling holding that a transferor's basis in transferee stock is zero under Section 362(a) if the stock is received in exchange for transferor stock.

Background
In Revenue Ruling 74-503,[30] corporation X (transferor) transferred shares of its treasury stock to corporation Y (transferee) in exchange for newly issued shares of Y stock. In the exchange, X obtained 80% of the only outstanding class of Y stock. The 1974 ruling concludes that the basis of the X treasury stock received by Y is zero and the basis of the newly issued Y stock received by X is zero.

Analysis

The 1974 ruling states that X's basis in the Y stock received in the exchange is determined under Section 362(a). In Revenue Ruling 2006-2,[31] the Service states this conclusion is incorrect. The Service also states that the other conclusions in the ruling, including the conclusions that X's basis in the Y stock received in the exchange, and Y's basis in the X stock received in the exchange are zero, are being studied.

In reaching its incorrect conclusion that X's basis in Y stock is determined under Section 362(a), Rev. Rul. 74-503 indicates that Section 358(a) applied to determine the basis of property received by a transferor in a Section 351 transfer. However, as the Service addressed in the 1974 ruling, Section 358(e) provides that Section 358(a) does not apply to property acquired by a corporation by the exchange of its stock as consideration for the transfer. Because X acquired the Y stock in exchange for its stock, Section 358(a) does not apply. The 1974 ruling continues that under Treas. Reg. Section 1.1032-1(d), the basis of the X stock received by Y, and the basis of the Y stock received by X will be determined under Section 362(a), because the transaction qualifies under Section 351.

In the 2006 Revenue Ruling, the Service does not state why the conclusion in the 1974 ruling is wrong. It does not address whether the analysis regarding the non-application of Section 358(a) is incorrect, or whether the analysis regarding the application of 362(a) is incorrect; it simply states that the conclusion that basis is determined under Section 362(a) is incorrect. Several commentators have analyzed why the Service concluded that the application of Section 362(a) is incorrect, but that discussion is beyond the scope of this update.

Final Regulations Regarding Information Reporting for Taxable Stock Transactions

Effective December 5, 2005, the Service issued final regulations requiring information reporting by a corporation if control of the corporation is acquired, or the corporation has a substantial change in capital structure, and the corporation or any shareholder is required to recognize gain under Section 367(a).[32] At the same time, the Service issued final regulations concerning information reporting requirements for brokers regarding transactions described in Section 6043(c).[33]

Sections 6043(c) and 6045
Section 6043(c) provides that if any person acquires control of a corporation, or if there is a recapitalization or other substantial change in capital structure of a corporation, the corporation must file a return identifying the parties to the transaction, the fees involved, the changes in the capital structure involved, and any other information requested by the Secretary.

Section 6045 provides that every broker must file a return showing the name and address of each customer, with details including gross proceeds and any other information requested by the Secretary.

Background
On November 18, 2002, the Service published the 2002 temporary and proposed regulations generally requiring information reporting under Section 6043(c) for certain large corporate transactions involving acquisitions of control and substantial changes in the capital structure of a corporation. The 2002 regulations were withdrawn and the 2003 temporary and proposed regulations were issued. The 2003 regulations changed the time and manner of filing, making the Form 8806 a stand-alone form required to be filed within 45 days following the transaction, and expanded the list of exempt recipients to include brokers, requiring them to file an information return if certain criteria are met (Form 1099-B).[34]

On December 31, 2004, the IRS issued Notice 2005-7[35] responding to enactment of Section 6043A. Section 6043A was added by the American Jobs Creation Act of 2004 and provides for information reporting by an acquiring corporation in any taxable acquisition, according to forms or regulations prescribed by the Secretary. Notice 2005-7 stated that taxpayers required to report under Temp. Treas. Reg. Sections 1.6043-4T and 1.6045-3T must continue to report pursuant to those regulations. The notice observed that Section 6043A supplements the information reporting provisions of Sections 6043(c) and 6045, and it requested comments on the

coordination of Section 6043A with the requirements of the 2003 temporary and proposed regulations.

Final Regulations
With the revisions explained below, the final regulations adopt the 2003 temporary regulations. The final regulations limit the information reporting to transactions in which the reporting corporation or any shareholder is required to recognize gain under Section 367(a).

Changes from Proposed Regulations
In the final regulations, the definition of acquisition of control of a corporation in Treas. Reg. Section 1.6043-4T(c)(1)(i) is revised to omit transactions where stock representing control of a corporation is distributed by a second corporation to shareholders of the second corporation because such transactions would not result in a recognition of gain under Section 367(a). The rules regarding constructive ownership in Treas. Reg. Section 1.6043-4T(c)(3),[36] and Section 338 elections in Treas. Reg. Section 1.6043-4T(c)(5) have been deleted since those special rules are unnecessary regarding transactions that may result in recognition of gain under Section 367(a).

The definition of change in capital structure in Treas. Reg. Section 1.6043-4T(d)(2) has been modified to remove the inclusion of recapitalizations and redemptions since those transactions would not result in a recognition of gain under Section 367(a). Additionally, Examples 2 and 3 in Treas. Reg. Section 1.6043-4T(h) have been omitted because those examples addressed circumstances beyond Section 367(a).

The proposed regulations under Sections 6043(c) and 6045 issued on December 30, 2003 (and corrected on February 13, 2004) remain outstanding with respect to the transactions not covered by the final regulations.

ENDNOTES

1 Shell Oil Company, P.O. Box 2463, Houston, TX 77252-2463; samira.salman@shell.com, glenn.leishner@shell.com.

2 PLR 200603009 (Jan. 20, 2006).

3 “Old and cold” represents the stock that the company owns prior to the restructuring steps.

4 Treas. Reg. Section 1.1502-33(f)(1).

5 PLR 200604017 (Jan. 27, 2006).

6 Includible subsidiaries are corporations under Section 1504(b) and that satisfy the stock ownership requirements of Section 1504(a)(2).

7 I.R.C. Section 1504(a)(3)(B).

8 T.D. 9242, 71 Fed. Reg. 4259 (2006).

9 *Id.*

10 T.D. 9038, 68 Fed. Reg. 3384 (2003).

11 REG-117969-00, 70 Fed. Reg. 746 (2005).

12 T.D. 9242, 71 Fed. Reg. 4259 (2006).

13 Either by a state conversion statute or an entity classification election under Treas. Reg. § 301.7701-3.

14 T.D. 9242, 71 Fed. Reg. 4259 (2006).

15 Treas. Reg. Section 1.368-2(b)(1)(iii), Example 11.

16 T.D. 9242, 71 Fed. Reg. 4259 (2006).

17 *Id.*

18 *Id.*

19 *Id.*

20 *Id.*

21 T.D. 9244, 71 Fed. Reg. 4264 (2006).

22 *Id.*

23 *Id.*

24 *Id.*

25 *Id.*

26 *Id.*

27 *Id.*

28 *Id.*

29 *Id.*

30 1974-2 C.B. 117.

31 2006-2 I.R.B. 261.

32 T.D. 9230, 70 Fed. Reg. 72376 (2005).

33 *Id.*

34 *Id.*

35 2005-3 I.R.B. 340.

36 Two or more corporations acting pursuant to a plan or arrangement in Treas. Reg. Section 1.6043-4T(c)(4).

DEMYSTIFYING THE IRS POSITION ON SOLID WASTE DISPOSAL FACILITIES

By W. Mark Scott[1]

This paper explicates the current views of the IRS in its audits of municipally financed solid waste recycling facilities. The focus of this paper is the position of the IRS in municipal bond examinations. As such, the paper will not address the current project being undertaken by the policymakers to change the existing rules for future transactions.[2]

The IRS initiated its first examination of a solid waste financing in 1995. The IRS asserted in that case that certain privately owned or operated disposal facilities used to recycle solid material did not comply with the requirements found in the long-standing regulations issued under prior section 103(b) of the Internal Revenue Code of 1954.[3] The issue raised in the examination was the topic of a technical advice memorandum.[4] During the audit process, the IRS was informed that the position being taken in the particular audit was consistent with the opinion of many bond counsel. Consequently, shortly after the issuance of a TAM supporting the position taken by the IRS in the examination, the IRS opened an audit project initiative that consisted of

approximately 40 examinations of privately owned or operated recycling facilities financed by tax-exempt bonds. The IRS has continued with this audit program by opening new audits in 2004 and 2005.

The IRS has now concluded a significant number of examinations involving privately owned or operated solid waste recycling facilities, some with and some without concern as to the tax-exempt status of the financing. This paper will answer questions raised by issuers, borrowers, bondholders, and practitioners regarding the position that the IRS has taken in these audits.

Questions and Answers:

1. What are the primary legal and factual issues being raised by the IRS in its examination of solid waste financings?

The IRS is primarily focusing on whether the solid material being recycled by the solid waste disposal facility constitutes "solid waste." Treas. Reg. Section 1.103-8(f)(2)(ii)(b) provides that:

> [T]he term "solid waste" shall have the same meaning as in section 203(4) of the Solid Waste Disposal Act (42 U.S.C. § 3252(4)), except that for purposes of this paragraph, material will not qualify as solid waste unless, **on the date of issue** of the obligations issued to provide the facility to dispose of such waste material, it is property which is useless, unused, unwanted, or discarded solid material, which has **no market value at the place where it is located**. Thus, where any person is willing to purchase such property **at any price**, such material is not waste. Where any person is willing to remove such property at his own expense but is not willing to purchase such property at any price, such material is waste.

Section 203(4) of the Solid Waste Disposal Act provides that:

> The term "solid waste" means garbage, refuse, and other discarded solid materials, including solid-waste materials resulting from industrial, commercial, and agricultural operations, and from community activities, but does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants.

The IRS asserts that the definition of solid waste for purposes of tax-exempt financing is static and does not change from year to year based on changes in the definition of solid waste found in the Title 42 of the U.S. Code, which governs environmental protection.[6]

Thus, to determine whether material is solid waste and, consequently, whether a particular facility may be financed as a solid waste disposal facility under section 142, Treas. Reg. Section 1.103-8(f)(2)(ii)(b) requires the material to have no market value where it is located on the date of issue of the bonds issued to finance the disposal facility. The IRS applies this "value test" to the solid material being recycled by determining whether any price is paid for the solid material to be recycled. If so, then, in the view of the IRS, it is, by definition, not solid waste.

2. Does the IRS believe that recycling facilities qualify as solid waste disposal facilities?

Yes. Section 1.103-8(f)(2)(ii)(a) of the regulations defines a solid waste disposal facility as any property or portion thereof used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste.

Under Treas. Reg. Section 1.103-8(f)(2)(ii)(c), a facility that recycles solid material can qualify as a solid waste disposal facility under section 142 of the Code so long as solid waste constitutes at least 65 percent of the total materials introduced into the recycling process. Treas. Reg. Section 17.1(a) further provides that solid waste recycling facilities can be operated at a profit provided that the waste disposal function only includes the processing of such materials in order to put them into the form in which they are in fact sold or used.

The IRS has audited several recycling facilities that meet its strict interpretation of these provisions.

3. Why is the IRS restricting the use of tax-exempt financing for recycling facilities if the purpose behind section 142 was to permit those financings?

The IRS believes that section 142 was designed to permit the financing of facilities that *dispose* of solid waste and was not intended to constitute a broad recycling statute. The IRS has asserted that although recycling can constitute one form of disposal, strict requirements must be satisfied.

To support this contention, the IRS compares section 142 with prior section 48 of the Code, which permitted a tax credit for certain recycling facilities. The regulations under prior section 48 defined solid waste to have the same meaning as the definition for tax-exempt bond financing, with several significant differences. For instance, the regulation under section 48 defined solid waste to mean the same as the definition for section 103 except that, for section 48 purposes, solid material that has a market value at the place it is located "only by reason of its value for recycling" is not considered to have market value.[7] Therefore, according to the IRS, by including solid material with certain market value, the definition of solid waste for purposes of section 48 was intended to be broader than the definition of solid waste for purposes of section 142. The IRS cites to the preamble of the cited section 48 regulations for confirmation of its analysis.[8]

Accordingly, per the IRS, the types of property that could be recycled in accordance with a section 48 facility were broader than the types that can be recycled by a section 142 facility. On the other hand, as section 48 of the Code permitted a credit for recycling only, the types of disposal permitted to be financed with tax-exempt bonds are broader than the single type of disposal, that is, recycling, permitted under section 48.

4. Is the IRS citing any other support for its rationale?

Yes. The IRS cites to several attempts to legislate a change to section 142 as support for its position that the recycling permitted by the statute was intentionally limited. For instance, the IRS has cited to former Sen. Al Gore's attempt in 1989 to "… amend the Tax Code to include qualified recycling facilities as facilities that may be financed with tax-exempt bonds" so that "… recyclers [can] access tax-exempt facility bonds to ensure that recyclers can compete on a level playing field with other solid waste options." 135 Cong. Rec. S15731 (1989).

The IRS asserts that Sen. Gore's bill was an attempt to broaden the scope of section 142 to permit the financing of new recycling plants "such as secondary paper mills" under section 142 of the Code. The IRS points out that the bill specifically permitted the financing of recycling facilities for some commercially saleable material, such as "waste paper and paperboard," and provided that "[r]efuse shall not fail to be treated as waste merely because it has a market value at the place it is located only by reason of its value for recycling."

Additionally, the IRS asserts that the proposed legislation introduced in 1995 by Sen. Judd Gregg, R-N.H., was another attempt to broaden the scope of the existing code provision. Sen. Gregg's bill would have expanded the definition of solid waste disposal facilities to permit the financing of "qualified recycling facilities" that "sort and prepare municipal, industrial and commercial refuse" or recycle "qualified refuse." Under this bill, qualified refuse was defined to mean "yard waste … food waste … waste paper and paperboard … plastic scrap … rubber scrap … ferrous and nonferrous scrap metal … waste glass … construction and demolition waste, and … biosolids (sewage sludge)." This bill also provided that "[r]efuse shall not fail to be treated as waste merely because such refuse has a market value at the place such refuse is located only by reason of the value of such refuse for recycling." 141 Cong. Rec. S3969 (daily ed. Mar. 15, 1995).

5. How is the IRS applying the existing "value test" to solid waste materials?

To date, in most of the cases that the IRS has reviewed, the recycled material is generated, collected, and recycled by three distinctly different parties or industries. To this end, the IRS is basing its determination as to whether the solid material being recycled is "solid waste" by applying the value test to the ultimate method of acquisition by the party that is benefiting from the tax-exempt financing. Thus, if the recycler is benefiting from tax-exempt financing, the IRS is applying the value test to the solid material in the form in which it is acquired by the recycler.

Treas. Reg. Section 1.103-8(f)(2)(ii)(b) states that material will not qualify as solid waste unless, **on the date of issue** of the obligations issued to provide the facility to dispose of such waste material, it is property which is useless, unused, unwanted, or discarded solid material, which has **no market value at the place where it is located**. Thus, regardless of how the material is acquired (on the open market or in accordance with a long-term agreement), the IRS tests whether any price was paid for the solid material by determining the value of, or price paid for, such material in the area in which it is located as of the issue date of the tax-exempt bonds financing the facility.

An example of this application can be found in an IRS ruling published shortly after the regulations were issued. In Rev. Rul. 75-184, 1975-1 C.B. 41, a recycler of old corrugated cardboard (OCC) entered into a long-term contract with a waste collector before the issuance of bonds. The contract provided for the purchase, at a set price, of OCC that had been separated from the refuse stream, sorted, baled, and loaded for transportation. The revenue ruling states that because the OCC will have value at the waste collector's location and that the recycler is willing to purchase the property at a stated price, the material will not qualify as solid waste.

6. Is the IRS drawing a distinction in those instances in which the solid material is collected by the recycler?

Temp. Treas. Reg. Section 17.1 provides that when material or heat are recovered, the waste disposal function includes the processing of those materials or heat in order to put them into the form which is in fact sold or used, but does not include further processing, which converts the materials or heat into other products.

The example included in Temp. Treas. Reg. Section 17.1 is illustrative of that provision. In particular, the example begins, as follows:

> Company A intends to construct a new facility to process solid waste which City X will deliver to the facility. City X will pay a disposal fee for each ton of solid waste that City X dumps at the facility. The waste will be processed by A in a manner which separates metals, glass, and similar materials. As separated, some of such items are commercially saleable; but A does not intend to sell the metals and glass until the metals are further separated, sorted, altered, and cleaned and the glass is pulverized. The metals and pulverized glass will then be sold to commercial users. The waste disposal function includes such processing of the metals and glass, but no further processing is included.

The example notes that, during the waste disposal process, there will be an intermediate stage in which separated materials will become commercially saleable. Nevertheless, the waste disposal function will include additional processing by the collector of the separated materials to put the materials in the form in which they will be sold to commercial users.

However, if the separated materials had been sold for a positive price to the commercial user when they were first commercially saleable, the IRS would not have permitted the commercial user to tax-exempt finance the same facilities as solid waste disposal facilities. The example, therefore, permits a collector to tax-exempt finance facilities that could not be tax-exempt financed by the purchaser of the same material.

The IRS is interpreting this language to permit the financing of additional facilities that perform some limited amount of additional processing on the solid material to put the material in the form in which it is, in fact, sold or used. The additional facilities must be related to the disposal process and process the material before the transformation of that material into a significantly different product. The degree to which any additional processing is allowed by the IRS, however, is a matter of negotiation.

Therefore, the IRS understands that regulation section 17.1 can be cited to demarcate, at the very least, a slight difference between financings of private recyclers depending on whether they collect or purchase their recyclable material and the IRS has, where appropriate, taken this difference into account during the examinations of integrated facilities. The IRS has not, however, recognized this distinction as a change to either the definition of the value test or its application.

7. How is the IRS supporting its limitation on additional processing allowed by Temp. Treas. Reg. Section 17.1?

The IRS is citing to congressional enactment of section 103(g) of the Internal Revenue Code of 1954 (subsequently

repealed by the Tax Reform Act of 1986). This provision was enacted to encourage the burning of solid waste (refuse-derived fuel, or RDF) to produce steam or the processing of waste into alcohol. Congress enacted section 103(g) out of concern for the amount of waste being landfilled, as well as the country's need for imported oil.[9]

In a typical "trash to energy facility," raw trash is dumped at the facility (at a cost to the person who dumped it). The trash is sorted and chopped up, which converts a portion of it into RDF. The RDF is then burned to produce energy. Also, certain sorted materials not making up a portion of the RDF are sold to third parties for recycling.

In the legislative history for section 103(g), the Finance Committee Report described the reason for the section's enactment as follows:

> In general, such [solid waste disposal] facilities include property necessary for the processing of solid waste into a form which is commercially marketable, but such facilities do not include property for the further processing of the commercially marketable product of the solid waste. …
>
> Since the regulation [Temp. Treas. Reg. Section 17.1] was promulgated, methods of processing the waste remaining after separation of glass and metal have advanced to the stage that the residual waste may be transformed into a commercially salable energy form known as refuse-derived fuel. In certain instances, this material is burned to produce steam which is sold or is used to generate electric energy. As a result of the fact that the refuse-derived fuel is commercially marketable, it is unclear whether equipment which utilizes refuse-derived fuel and is used to produce steam would qualify as solid waste disposal facilities.[10]

The IRS cites this legislative history to assert that Congress understood certain practical limits inherent in Temp. Treas. Reg. Section 17.1.

8. In determining whether certain solid material is waste, is the IRS comparing the price paid for the solid material with the cost of processing the solid material to the recycler?

No. This issue has been raised and rejected in a number of examinations. The IRS asserts that the appropriate question is not whether the costs of processing solid material to the recycler are greater than the purchase price, but whether the solid material meets the definition of solid waste. In other words, the IRS is testing whether the recycler is paying **any price** for the solid material. Accordingly, the IRS has indicated that as long as any price is being paid for the solid material, the material is not solid waste. This is true regardless of the costs incurred by the generator or collector in collecting, sorting, or processing such solid material.

The IRS asserts that it has consistently applied this position since the 1970s.

9. Would it matter if the recycled solid material was diverted from a landfill?

The IRS is not treating as relevant the question of whether the solid material would have been deposited in a landfill absent collection, processing, and recycling.

As with the previous question, the IRS asserts that this question was raised in the early 1970s shortly after the solid waste regulations were issued. The IRS also asserts that its interpretation has been consistently applied.

10. How, then, is the IRS treating transportation and "handling" costs incurred by the collector or recycler for purposes of determining value?

Treas. Reg. Section 1.103-8(f)(2)(ii)(b) provides that where any person is willing to remove solid material at his own expense but is not willing to purchase such property at any price, such material is waste. Therefore, the IRS will not treat direct transportation costs incurred or reimbursed by a recycler as part of the price for solid material.

"Handling" costs have previously been permitted in certain specific cases upon the request of a private ruling. Typically, the handling costs granted exclusion from the price of the material were identified costs that were closely related to the costs of transportation.[11] Thus, the IRS is permitting, on a case-by-case basis, acceptable levels of handling costs closely related to the transportation of solid waste provided that those handling costs are directly incurred, paid, or reimbursed by the beneficiary of the tax-exempt financing.

To date, the IRS has not permitted a reduction for transportation and handling costs incurred by generators and collectors. Furthermore, the IRS has not reduced the purchase price for the costs of transportation and handling incurred before the transportation and delivery of the solid material to the financed facility. For example, if the facility financed with tax-exempt bonds recycles OCC into linerboard and the OCC is purchased by the recycler from a collector after it is sorted and baled, the IRS is not permitting the price of OCC delivered to the recycler to be reduced by the amount of transportation and handling costs incurred by the collector in transporting the OCC to the collector's facility for processing and baling. The IRS is, however, permitting the recycler to reimburse the collector for costs incurred in transporting the solid material from the collector's facility to the recycler's financed facility.

11. Will the IRS challenge a long-term contract that indicates that the entire price paid for the solid material is for transportation and handling costs?

On April 30, 1999, a statement was read on behalf of the Treasury Department concerning the issuance of tax-exempt bonds to finance recycling facilities. The statement reads as follows:

> A) A bona fide arms-length agreement between an unrelated buyer and seller is generally the best evidence regarding whether material subject to the agreement has a market value.
>
> B) A long-term contract pursuant to which a buyer pays only for the supplier's transportation and handling costs in a manner that is consistent with existing rulings will continue to be a permitted method of structuring transactions and establishing that a material subject to the contract has no value. However, the IRS may always scrutinize a contract and its cost allocation to ascertain that no amount is being paid for the material and that any and all payments are properly allocable to transportation and handling costs.[5]

As indicated by the Treasury statement, the IRS will generally regard a bona fide arm's-length agreement between an

unrelated buyer and seller as the best evidence regarding whether material subject to the agreement has a market value. Therefore, the IRS is, typically, not challenging long-term contracts provided the facts and circumstances surrounding any such agreement indicate that the agreement is bona fide and was entered into in an arm's-length transaction. Obviously, IRS agents will sometimes challenge such contracts, especially if the contract would appear inconsistent with the existing market in which the tax-exempt bonds are issued (the existence of an increasingly positive market price for separated and sorted recyclable material).

12. Is the IRS challenging tax-exempt financed recycling facilities that recycle a marketable commodity?

Yes. The IRS is focused on the preamble to section 1.48-9 of the income tax regulations, which specifically states that solid waste for tax-exempt bond purposes would generally not include "scrap metal, newsprint, and fibers." In the view of the IRS, the preamble supports the conclusion that tax-exempt financing would not be available for solid material for which a positive market exists on the date of the issuance of the bonds. The IRS points to this preamble language to justify its interest in auditing facilities that recycle solid material such as newsprint, OCC, scrap metal, and glass. In the view of the IRS, recycling marketable materials with positive market prices is equated more with the manufacture of a new product than the disposal of solid waste.

13. Does this mean that the IRS is attempting to invalidate any bond issued to finance a facility that recycles a marketable commodity with a positive market price?

Yes, with one exception. Treas. Reg. Section 1.103-8(f)(2)(ii)(b) requires the IRS to determine the value of solid material on the date of issue of the bonds used to finance the recycling facility. Solid material may satisfy the regulatory definition of solid waste on the date of issue, but then fail to qualify as solid waste as a market for the material develops during the life of the facility. In such an instance, notwithstanding the subsequent development of a market for the solid material, interest paid on the bonds would continue to be excludable from income. In the event of an IRS audit, however, the borrower should be prepared to prove market value on the date of issue of the bonds.

If specific facts surrounding value on the date of issue are not available, the IRS will generally look to similarly situated facilities located in the same geographic area to determine whether a value existed for the solid material in question on the date of issue. Alternatively, the IRS may determine that a value existed based on a prevailing market price for the solid material in question in the same geographic area.

14. What if less than 65 percent of the solid material that is being recycled qualifies as solid waste?

A solid waste disposal facility can include a recycling facility under Treas. Reg. Section 1.103-8(f)(2)(ii)(c) if at least 65 percent of the material introduced into the process constitutes solid waste. The IRS is applying a strict reading to this test. In its view, a facility that disposes of solid waste by reconstituting, converting, or otherwise recycling it into material that is not waste will qualify as a solid waste disposal facility only if solid waste constitutes at least 65 percent, by weight or volume, of the total materials introduced into the recycling process. The IRS is challenging the tax-exempt status of bonds used to finance any portion of a facility that does not meet this test, even when those bonds are weighted according to the actual percentage of solid waste inputted into the process.

Treas. Reg. Section 1.103-8(f)(2)(ii)(d) and Temp. Treas. Reg. Section 17.1(b) indicate that when a solid waste disposal facility has multiple functions, the portion of the cost of property allocable to solid waste disposal must be allocated to those separate functions. The regulations further permit this allocation of the cost of such property between the property's solid waste disposal function and any other functions to be made by any method which, with reference to all the facts and circumstances with respect to such property, reasonably reflects a separation of costs for each function of the property.

For its position, the IRS is citing to legislative history from 1979:

> In addition, furnaces and boilers used to burn solid waste and transform the resulting heat into steam are treated as solid waste disposal facilities. However, where less than 65 percent, by weight or volume, of the material burned is solid waste, the boilers will not qualify as solid waste disposal facilities.
>
> In addition, in the case where solid waste is separated and processed, and the processed solid waste product is burned and the resulting heat is used to produce steam, the furnace and boiler used to burn the product and produce steam are, in general, treated as solid waste disposal facilities. However, where the processed product is commercially salable, neither the furnace nor the boiler will qualify as a solid waste disposal facility unless at least 65 percent, by weight or volume, of the material burned is a processed solid waste product.[12]

The IRS is also citing to the lack of rulings allowing a lower percentage of recyclable materials. Accordingly, the IRS is examining whether financed facilities meet the 65 percent test and will take a strict view on that test.

15. Assuming the input of at least 65 percent of the recyclable materials meets the definition of solid waste, will the IRS examine any other aspects of the financing?

Section 17.1 of the temporary regulations provides that a facility that otherwise qualifies as a solid waste disposal facility will not be treated as having a function other than solid waste disposal merely because material that has utility or value is recovered or results from the disposal process. However, where materials are recovered, the waste disposal function includes the processing of such materials, which occurs in order to put them into the form in which the materials are in fact sold or used, but does not include any further processing, which converts the materials into other products. Therefore, the regulations define the disposal function of a facility to include the portion of the facility that processes solid waste to a point in which it can be sold or used.

Rev. Rul. 76-222, 1976-1 C.B. 26, reviewed a proposed issuance of solid waste disposal bonds to finance the acquisition and construction of a facility designed to separate garbage into combustible and noncombustible fractions. The

garbage was to be collected by independent collectors and dumped at collection stations operated by the operator of the facility. The operator was to pay nothing for the material, and the ruling cited as a fact that the garbage was useless, unwanted material for which no person would pay any amount. The garbage had to be processed by the operator to remove the noncombustible fractions and it also had to be reduced to a small, uniform size. The combustible fraction was fed directly from the operator's classifiers to a surge bin from which it was blown into the boilers of the purchaser, a public utility. Therefore, once the processed garbage reached the surge bin, it was in a form in which it was sold as fuel. At this point, the ruling concludes that the material was no longer solid waste since it was no longer useless and unwanted. The ruling further concludes that the operator's waste disposal function included the processing of the waste into the form that was subsequently sold, but did not include any further processing because once the material was in the form in which it could be sold, it was no longer useless and unwanted. The ruling holds, therefore, that any equipment, such as the fans and ductwork necessary to pneumatically transport fuel from an operator's bin to a purchaser's boilers, would not qualify as part of an exempt solid waste disposal facility.

The IRS is relying on this regulatory language and ruling to examine whether financed facilities include any equipment or facility that converts marketable material into other products.

16. What if the facility is to be expanded and improved with a new bond issue several years after its construction? Will the IRS allow the tax-exempt financing of improvements if the facility originally qualified for tax-exempt financing?

Not necessarily. The IRS asserts that the Code and regulatory tests require it to test whether material qualifies as solid waste (that is, to value test the material) on the date of issue of any new money bonds. Therefore, notwithstanding prior compliant issues, the IRS is treating every new money financing as a separate issue for all purposes.[13] For this purpose, the IRS is generally basing its factual conclusion of multiple issue dates on whether the issuer has filed multiple Forms 8038, "Information Return for Tax-Exempt Private Activity Bond Issues."

The IRS is applying the same rule regardless of whether the multiple financings are necessitated by a desire to make improvements to an old facility or to complete the financing of a new facility. For this purpose, issuers and borrowers are cautioned to review their qualification for financing on the issue date of each separate tax-exempt issuance, even if such separate issuances are only necessitated by the lack of available volume cap from the state's annual limitation on the issuance date of the first bond issue.

Accordingly, during the municipal bond examination, the IRS may open one or more additional examinations of earlier or later bond issues to ascertain whether such other issues also comply with federal tax laws. In such instances, the IRS has been seeking to recover the tax subsidy stemming from only the nonqualifying bond issues.

17. If a determination is made that interest paid on the bonds does not qualify for exclusion based on the analysis of the recycling facility, are there any other adjustments that the IRS will make in the examination?

Yes, the IRS will likely open a separate examination for purposes of eliminating the interest deduction of the private owner of the facility in accordance with section 150(b)(4) of the Code.

18. Can the adjustment under section 150(b)(4) be made separate from the adjustment of bondholders' taxable income?

Yes. Under the existing structure of the IRS, the Large and Mid-Size Business Division will typically have jurisdiction over the adjustments made by section 150(b)(4). The IRS Office of Tax Exempt Bonds is offering to postpone the taxation of bondholders pending the resolution of the section 150(b) adjustments on conduit borrowers.[14] This offer is available only in those cases in which the conduit borrower expeditiously proceeds to contest all legal and factual issues in a court of law.

Conclusion:

The IRS permits limited recycling of solid waste as a specifically permitted disposal method under the existing regulations. The IRS, however, is taking very strict views of the sorts of recycling permitted under the regulations and has found support for these views from the Office of Chief Counsel and the Office of Appeals.

When the IRS determines that a solid waste recycling financing fails to comply with applicable law, the IRS is attempting to recapture, on behalf of the federal government, all of the taxes owed on interest payments and early redemption of the bonds. The IRS is also making adjustments to the conduit borrowers' tax returns to deny the borrowers' interest deduction for interest paid on its loan from the bond proceeds.

ENDNOTES

1 The author is a member of the State Bar of Texas and is board certified in tax law by the Texas Board of Legal Specialization. The author, formerly the Director, Tax Exempt Bonds for the IRS, is a partner in the Washington, DC office of Vinson & Elkins LLP This article was originally pblished in Tax Notes. An earlier version of this article was prepared by the author and presented to IRS bond agents in internal training programs. IRS attorney and tax law specialist Steven Chamberlin assisted in the preparation of that earlier version.

2 Prop. Treas. Reg. § 1.142(a)(6)-1.

3 Interest on a private activity bond is not excludable from gross income under section 103(a) of the Code. However, the law contains exceptions to this general rule for certain qualified private activity bonds including "exempt facility bonds" that finance "solid waste disposal facilities." Sections 141(e)(1)(A) and 142(a). Therefore, the Code permits tax-exempt financing of privately owned or operated solid waste disposal facilities, provided various requirements are met. The statutory scheme under sections 103 and 142 of the Code was enacted as part of the Tax Reform Act of 1986. *See* sections 1301 *et seq.* of Pub L. No. 99-514, 1986-3 C.B. (Vol. 1) 519-527. The legislative history accompanying the 1986 Act imports the definitions of the terms "solid waste" and "solid waste disposal facility" from the regulations promulgated under the predecessor code provision (section 103(b)(4)(E) of the Internal Revenue Code of 1954). The corresponding House Report incorporated all of the then current law to the extent not amended. Moreover, the characterization of "solid waste disposal facilities" under the House Report expressly referred to the regulatory rules found in section 1.103-8(f)(2)(ii). H.R. Rep No. 426, 99th Cong., 1st Sess. 497, 518 (1985), 1986-3 C.B. (Vol. 2) 497, 518. The Conference Report stated that "solid waste disposal facilities" are defined, with exceptions not relevant to the present inquiry, as under the then current law. H.R. Conf. Rep. No. 841, 99th

Cong., 2d Sess. II-704 (1986), 1986-3 C.B. (Vol. 4) 704. Thus, "solid waste disposal" regulations issued under prior section 103 of the 1954 Code are instrumental in defining present law, as found in the 1986 Code.

4 Tech. Adv. Mem. 1999-18-001 (May 7, 1999).

5 IRS Statement on Solid Waste, read by Bruce M. Serchuk, a lawyer in the IRS's Office of Chief Counsel, at the American Bar Association Tax Section's Committee on Tax-Exempt Finance, April 30, 1999.

6. T.D. 7765, 1981-1 C.B. 22, 26.

7. Treas. Reg. § 1.48-9(g)(5)(i)(B).

8. *See* T.D. 7765, 1981-1 C.B. 24, 26 and the legislative history cited therein.

9. *See* Senate Discussion, Vol. 125 Cong. Rec. S18683 (Dec. 15, 1979).

10. S. Rep. No. 96-394, 96th Cong., 1st Sess., at 104 (Nov. 1, 1979) (emphasis added).

11. *See* Priv. Ltr. Rul. 7941045 (July 12, 1979) and Priv. Ltr. Rul. 7923073 (Mar. 12, 1979).

12. Senate Report No. 96-394, Nov. 1, 1979.

13. *See* sections 1.150-1(c) and 1.103-8(a) of the regulations. *Compare* section 1.103-7(d) of the regulations.

14. I.R.M. 4.81.1.17.

RECENT DEVELOPMENTS IN INTERNATIONAL TAX

Mark R. Martin[1]

1. Foreign Tax Credit

Guardian Indus. v. United States[2] involved the interplay between the check-the-box rules and the foreign tax credit rules. Guardian, through subsidiaries, had a large operation in Luxembourg, where it employed 1,200 persons and operated three manufacturing facilities. It filed returns on a consolidated basis in Luxembourg. The first-tier Luxembourg entity was an SARL, which was treated as a disregarded entity for U.S. tax purposes (the "Lux SARL").

In *Guardian*, the taxpayer argued that, under the Luxembourg combined filing rules, the Lux SARL was the taxpayer responsible to the Luxembourg tax collectors for the taxes of the combined group. This is important because, under Treas. Reg. Section 1.901-2(f)(1), the taxpayer by whom foreign taxes are considered paid for purposes of Sections 901 and 903[3] is "the person on whom foreign law imposes legal liability for such tax, even if another person (for example, a withholding agent) remits such tax." For taxes on combined income, such as with a parent corporation and a subsidiary, Treas. Reg. Section 1.901-2(f)(3) provides that, if the taxpayers are jointly and severally liable for the income tax under foreign law, "foreign law is considered to impose legal liability on such person for the amount of the foreign income tax that is attributed to its portion of the base of the tax, regardless of who actually pays the tax."[4] That rule results in a proportional allocation between the parties, which the taxpayer in *Guardian* needed to avoid. Thus, the taxpayer argued that the Luxembourg rules did not require joint and several liability, but rather made the Lux SARL solely liable for the taxes of the Luxembourg consolidated group.

Both parties presented reports from experts on Luxembourg law. Guardian's expert, the Deputy Tax Director of the Luxembourg Administration des Contributions Directes, agreed with Guardian's view that only the Lux SARL was liable for the tax. The government's expert disagreed.

The Court stated that the manner in which the consolidated regime is administered by the Luxembourg tax authorities is consistent with the parent company having sole liability for the consolidated group corporate income tax. While individual members of the group file tax returns, the income or losses of the members are attributed to the parent who files a consolidated return and receives a notice of assessment for the tax. The members each receive an assessment notice indicating zero taxable income.

The Court found that the Lux SARL was liable for the Luxembourg consolidated group's tax in that country. Therefore, it was the "technical taxpayer" that paid the tax for purposes of Section 901. Since the Lux SARL was a disregarded entity, the tax was treated as paid directly by a member of the U.S. consolidated group.

Since all but one of the Lux SARL subsidiaries were per se corporations for U.S. federal income tax purposes, the foreign tax credits generated by the subsidiaries' income would not generally be available to the Guardian U.S. consolidated group until the earnings were repatriated in the form of a dividend and a Section 902 credit could be taken. By checking the box on the Lux SARL, the Guardian U.S. consolidated group was able to accelerate the utilization of the foreign tax credits. Moreover, the income that had generated the credits was deferred from U.S. taxation.

The Government has appealed the Guardian Industries case, and the IRS and Treasury Department plan to issue guidance by summer to address how the foreign tax credit rules apply to foreign consolidated groups and hybrid entities.[5]

2. Cost Sharing

A cost-sharing arrangement ("CSA") is an agreement between two or more related parties to share the costs and risks of a research and development project in exchange for a specified interest in the project's results.[6] Because the participants in the arrangement jointly own the developed technology, there is typically no royalty obligation with respect to use of the technology by any participant. Thus, among other things, the use of a CSA may eliminate withholding taxes generally applicable to royalties. In essence, the consideration for the use of the intangibles developed as a result of the CSA is paid in advance, as opposed to in arrears (typically as royalties) where the intangibles are developed by another person (the developer). In effect, a cost-sharing arrangement involves multiple developers.

When related parties desire to jointly develop intangible property, they must enter an appropriate agreement to reflect the terms on which the project will be undertaken, including obligations for cost contributions and rights to use the fruits of the project.[7] This is a rather straight forward proposition for the development of new technology. However, when a CSA involves the contemplated evolution of existing technology,

the party making such preexisting intangible property available to other controlled participants in the CSA must be compensated for the use of such property. Specifically, each of the CSA participants must make a "buy-in" payment to the owner of the existing technology.[8]

In recent years, the IRS and the Treasury Department have become increasingly concerned about the use of CSAs as a means of transferring intangibles out of the United States. This is a quintessential tax base defense concern. In particular, the IRS and the Treasury Department have expressed concern with the determination of "buy-in" payments for contributions of existing intangible assets to a CSA. To address these concerns, the IRS and the Treasury Department issued proposed regulations to restate the cost sharing provisions of the Section 482 regulations.[9] The proposed cost-sharing regulations were issued on August 22, 2005.

a. Proposed Regulations

For purposes of determining the results that would have been realized under an arm's length CSA, the proposed regulations adopt as a fundamental concept an "investor model" for addressing the relationships and contributions of controlled participants in a CSA.[10] The preamble to the proposed regulations provides that:

> There are special implications that are derived from determining the arm's length compensation for external contributions in line with the investor model. In evaluating that arm's length compensation, it is appropriate, consistent with the investor model, to determine (1) what an investor would pay at the outset of a cost sharing arrangement for an opportunity to invest in that arrangement, and (2) what a participant with external contributions would require as compensation at the outset of a cost sharing arrangement to allow an investor to join in the investment.[11]

The proposed regulations begin by specifying the transactions relevant to a CSA. Specifically, the proposed regulations identify "cost sharing transactions," which relate to the ongoing sharing of intangible development costs, as well as "preliminary or contemporaneous transactions," which relate to compensation for their external contributions to the CSA (that is, what the existing regulations refer to as the "buy-in").[12]

As long anticipated, the proposed regulations provide guidance on the valuation of the arm's length amount to be charged in a preliminary or contemporaneous transaction (*i.e.*, a "buy in").[13] Specifically, the proposed regulations set forth new specified methods and provide rules for application of existing specified methods, for purposes of determining the arm's length compensation due with respect to external contributions in preliminary or contemporaneous transactions.[14]

The proposed regulations provide guidance on allocations that the IRS may make to more clearly reflect arm's length results for cost sharing transactions and preliminary or contemporaneous transactions. In particular, the proposed regulations provide guidance on the periodic adjustments that the IRS may make in situations where the actual results of a controlled participant's investment attributable to cost contributions and external contributions is widely divergent from reasonable expectations at the time of the investment.[15] Such periodic adjustment rights arise from the "commensurate with income" provisions of the Internal Revenue Code.[16] Interestingly, the proposed regulations provide that periodic adjustments may only be made by the IRS.

Finally, the proposed regulations include provisions regarding the administration of, and compliance with, the cost sharing rules. These include contractual provisions required for CSAs, documentation that must be maintained (and produced upon request by the IRS), accounting requirements, and reporting requirements.[17] Transition rules are provided for compliance in the case of qualified CSAs under existing Treas. Reg. Section 1.482-7.[18]

b. IRS Examination Checklist

In early August 2005, the IRS issued a checklist for CSAs (the "Checklist").[19] The Checklist provides that it is a tool to help International Examiners and Field Specialists review and evaluate CSAs in connection with the examination of such arrangements.

The Checklist sets forth examples of documents that should be requested at the outset of the examination, including the cost sharing agreement and inter-company license agreements. The Checklist instructs agents to carefully examine the determination of "intangible development costs" included in the "cost sharing pool," including a warning that some taxpayers may attempt to limit cost sharing payments by reducing the scope of expenses allocable to the pool.

In the context of determining buy-in payments for existing intangibles contributed to the CSA, the Checklist warns that licenses to "make and sell" products using current generation intangibles generally will not provide a comparable basis for valuing the buy-in for intangibles that are used as a platform for further research and development. Thus, this comment foreshadowed the promulgation of the proposed cost sharing regulations (discussed above), which include the "investor model" for valuing buy-in payments.

Also in the context of valuing buy-in payments, the Checklist suggests that the International Examiner obtain minutes, papers, memos and notes of product development committees and other committees, including the "audit committee." In connection with the audit committee, the Checklist notes "especially after Sarbanes-Oxley."

Finally, in the buy-in context, the Checklist notes that buy-in valuations are subject to periodic adjustments, but solely by the IRS. Again, this foreshadowed the same concept in proposed cost sharing regulations.

The Checklist also addresses accounting for stock-based compensation in CSAs, which compensation must be included in the cost sharing pool. In this regard, the Checklist provides a list of documentation that should be requested by the International Examiner and notes that the "stock-based compensation issue was litigated in the *Xilinx* case." The *Xilinx* case is discussed below.

c. *Xilinx v. Commissioner*

Shortly after the IRS and the Treasury Department issued the proposed cost sharing regulations discussed above, the Tax Court decided *Xilinx v. Commissioner*, 2005 U.S. Tax Ct. LEXIS 24 (Aug. 30, 2005). In that case, Xilinx and

its foreign subsidiary were participants in a CSA. In determining the allocation of costs pursuant to the agreement, Xilinx did not include any amount related to the issuance of stock options to its employees. In its notice of deficiency, the IRS determined that stock options should have been included in the cost pool under the CSA.

Based on testimony provided at trial, the Tax Court found that unrelated parties do not take into account, directly or implicitly, stock options for purposes of determining costs relating to CSAs, as such costs are difficult to estimate, unpredictable, potentially large in amount, and may create perverse incentives for unrelated parties (*e.g.*, desire that the partner's stock price diminish).

Since Treas. Reg. Section 1.482-1(a)(1) establishes that the arm's-length standard applies to cost sharing agreements (Treas. Reg. Section 1.482-7), and since unrelated parties would not take stock options into account in determining their cost pool, the Tax Court found that the IRS's determination that such costs should be included in Xilinx's cost pool was arbitrary and capricious. Moreover, the Tax Court found that Xilinx's failure to include stock options in its cost pool meet the Section 482 arm's-length standard.

The *Xilinx* case involved taxable years 1996 through 1999. Final Treasury Regulations require that stock options be included in the cost pool.[20] However, these regulations are effective for calendar year taxpayers beginning in January 2004.

This case is obviously good news for taxpayers with existing cases involving calendar years before 2004. Moreover, this case raises a doubt as to the validity of the final Treasury Regulations, as the Tax Court found that unrelated parties would not take stock options into account in determining their cost pool.

3. Dual-Chartered Entities

Treas. Reg. Section 301.7701-2(b)(8) lists certain entities by country and provides that such entities are deemed to be corporations for U.S. federal income tax purposes. Such "per se" corporations may not elect an alternative U.S. tax classification. However, some tax practitioners developed a technique to classify per se corporations as either disregarded entities or partnerships for U.S. federal income tax purposes.

The technique generally consisted of taking a per se foreign corporation and domesticating the entity as a single member limited liability company under U.S. state corporate law, while retaining the charter in the foreign jurisdiction. Some states, including Delaware, allowed such dual charters. The foreign per se corporate entity would continue to operate under foreign law without any noticeable changes in the foreign jurisdiction even though it was also considered to maintain a dual charter in a state such as Delaware. Because the per se foreign corporation was dually chartered as a single member limited liability company in a U.S. state, the foreign corporation would take the position for U.S. federal income tax purposes that its entity classification should be governed by its existence as a U.S. single member limited liability company and, thus, it could be treated as a disregarded entity for U.S. federal income tax purposes.

Using this dual chartered entity technique, a multi-national enterprise could arguably reduce its U.S. subpart F income.

> ***Illustration***: A U.S. corporation ("USCo") owns a foreign corporation in a low tax jurisdiction ("ForCo"). ForCo owns a corporation ("ForCo Sub") in a high tax jurisdiction ("Foronia"). Assume that ForCo purchases goods from vendors in China for sale to ForCo Sub. The ForCo Sub then distributes the goods in Foronia. Generally, the gains earned by ForCo from the purchase of Chinese goods and sale of those goods to ForCo Sub (a related party) would constitute "foreign base company sales income" within the meaning of Section 954(d). Such foreign base company sales income would represent subpart F income to USCo, and the subpart F income would be taxed to USCo on a current basis at U.S. corporate income tax rates.
>
> However, if USCo could successfully assert that ForCo Sub was a disregarded entity for U.S. federal income tax purposes, the related-party sales of goods from ForCo to ForCo Sub should be ignored for U.S. federal income tax purposes. Thus, the deemed sale of goods directly from ForCo to customers in Foronia would not constitute "foreign base company sales income," and USCo would not have subpart F income.

On August 12, 2004, the IRS and Treasury issued temporary regulations regarding the classification of business entities that are created or organized under the laws of more than one jurisdiction (so-called dually chartered entities).[21] On January 30, 2006, the IRS and Treasury issued final regulations regarding dually chartered entities.[22] These final rules are intended to prevent taxpayers from organizing as a corporation in one country and then taking the position that that structure may be disregarded if the entity takes a different form in another jurisdiction. Thus, the final rules would preclude ForCo Sub in the ***Illustration*** from changing from a corporation organized in Foronia to a disregarded entity organized in Delaware for U.S. federal income tax purposes.

The Treasury Regulations specifically operate by providing that, if an entity is characterized as an association taxable as a corporation under the Treasury Regulations in one jurisdiction, it will be characterized as a corporation for all purposes.[23] Thus, in the ***Illustration***, ForCo Sub would be treated as a corporation since it was organized as an entity that was an association taxable as a corporation in Foronia.

The final Treasury Regulations also address whether a dually chartered entity is a domestic or foreign entity. Specifically, the Treasury Regulations provide that "a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity."[24] The Treasury Regulations treat an entity as "domestic" if it is created or organized in the United States or under the law of the United States or of any state.[25] An entity is "foreign" if it is not "domestic."[26] In the ***Illustration***, ForCo Sub would be treated as a domestic corporation since it is an entity classified as a corporation and it is dually chartered as a limited liability company in a state in the United States.[27]

4. Dual Consolidated Loss Regulations

The United States taxes the worldwide income of domestic corporations. A domestic corporation is a corporation organized in the United States.[28] Some countries use criteria other than place of organization to determine whether corporations are residents for tax purposes. For

example, some countries treat corporations as tax residents if they are managed or controlled in that country. If one of these countries determines that a corporation is a tax resident, the corporation is generally subject to income tax in that country. Thus, if such a corporation is a domestic corporation for U.S. tax purposes, it is a dual resident corporation and is subject to the income tax of both the foreign country and the United States.

Prior to the Tax Reform Act of 1986, if a corporation was a resident in both the United States and a foreign country, and the foreign country permitted the losses of the corporation to be used to offset the income of another person (for example, as a result of consolidation), then the dual-resident corporation could use any losses it generated twice – once to offset income that was subject to U.S. tax, but not foreign tax, and a second time to offset income subject to foreign tax, but not U.S. tax (a so-called "double-dip"). To prevent the double-dip of a single economic loss, Section 1503(d) provides that a dual consolidated loss of a corporation cannot reduce the taxable income of any other member of the corporation's affiliated group.

The IRS and Treasury issued final regulations under Section 1503(d) in 1992.[29] These final regulations were updated and amended over the next 11 years. Newly proposed Treasury Regulations[30] would rewrite the existing Section 1503(d) dual consolidated loss regulations. The proposed regulations address three fundamental concerns that arise in connection with the current regulations. First, the regulations generally modify the scope of the existing regulations. For example, the current regulations may apply to certain structures where there is little likelihood of a double-dip. Moreover, the current regulations do not apply to certain structures that arguably provide taxpayers benefits similar to a double-dip that Section 1503(d) is intended to deny. Thus, as stated in the preamble to the proposed regulations, "the proposed regulations are designed to minimize these cases of potential over- and under-application."[31]

The existing Section 1503(d) dual consolidated loss regulations have not been updated to reflect the evolution of the entity classification regulations. The proposed regulations modernize the dual consolidated loss regime to take into account the entity classification regulations and to resolve related issues so that the rules can be applied with greater certainty. Finally, the proposed regulations contain several provisions designed to reduce, to the extent possible, the administrative burden imposed on taxpayers and the IRS in the current dual consolidated loss regulations.

ENDNOTES

1 Mark R. Martin is a partner in the Houston office of Gardere Wynne Sewell LLP.

2 65 Fed. Cl. 50 (2005).

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

4 *See Biddle v. Commissioner*, 302 U.S. 573 (1938).

5 "Guidance on Foreign Tax Credits in Hybrids, Consolidated Groups May Be Out by Summer," 45 BNA Daily Tax Reporter, p. G-7 (March 8, 2006).

6 Treas. Reg. § 1.482-7(a)(1).

7 *See* Treas. Reg. § 1.482-7(b).

8 Treas. Reg. § 1.482-7(g).

9 Prop. Treas. Reg § 1.482-7.

10 Fed. Reg. Vol. 70, No. 166, p. 51115 (Aug. 29, 2005).

11 *Id.*

12 Prop. Reg. § 1.482-7(b)(2) and (3).

13 Prop. Reg. § 1.482-7(b)(3).

14 Prop. Reg. 1.482-7(g).

15 Prop. Reg. § 1.482-7(i).

16 I.R.C. §§ 367(d) and 482.

17 *See* Prop. Reg. § 1.482-7(k).

18 Prop. Reg. § 1.482-7(m).

19 IRS, "LMSB Division Prepares Audit Checklist for Cost Sharing Arrangements," 2005 *Tax Notes Today*, 153-8, Aug. 10, 2005 (Audit Checklist).

20 Treas. Reg. § 1.482-7(d)(2).

21 T.D. 9153 (Aug. 12, 2004).

22 T.D. 9246 (Jan. 30, 2006).

23 Treas. Reg. § 301.7701-2(b)(9)(i).

24 Treas. Reg. § 301.7701-5(a).

25 *Id.*

26 *Id.*

27 Treas. Reg. § 301.7701-5(b), Ex. 1.

28 Treas. Reg. § 301.7701-5(a).

29 T.D. 8434, 1992-2 C.B. 240.

30 Fed. Reg. Vol. 70, No. 99 at 29868 (May 24, 2005).

31 *Id.*

TEXAS PROPERTY TAX LAW DEVELOPMENTS

John Brusniak, Jr.[1]

CERTIFIED TAX STATEMENT NAMING PERSON OWING TAXES OTHER THAN THE DEFENDANT IN DELINQUENT TAX TRIAL DOES NOT CONSTITUTE EVIDENCE OR RAISE PRIMA FACIE PRESUMPTION.

Pete Dominguez Enter., Inc. v. County of Dallas, No. 05-05-00535-CV (Tex. App.–Dallas, March 22, 2006, no pet. h.) (to be published).

Taxing unit sued "Pete Dominguez Enterprises, Inc." to collect delinquent taxes. At trial, it introduced over defendant's objection, as its sole evidence, a certified tax statement stating that "Pete Dominguez" was the owner of the taxed property. On appeal, the court held that the certified statement was not evidence of liability by the corporate entity, and the taxing unit's failure to introduce additional evidence to connect the parties was fatal to its case. As a result, no *prima facie* case was established and judgment for the defendant taxpayer was granted.

FORMER APPRAISAL DISTRICT ATTORNEY MAY REPRESENT TAXPAYERS UNLESS APPRAISAL DISTRICT CAN DEMONSTRATE THAT ATTORNEY POSSESSED FACTUAL DATA THAT WOULD CONSTITUTE A THREAT TO CONFIDENCES PREVIOUSLY REVEALED.

In re Drake, No 04-05 -00465-CV (Tex. App. –San Antonio, February 15, 2006, no pet. h.) (to be published).

After 22 years of representing an appraisal district, an attorney terminated his employment with the district and sought to represent a taxpayer in suits against the district. The appraisal district sought disqualification of the attorney, alleging violations of attorney disciplinary rules pertaining to confidences revealed to the attorney. The court disagreed, ruling that the district was required to prove that factual matters had arisen during the course of the prior representation that were so substantially related to the facts of the new lawsuits as to indicate that a genuine threat existed that confidences previously revealed to the attorney would be divulged. Matters pertaining to the trial of valuation disputes, familiarity with the inner workings of the appraisal district, preferences for expert witnesses, and knowledge of documents that could be obtained through the public information process pertaining to prior litigation do not provide a basis for attorney disqualification.

TAXING UNITS DO NOT HAVE COMMON LAW RIGHT TO SUE TAXPAYERS FOR ALLEGEDLY FRAUDULENT CONDUCT AFFECTING TAX VALUATIONS; TAX CODE PROVIDES TAXING UNIT WITH REMEDIES FOR SUCH CONDUCT.

Jim Wells County v. El Paso Production Oil and Gas Co., No. 01-04-01277-CV (Tex. App. –Houston [1st Dist.] January 26, 2006, pet. filed) (to be published).

Taxing units filed a common law suit against oil companies alleging fraud and conspiracy to manipulate oil and gas markets in order to underpay their *ad valorem* taxes. The suit was dismissed on a plea to the jurisdiction and the taxing units appealed. The court upheld the dismissal, finding that governments have no common law right to collect taxes, and their rights to do so are controlled by a comprehensive legislative scheme. That scheme provides remedies for the taxing units to protest such fraudulent conduct to an appraisal review board and to thus seek the recovery of the omitted property.

MOVABLE PROPERTY HAS A TAX SITUS IN A TAXING UNIT IF IT IS LOCATED THERE FOR MORE THAN A LIMITED PERIOD OF TIME; THAT PERIOD IS DETERMINED BY THE USE OF THE PROPERTY IN THE PRIOR CALENDAR YEAR; EVENTS OCCURRING SUBSEQUENT TO JANUARY 1 ARE IRRELEVANT.

Patterson-UTI Drilling Co., v. Webb County Appraisal District, 182 S.W.3d 14 (Tex. App. –San Antonio 2005, no pet.).

Drilling company moved drilling rigs from county to county and job to job. The rigs would not be moved to a new location until a new job was procured for them. Two rigs spent a total of 159 and 175 days in a county, and were idle for 40 days and 68 days respectively as of January 1 of a tax year after completing their contractual assignments while awaiting a new job. The rigs subsequently were used on new jobs within the same county and stayed for the ensuing calendar year in the county. The taxpayer rendered the rigs in its home county for taxation. However, the appraisal district of the county where they were physically located rendered them up for taxation, and the taxpayer appealed. The court held that movable property does not acquire a tax situs unless it is located in a taxing unit for more than a limited period. Whether an item has been located somewhere for more than a temporary period is determined by its use in the prior tax year. Events occurring after January 1 of the tax year are irrelevant. The court held that these rigs did not have a tax situs in the county of use and, because of their mobile nature, they were taxable at the taxpayer's principal place of business.

ENDNOTES

1 Brusniak McCool & Blackwell, P.C. 17400 Dallas Parkway, Suite 112, Dallas, Texas 75287-7305, (972) 250-6363, (972) 250-3599 fax, brusniak@txtax.com

RECENT DEVELOPMENTS APPLICABLE TO TAX-EXEMPT ORGANIZATIONS

Tyree Collier[1]

The following is a summary of selected recent developments in the law applicable to tax-exempt organizations, prepared by Tyree Collier for the Exempt Organizations Committee of the Section of Taxation. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "Code").

A. Legislative Reform. As of the drafting of this article in mid-March, the conference committee reconciling the Senate and House versions of the Tax Reform Act of 2005 had only recently been formed and was starting to meet. As discussed in more detail in the February 2006 issue of the Texas Tax Lawyer, the Senate version contains a number of significant revisions to the federal income tax laws impacting organizations described in Section 501(c)(3). These revisions include, among others, a floor for charitable contribution deductions taken by individuals, an allowance of charitable contribution deductions for non-itemizers, several new restrictions and potential penalties regarding donor advised funds, several new restrictions and potential penalties regarding Section 509(a)(3) supporting organizations, increased penalties for violations of the private foundation restrictions, a prohibition against private foundation grants to supporting organizations, an annual notice requirement for certain exempt organizations not currently required to file Form 990 each year, independent certification of certain information on Forms 990-T, and public disclosure of Forms 990-T.

The House version of the Tax Reform Act of 2005 does not contain similar provisions, but statements made by members of Congress and their aides indicate it is likely that most or all of the exempt organization provisions in the Senate version will be part of the final bill. It is expected that the conference committee will complete its reconciliation around the time that this May 2006 issue of the Texas Tax Lawyer is mailed.

B. Guidance on Fundraising Letters Involving Politicians. The IRS recently ruled that a Section 501(c)(3) organization's use of certain fundraising letters signed by members of Congress would not constitute prohibited political intervention by the Section 501(c)(3) organization. PLR 200602042 (Oct. 19, 2005).[2] The Section 501(c)(3) organization involved was a research and educational institution whose mission is to formulate and promote certain public policies. Its most successful direct mail fundraising letters have been those utilizing public figures, such as members of Congress, whose views on important topical issues coincide with those the organization believes are held by its supporters. The fundraising letters are sent out either on the letterhead of the signatory (e.g., the member of Congress signing the fundraising letter) or on the letterhead of the organization with the signatory's name and position prominently displayed near the top of the first page. The letters describe and praise the work of the Section 501(c)(3) organization, and end with a request for a charitable tax-deductible contribution to the organization. They also include a survey of information recipients are asked to provide to the Section 501(c)(3) organization.

The organization represented to the IRS that its fundraising letters are "released at random," without timing them to a particular signatory's candidacy for public office, and generally without regard to the home state or district of a particular signatory. The ruling includes almost verbatim the text of two fundraising letters, one signed by a Senator and one by a Representative, which are highly partisan in nature. The ruling states that whether a particular letter constitutes prohibited campaign intervention must be determined based on all the surrounding facts and circumstances of each letter. It states further that such a determination does not hinge upon a communication constituting "express advocacy," but rather on the "effect of the communication as a whole."

The ruling holds that the two fundraising letters discussed therein do not constitute prohibited political intervention by the Section 501(c)(3) organization. That holding is based on the facts that the letters are not mailed to the state or district where the signatory seeks reelection, the results of the surveys contained in the letters are not provided to the signatories, and nothing in the letters encourages a contribution to the signatories or their campaigns.

C. Fact Sheet and Summary of Closed Examinations on Political Intervention. The IRS recently published an information release summarizing the results of examinations it conducted regarding alleged political intervention by Section 501(c)(3) organizations during the 2004 election season. IR 2006-36 (Feb. 24, 2006). A fact sheet on political intervention was issued at the same time. FS-2006-17 (Feb. 24, 2006). In the information release, the IRS announced it has closed 82 out of 110 exempt organizations examinations related to such alleged political intervention and that nearly 75% of the examinations closed resulted in a determination that there was at least some level of prohibited political activity. The prohibited intervention ranged from cash donations to campaigns to churches endorsing political candidates. The release explained that most of the violations were isolated, one-time violations that the IRS addressed through written advisories to the organizations. In three cases, however (none of which involved churches), the IRS proposed revocation of exemption.

The fact sheet issued by the IRS provides examples and explanations of political campaign intervention. While many of the examples and explanations are fairly obvious (for example, distributing materials that support or oppose a candidate is prohibited even if the materials are prepared by another organization), the fact sheet provides a helpful summary because it addresses a large group of examples in a single document. Specific examples covered in the fact sheet include voter education, voter registration drives, activities by organizational leaders, appearances made by candidates, equal opportunities to participate, public forum events including moderator comments at such events, appearances made by candidates in a non-candidate capacity, issue advocacy, voter guides,

business activities (such as rental of mailing lists, leasing of office space, and acceptance of paid political advertising), and web site activities.

D. Filing Fees Increased. Effective July 1, 2006, the filing fees applicable to applications for exemption are increasing. *See* IR 2005-144 (Dec. 19, 2005). The filing fees for such applications will increase from $150 to $300 for organizations with anticipated gross receipts of $10,000 or less per year, from $500 to $750 for organizations with anticipated gross receipts in excess of $10,000 per year, and from $500 to $900 for group exemption requests.

E. Criticism of American Red Cross. Senate Finance Committee Chairman Charles Grassley outlined several concerns regarding the governance and operations of the American Red Cross in a February 27, 2006 letter to the Chairman of its Board of Governors. *See* http://finance.senate.gov/press/Gpress/2005/peg022706.pdf. Among other complaints, Senator Grassley's letter criticized the organization for (i) having too many directors (50 on the current board); (ii) having a large number of directors who rarely attend board meetings; (iii) having a few directors who intervene in day-to-day management decisions such as decisions regarding non-executive personnel hires; and (iv) straying too far from its authorized purposes. Such criticisms could be, and increasingly are, directed at a variety of large nonprofit organizations in the United States, some of which are responding by restructuring their governance. Senator Grassley's letter mentions the Nature Conservancy as one organization that has recently reduced the size of its board considerably.

ENDNOTES

1 Jenkens & Gilchrist, 1445 Ross Ave., Ste. 3200, Dallas, Texas 75202.

2 Release Date January 13, 2006.

INDIVIDUAL TAX PLANNING TIPS USING THE 15% CAPITAL GAINS TAX RATE BEFORE IT EXPIRES IN 2008

E. Rhett Buck, Attorney-CPA

The 2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) cut the capital gains tax rate from 20% to 15% for qualifying capital assets held for more than one year and sold after on or after May 6, 2003. Further, for taxpayers in the 10% and 15% income tax brackets, the capital gains tax rate is reduced to 5% for 2003 through 2007, and 0% for 2008. Also, the capital gains tax rates of 20% and 10% on property held one year or more, or 18% and 8% on property held for five years and acquired on or after January 1, 2000, are eliminated, but only through 2008. The 28% rate continues to apply to collectibles and Section 1202 stock.[1] The 25% rate continues to apply to capital gains attributable to depreciation (and ordinary income tax rates apply to the extent gain is attributable to accelerated depreciation) on Section 1250 depreciable real property.

The more favorable lower rates provided by JGTRRA increase again after 2008. Therefore, individuals who have qualifying capital assets should consider the following planning tips to maximize their tax savings before this valuable tax benefit expires.

Planning tips:

Capital Gains tax rates have never been lower. Taxpayers with qualifying capital assets should consider transferring capital assets to children for sale during 2003-2007 at 5% or during 2008 at 0% (if the children are in the 10% or 15% income tax bracket). However, taxpayers also should consider that accumulated long-term losses now offset gains at the lower 15% rate and, therefore, may be more valuable if preserved until after 2008.

Section 1031 Deferral: Taxpayers should consider using a Section 1031 like-kind exchange or a multi-property exchange to sell and defer capital gains tax.

Capital Gains vs. Ordinary Income: In addition to the rate differential (maximum 15% capital gains tax rate versus maximum 35% ordinary income tax rate), JGTRRA accelerates the differential (5% drop in capital gains tax rates versus 3.6% drop in ordinary income tax rates). This indicates favored treatment of capital gains over ordinary income for the affected years.

"Enron" capital loss deduction: As a result of the Enron scandal, in IR-2004-27 (Mar. 1, 2004), the IRS ruled that a taxpayer could not take ordinary theft loss deductions for losses on stock caused by insider fraud.

Section 1202 Stock: Under Section 1202, an individual's 28% capital gains tax rate on up to $10 million gain on sales of qualifying small business stock held over five years is cut to 15%. However, a Section 1202 stock election may not be preferable because, even though the lower 15% capital gains rate may be used, under Section 1202, 42% of the excluded gain is an AMT preference item, resulting in an effective tax rate of 19.88%.

Section 1244 ordinary loss treatment: Under Section 1244, up to $100,000 ordinary losses per year may be taken on qualifying small business C or S corporation stock.

Avoid taking short-term capital gains: Short term capital gains are taxed at ordinary income rates. Therefore, delay taking capital gains until the holding period exceeds 12 months.

Avoid selling calls and puts on long-term stocks: Sale of a call or put on stock tolls the holding period, resulting in certain issues relating to calculating the applicable holding period.

Therefore, as discussed above, individual taxpayers should consider taking advantage of the lower capital gains tax rates enacted under the JGTRRA by 2008 before the lower rates expire.

ENDNOTES

1 All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

WITH THE PRICE OF OIL – TEXAS WILDCATTERS ARE DRILLING EVEN IN ISRAEL

Martin M. Van Brauman[1]

In the northern portion of Israel's central coastal plain, there are drill sites displaying the flag of the Lone Star State with wildcatters walking around in cowboy boots and reading well logs. With the price of oil so high, U.S. independent oil companies are reevaluating many areas and balancing risk versus potential return after tax, assuming commercial production. As it is common knowledge that there is no oil in Israel, its tax laws reflect that perception. Many companies in the past have drilled all over Israel but, with new technology and the ability to drill deeper wells, there is new activity.

Lately, Israel has experienced some substantial onshore oil and gas discoveries. For example, Givot Olam Oil Exploration LP, a public company listed on the Tel Aviv stock exchange, was granted a 30-year production lease for 62,500 acres in April 2004.[2] The recent discoveries have spurred U.S. companies to obtain permits and licenses for exploratory drilling. With potential petroleum activity in Israel, U.S. companies should consider the petroleum laws and tax laws of Israel, which seem to mirror the state of petroleum laws of the 1950s with its 27½ percent depletion allowance and no special tax on petroleum income.

The U.K. tax system greatly influenced the Israeli fiscal system and its corporate tax system in the 1950s. However, the influence of the U.S. oil and gas tax law of the 1950s is evident in the current petroleum law and tax law. The Israeli Petroleum Law, 5712-1952 (the "Law"), governs petroleum operations in Israel, both onshore and offshore. The Law, enacted in 1952, repealed the prior Oil Mining Ordinance of 1938 and its regulations and underwent revision in 1965, in an attempt to encourage foreign interest in exploration activities. The administration of the Law is vested in the Minister of National Infrastructures, the Petroleum Commissioner, and the advisory Petroleum Commission.

Petroleum Law, 5712-1952

The Law is under the responsibility of the Minister of National Infrastructures. The Law provides for an administrative structure, headed by the Petroleum Commissioner who acts in consultation with the advisory Petroleum Commission. Applications for petroleum rights are submitted to the Petroleum Commissioner in accordance with the provisions set out in the Law and Regulations. The award of petroleum rights, with the exception of the preliminary permit and the priority right, is a matter of public record and is published in the Petroleum Register and in *Reshumot* (the official gazette).

The Law governs the exploration and production of petroleum[3] in Israel, including the continental shelf. All petroleum resources belong to the State, and no person is allowed to explore for, or produce, petroleum without receiving a right under the Law. The Law provides for an initial preliminary permit for the exploration stage, followed by a license for testing and finally a lease for production.

The preliminary permit is granted for a period not exceeding 18 months.[4] The permit allows the applicant to conduct preliminary investigations, except for test drilling, to ascertain the prospects for discovering petroleum in the area.[5] The holder of the preliminary permit is entitled to request a priority right on the permit area, which, if granted, prevents the awarding of any other petroleum right on the area.[6] The priority right fee[7] is NIS[8] 4.95 per month per 1000 dunams (or approximately $1.06 per month for 247 acres).[9]

There are no statutory restrictions as to the maximum size of the permit area or to the number of permits that may be held by one applicant. However, the policy is to award an area based upon the applicant's reasonable plan of operation and the applicant's financial resources to execute the plan. The holder of a preliminary permit must provide reasonable security or a guarantee for compensation against damage to the person who is the owner or who has the enjoyment of land on which petroleum operations are conducted.[10]

The grant of a petroleum right does not automatically entitle its holder to enter upon the land to which the right applies or to carry out exploration and production work.[11] Entry requires the consent of the private or public holders of the surface rights and of other public regulatory bodies. The holder of petroleum right may request that the government acquire, on its behalf, land needed for petroleum purposes.[12]

The license grants an exclusive right for further exploration work and requires the drilling of test wells.[13] The initial term of a license is up to three years and may be extended for up to an additional four years.[14] A license area may not exceed 400,000 dunams (approximately 98,500 acres).[15] As of December 2005, for the onshore areas and for every 1000 dunams, the first and second year annual fee is NIS 90.14 ($19.34); the third year fee is NIS 150.01($32.19); the fourth year fee is NIS 299.32 ($64.34); and the fifth year and subsequent years annual fee is NIS 896.97 ($192.48).

Upon discovery of petroleum, the licensee has a statutory right to receive a production lease.[16] The initial lease term is 30 years and may be extended to a maximum period of 50 years.[17] A lease confers upon the lessee the exclusive right to explore for and produce petroleum in the lease area and requires the lessee to commence development drilling within 6 months.[18] The lessee is entitled to transport and to market the petroleum produced, subject to the right of the government to call upon the lessee to supply local needs first at market price.[19]

A lessee is subject to a leasehold fee for the leased area at the rate of NIS 899.35 ($192.99) per 1,000 dunams (or any part thereof) per year (or part thereof).[20] A lessee who pays a royalty is exempt from the leasehold fee for a continuous area of 50,000 dunams to be selected by him and around each producing well in the leased area, and the configuration of which is approved by the Petroleum Commissioner. This exemption is available provided that no new production area (or part thereof) any where coincides with an earlier production area (or part thereof).[21]

A lessee is liable for a royalty of one-eighth (12½%) in kind or cash at the option of the Commissioner of the quantity of petroleum produced and saved from the leased area excluding the quantity of petroleum used by the lessee in operating the leased area.[22] However, the royalty payment would not be less than the minimum royalty payments provided under the Law.[23]

The holder of a petroleum right (permit, license, or lease) is expected to carry out its operations with due diligence and in accordance with the accepted practice in the petroleum industry.[24] The holder is required to submit progress and final reports, as detailed in the Law and Regulations.[25] The information supplied by the holder of a petroleum right is kept secret for as long as it has a petroleum right on the area concerned.

The owner of the petroleum right is entitled to import into Israel, free of customs duties and other import levies, the goods required by him for petroleum exploration purposes, such as all machinery, equipment, installations, fuel, structures, and transportation facilities.[26] Such items are also free of purchase tax.[27] Where the holder of a petroleum right has acquired cement, fuel, or unused tires, if the price it paid included excise tax, the holder may have refunded to him the excise paid to the extent that it has used such materials for petroleum purposes.[28]

A petroleum works contractor, who carries out operations for petroleum purposes by order of the holder of a petroleum right, has the right to the same exemption referred to in the foregoing paragraph if the Minister of National Infrastructures gives a certificate for that purpose.[29] The holder of a petroleum right and a petroleum works contractor shall be entitled to export material that has been imported by them, subject to the right of the Petroleum Commissioner to purchase certain installations on the expiration of a surface lease.[30]

The Value Added Tax Law ("VAT Law"), provides for a value added tax ("VAT") of 17% on the import and sale of goods or services rendered in the regular course of business or any other such activities of a commercial nature.[31] The law provides for a tax rate of 0% with respect to certain exports approved by the Customs Inspector and an exemption with respect to certain imports approved by the Minister of Finance. The VAT Law provides that the sum due by a taxpayer in respect of VAT shall be reduced by the amount of VAT, which has been paid by the same taxpayer to others. For any excess VAT paid, the tax authorities will refund this excess within 30 days.

Corporate Tax

A foreign company establishes a place of business in Israel by registering with the Registrar of Companies.[32] Along with the registration application, a foreign company must file a certified copy of its documents of incorporation, a statement providing the name of the directors, the Israeli resident agent, and a power of attorney authorizing a resident of Israel to act for the company in Israel.[33] The foreign company is required to file an annual statement in the form of a balance sheet similar to the requirements of a public company.[34]

Whether a company is registered in Israel or is a foreign company operating in Israel through a branch, it is liable to pay Companies Tax on its taxable income from Israeli sources at a flat rate. A branch is liable to pay tax on all income "accruing in, derived from, or received in Israel."[35] The Companies Tax rate has been reduced from 34% in 2005 to 31% in 2006 and will be reduced to 29% and 27%, respectively, for 2007 and 2008. In 2009, the rate will be 26% and, in 2010, it will drop to a final 25%.

Exploration and development expenditures incurred by a holder of a petroleum right may be treated either as a revenue expense or capital expense at the option of the holder.[36] The election affects the treatment of all exploration and development expenses for subsequent years. If a discovery is made after the exercise of the option, the holder may change the option within one year of the discovery.

When capital expenditures have been incurred by an owner of a petroleum right for the purpose of acquiring land reasonably required for petroleum exploration, production, or development, the owner may deduct as an expense the total of such expenditures divided by the number of years over which it is entitled to hold the land.

The expenditures are deducted in the taxable year in which such expenditures are incurred and in any subsequent taxable year until all expenditures have been exhausted. If the right of the holder of a petroleum interest to hold such land has expired before the total deductions have been exhausted, the holder may deduct in that taxable year the total amount not yet deducted.

The holder of an interest in a petroleum lease is allowed a deduction from income on account of the depletion of the petroleum reserve relating to such interest. This may be by way of percentage depletion or cost depletion, whichever is greater.

Percentage depletion is at the rate of 27.5% of gross income (meaning the actual or notional proceeds of sale, less royalties) derived from the interest during the tax year, but subject to a limit of 50% of the net income attributed to the relevant petroleum interest in that tax year. Cost depletion is determined by dividing the "adjusted cost" of the petroleum interest (being the cost price less accrued depletion allowances to date) at the beginning of the tax year, by the number of units remaining in the estimated petroleum reserve at the beginning of such year, and multiplying the sum by the number of units of petroleum produced from the interest and saved during the tax year.

Where a holder of a petroleum right has abandoned or discontinued operations in the year and, as a consequence, any of its assets for which a rate of depreciation has been prescribed have become worthless, the holder may deduct an amount equal to the cost of the assets less the accrued depreciation and less any salvage value.

Where full effect cannot be given in any tax year to any deduction allowed to the holder of a petroleum right, owing to there being no or insufficient profits or gains taxable for that year, the unused deductions are linked to the Israeli Cost of Living Index and may be carried forward into succeeding years until exhausted.

U.S./Israel Income Tax Treaty

Any income taxes imposed by the State of Israel on U.S. persons or U.S. entities are covered under the current *Convention Between the Government of the United States of America and the Government of the State of Israel With Respect to Taxes on Income* (the "Treaty").[37] The term "resident of Israel" means an Israeli corporation and any other person (except a corporation or any entity treated under Israeli law as a corporation) resident in Israel for purposes of Israeli tax, but in the case of a partnership, estate, or trust only to the extent that the income derived by such partnership, estate, or trust is subject to Israeli tax as the income of a resident either in the hands of the respective entity or its partners or beneficiaries.[38]

The term "Israeli corporation" means any body of persons taxed as a body of persons resident in Israel under the Income Tax Ordinance.[39] The term "person" is defined to include an individual, a partnership, a corporation, an estate, or a trust.[40]

A resident of the United States may be taxed by Israel on any income from sources within Israel and only on such income, subject to the limitations set forth in the Treaty.[41] Income from real property, including royalties and other payments in respect of the exploitation of natural resources and gains derived from the sale, exchange, or other disposition of such property or of the right giving rise to such royalties or other payments, may be taxed by the Contracting State in which such real property or natural resources are situated.[42]

Industrial or commercial profits of a resident of one of the countries are exempt from tax by the other country unless the resident has a permanent establishment in that other country.[43] If the resident has a permanent establishment in that other country, tax may be imposed by that other country on the profits of the resident but only on so much as attributable to the permanent establishment.

The term "permanent establishment" means a fixed place of business, such as a branch, through which a resident of one of the countries engages in industrial or commercial activity.[44] Also, a resident may be deemed to have a permanent establishment in the other country if such resident engages directly in industrial or commercial activity without a fixed place of business and not through an independent agent or broker in the other country.

Where an Israeli registered company distributes dividends, the dividends are subject to deduction of income tax at source at the rate of 25%, unless reduced by a tax treaty. The Treaty would reduce the withholding tax on intercorporate dividends to 12.5%, if the recipient owns at least 10% and was not paid by an "approved enterprise."[45]

A U.S. corporation would not be a tax resident of Israel, but a foreign branch (operating in Israel) of a U.S. corporation would be a tax resident under Israeli law and the Treaty. With respect to the statutes and laws of Israel, a U.S. corporation is not an "Israeli corporation," but if it operates through a foreign branch in Israel, the foreign branch would be treated as a permanent establishment in Israel. The U.S. corporation with an Israeli branch is subject to the income tax laws of Israel only with respect to the operations attributable to its permanent establishment in Israel.

A U.S. corporation operating as a foreign branch in Israel would be subject to the same tax liabilities as an Israeli registered company, except for distributions to its foreign parent corporation. It would not be subject to any withholding tax because a branch profits tax is not imposed under Israeli tax law.

Conclusion

On October 23, 2003, a budget bill was submitted to the Israeli Knesset by the government that would have made a major restructuring of the Israeli system for taxing petroleum operations and income if it had been adopted. An alternative proposal to amend the tax system was introduced in 2003 by the Ministry of National Infrastructures to impose a Petroleum Revenue Tax regime similar to the United Kingdom's Petroleum Revenue Tax. Studies in this area of a Petroleum Revenue Tax system have been placed on hold by the Petroleum Commissioner.

In February 2004, the Petroleum Commissioner and staff of the Ministry of National Infrastructures sent various proposed amendments to the Law to the Israeli petroleum industry for comments. In November 2005, the Petroleum Commissioner's office placed on hold all proposed amendments.

The Israeli laws relating to the taxation and administration of petroleum exploration and production operations have not changed essentially from the 1950s. If further exploratory drilling results in establishing potential reserves of oil and gas, amendments to the Law may be enacted to bring Israel's petroleum laws in line with those of other petroleum producing countries. Also, the tax laws may not be as favorable in the future. However, if commercial quantities of petroleum were discovered, any changes to the petroleum and tax laws would still need to be structured to encourage foreign investment in a very expensive drilling area.

ENDNOTES

1 Martin M. Van Brauman, J.D., LL.M., M.B.A. is a member of Ray, Cho, Wiley, Van Brauman & Gibson, P.L.L.C., and has over 20 years of experience with domestic and international tax transactions. He is board certified in tax law by the Texas Board of Legal Specialization. His firm specializes in cross-border transactions from Asia to Europe.

www.rcwlawyers.com.

2 *Exploration & Development*, Oil & Gas Journal, July 5, 2004 at 40-41.

3 "Petroleum means any fluid, whether liquid or gaseous, and includes oil, natural gas, natural gasoline, condensates and related fluid hydrocarbons, and also asphalt and other solid petroleum hydrocarbons when dissolved in and producible with fluid petroleum." Petroleum Law, 5712-1952, Part One, Art. One, Interpretation 1.

4 *Petroleum Law*, Part Two, Art. Two, Section 7A(b).

5 *Petroleum Law* at Part Two, Art. Two, Section 7(a).

6 *Petroleum Law* at Part Two, Art. Two, Section 7A(a), (c).

7 Fee as of January 2005. Fees are updated every three months to the Israeli Cost of Living Index.

8 NIS is New Israel Sheqalim.

9 1 dunam is 0.1 hectare or 0.2471044 acres or 1,000 square meters.

10 *Petroleum Law* at Part Two, Art. Two, Section 11(a).

11 *Petroleum Law* at Part Three, Art. One, Section 39.

12 *Petroleum Law* at Part Three, Art. One, Section 40.

13 *Petroleum Law* at Part Two, Art. Three, Section 13.

14 *Petroleum Law* at Part Two, Art. Three, Section 18(a), (b).

15 *Petroleum Law* at Part Two, Art. Three, Section 17(a).

16 *Petroleum Law* at Part Two, Art. Four, Section 26.

17 *Petroleum Law* at Part Two, Art. Four, Section 29(a), (b).

18 *Petroleum Law* at Part Two, Art. Four, Section 31.

19 *Petroleum Law* at Part Two, Art. Four, Section 33.

20 Fee as of January 2005.

21 *Petroleum Law* at Part Two, Art. Four, Section 32(a).

22 *Id.*

23 *Petroleum Law* at Part Two, Art. Four, Section 32(d), (e). These amounts are based on the value at the end of the year in question, of the number of barrels of petroleum set out below for each 1,000 dunams comprised in the lease area at year end; the value being calculated according to the price of a barrel of Middle East crude oil at the terminal point of a pipeline on the eastern Mediterranean coast.

1st lease year – 4 bbls

2nd lease year – 6 bbls

3rd lease year – 12 bbls

4th lease year – 20 bbls

5th and each succeeding lease year – 32 bbls

24 *Petroleum Law* at Part Two, Art. Four, Section 31.
25 *Petroleum Law* at Part Two, Art. Four, Sections 22 and 23

26 *Petroleum Law* at Part Three, Art. Two, Section 46(a).

27 *Petroleum Law* at Part Three, Art. Two, Sections 46 and 46A.

28 *Petroleum Law* at Part Three, Art. Two, Section 46B.

29 *Petroleum Law* at Part Three, Art. Two, Section 46C.

30 *Petroleum Law* at Part Three, Art. Two, Section 46D.

31 Value Added Tax, 5736-1975.

32 Companies Law 1999, Section 346.

33 *Id.* at Section 346(b).

34 *Id.* at Section 348(b).

35 Israeli Income Tax Ordinance, Section 2.

36 *Id.*

37 The CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE STATE OF ISRAEL WITH RESPECT TO TAXES ON INCOME was entered into force on December 30, 1994, and entered into effect for withholding taxes on February 1, 1995, and for other taxes on January 1, 1995.

38 *Id.* at Art. 3(1)(a).

39 *Id.* at Art. 2(1)(f)(ii).

40 *Id.* at Art. 2(1)(e).

41 *Id.* at Art. 6(1).

42 *Id.* at Art. 7(1).

43 *Id.* at Art. 8(1).

44 *Id.* at Art. 5.

45 An "approved enterprise" is subject to the Encouragement of Capital Investment Law that offers cash grants and a reduced tax rate on undistributed earnings or no cash grants and tax exemptions on undistributed income for a period of time and depending upon location.

RECENT DEVELOPMENTS APPLICABLE TO THE ENERGY AND NATURAL RESOURCES TAX AREA

Alexander G. McGeoch[1], Laura Ellen Jones[2] and Douglas E. Lamb[3]

IRS ESTABLISHES $1.3 BILLION SECTION 48A TAX CREDIT PROGRAM FOR IGCC AND OTHER ADVANCED COAL PROJECTS

On February 21, 2006, the Internal Revenue Service ("IRS") issued Notice 2006-24, 2006-11 I.R.B. 595, establishing the qualifying advanced coal project program for the deployment of domestic advanced coal-based generation technologies and providing guidelines for IRS certification of tax credits under Section 48A of the Internal Revenue Code.[4] Section 48A was enacted by Section 1307 of the Energy Policy Act of 2005 and provides a 20% investment tax credit for certified qualifying advanced coal projects using integrated gasification combined cycle technology ("IGCC") and a 15% investment tax credit for certified qualifying advanced coal projects other than IGCC.

On March 9, 2006, Senator Max Baucus (D-Mont.) introduced legislation (the "Baucus Bill") that would extend the Section 48A tax credit program for IGCC projects. The Baucus Bill would provide an additional three-year application period and allocate an additional $500 million in tax credits for IGCC projects that apply for an allocation of credits during such three-year period. On March 13, 2006, Senators Chuck Grassley (R-Iowa) and Baucus introduced similar legislation (The "Grassley Bill"). In addition, on April 6, 2006, Senator Ken Conrad (D-N.D.) introduced legislation that wold modigy Section 48A (the "Conrad Bill").

Qualifying Advanced Coal Projects

A "qualifying advanced coal project" must (a) use IGCC, (b) have a design net heat rate of 8,530 Btu/kWh (40% efficiency), or (c) in the case of retrofitted or repowered units, achieve a minimum efficiency of 35% and certain thermal design efficiency improvements. The project must also meet certain emission performance requirements (99% SO2 removal, 0.07 lbs/MMBtu NOX emissions, 0.015 lbs/MMBtu PM* emissions, and 90% Hg removal) and have a total nameplate generating capacity of at least 400MW. In addition, the fuel input for the project must be at least 75% coal.

Credit Allocation "Pools"

Notice 2006-24 provides that the IRS will allocate the $1.3 billion of Section 48A tax credits in the following "pools":

(a) $267 million to IGCC projects using bituminous coal as a primary feedstock (no more than $133.5 million to a single project); (b) $267 million to IGCC projects using subbituminous coal as a primary feedstock (no more than $133.5 million to a single project); (c) $266 million to IGCC projects using lignite as a primary feedstock (no more than $133 million to a single project); and (d) $500 million to projects using an advanced coal-based generation technology other than IGCC (no more than $125 million to a single project).

Allocation Priorities and Process

Notice 2006-24 provides that Section 48A tax credits will be allocated in annual allocation rounds over a three-year period based on certain priorities. The credits for projects using an advanced coal-based generation technology other than IGCC will be allocated to projects providing the highest ratio of nameplate generation capacity to the requested allocation of credits (*i.e.*, a 600 MW project requesting $125 million of tax credits will receive priority over a 400 MW project requesting $125 million of tax credits). For IGCC projects, the credits in each pool will be allocated first to priority projects that have greenhouse gas capture capability or increased by-product utilization and then to those priority projects providing the highest ratio of nameplate generation capacity to the requested allocation of credits. If credits remain in an IGCC pool after the priority allocation, the credits will be allocated to other non-priority IGCC projects that provide the highest ratio of nameplate generation capacity to the requested allocation of credits. If the credits for a particular pool are not fully allocated in the initial round, the remaining credits for that pool will be allocated in subsequent application and allocation rounds.

First Round Application and Certification Process

Notice 2006-24 provides that the IRS will consider a project for an allocation of Section 48A tax credits only if the Department of Energy (“DOE”) provides a certification of the project’s feasibility and consistency with the energy policy goals. Taxpayers must apply for DOE certification on or before June 30, 2006. After a taxpayer receives certification from the DOE (by October 1, 2006), a taxpayer must apply for an allocation of credits with the IRS under Section 48A before October 3, 2006. The IRS will accept or reject the application by November 30, 2006.

Application for DOE Certification

The application for certification from the DOE must include: (i) the name, address, and taxpayer identification number of the taxpayer; (ii) the name and telephone number of a contact person; (iii) the name and address (or other unique identifying designation) of the project; (iv) a statement specifying whether the project is an IGCC project or a project that uses another advanced coal-based generation technology; (v) a statement specifying the coal type that will be the primary feedstock for the project (for IGCC projects); (vi) the estimated total cost of the project and the estimated total qualified investment in the eligible property that will be part of the project; (vii) the amount of the credit requested for the project; (viii) a statement specifying the credit that the taxpayer prefers to receive (if the taxpayer is or will be requesting an amount of the qualifying gasification project credit under Section 48B for the same project); (ix) a statement specifying whether the project is a new, retrofitted, or repowered electric generating unit; and (x) the exact total nameplate generating capacity of the project. Appendix B of Notice 2006-24 provides more specific criteria and format information required for the application. For example, the application must be in the form of a Project Information Memorandum and contain certain detailed information, including, among other things, the project economics, a report from a qualified independent financial analyst regarding the applicant’s approach to project financing, and an opinion as to the likelihood of the applicant to achieve financial closure, engineering reports, market studies for the power and non-power output of the project, audited financial statements for the past three years, and information regarding the status of all project contracts and a copy or summary of such contracts.

Application for Section 48A Certification

The application for Section 48A certification by the IRS must include: (i) the name, address, and taxpayer identification number of the taxpayer; (ii) the name and telephone number of a contact person; and (iii) a paper copy of the completed application for the DOE certification submitted with respect to the project. The amount of the Section 48A tax credits allocated to a project will be determined at the time the IRS accepts the application for Section 48A certification. The taxpayer will be required to execute a closing agreement with the IRS that will provide for reduction or forfeiture of tax credits in certain circumstances. A taxpayer that receives an acceptance letter from the IRS has two years from the date of the acceptance letter to submit evidence to the IRS that it has obtained all federal and state environmental authorizations or reviews necessary to begin construction of the projects and, in the case of a new unit, entered into a binding contract for the purchase of the steam turbine(s). After receipt of such information, the IRS will decide whether or not to certify the project. If the taxpayer fails to satisfy these requirements, or to receive a certification from the IRS, the credit allocated to the project is forfeited. If the project is certified, the taxpayer has five years from the date of issuance of the certification to place the project in service and, if the project is not placed in service by the end of that period, the certification is void.

Effect and Review of Acceptance, Allocation, or Certification

An acceptance, allocation, or certification by the IRS of a project is not a determination that the project satisfies the requirements of Section 48A. The IRS may, upon examination (and consultation with the DOE), determine that a project does not qualify for Section 48A tax credits. A taxpayer does not have the right to a conference or to appeal any decisions of the IRS or the DOE under Notice 2006-24.

A copy of Notice 2006-24 can be obtained at *http://www.irs.gov/pub/irs-drop/n-06-24.pdf*. In addition, the National Energy Technology Laboratory has established a website for the submission of questions relating to the Notice at *http://www.netl.doe.gov/business/faq/tax_credit.html*.

IRS ESTABLISHES $350 MILLION SECTION 48B TAX CREDIT PROGRAM FOR INDUSTRIAL GASIFICATION PROJECTS

On February 21, 2006, the IRS issued Notice 2006-25, 2006-11 I.R.B. 609, establishing the qualifying gasification project program for deployment of domestic gasification projects and providing guidelines for IRS certification of tax credits under Section 48B of the Internal Revenue Code. Section 48B was enacted by Section 1307 of the Energy Policy Act of 2005 and provides a 20% investment tax credit for qualifying gasification projects.

The Baucus Bill would provide an additional $500 million in tax credits for qualifying gasification projects (for a total of $850 million). The credits would be allocated during the initial three-year period provided under the Energy Policy Act. The Grassley Bill contains a similar provision. In addition, the Conrad Bill would provide an additional $3,650,000 in tax credits for qualifying gasification projects (for a total of $4,000,000).

Qualifying Gasification Projects

A "qualifying gasification project" must employ gasification technology that converts a solid or liquid product from coal, petroleum residue, biomass, or other materials recovered for their energy or feedstock value into a synthesis gas composed primarily of carbon monoxide and hydrogen for direct use or subsequent chemical or physical conversion. These fuels must comprise at least 90% of the fuels required by the project for the production of chemical feedstocks, liquid transportation fuels, or coproduction of electricity. In addition, the project must be carried out by an "eligible entity," which is defined as any person whose application for certification under the program is principally intended for use in a domestic project that employs domestic gasification applications related to chemicals, fertilizers, glass, steel, petroleum residues, forest products, and agriculture.

Allocation Priorities and Process

Notice 2006-25 provides that Section 48B tax credits will be allocated in annual allocation rounds over a three-year period based on certain priorities. The total amount of credit that may be allocated under the program is $350 million. The credit will be allocated first to the projects that have carbon capture capability, use renewable fuel, or have project teams with experience that demonstrates successful and reliable operations of the gasification technology. If the requested allocation of credits for these priority projects exceeds $350 million, the credit will be allocated to the priority projects providing the highest ratio of the total amount of synthesis gas to be supplied by the project ("nameplate capacity") to the requested allocation of credits. If the requested allocation of credits for the priority projects does not exceed $350 million, the remaining credit will be allocated to the non-priority projects providing the highest ratio of nameplate capacity to the requested allocation of credits. If the credit is not fully allocated in the initial round, the remaining credits will be allocated in subsequent allocation rounds.

First Round Application and Certification Process

The Notice provides that the IRS will consider a project for an allocation of Section 48B tax credits only if the Department of Energy ("DOE") provides a certification of the project's feasibility and consistency with energy policy goals. Taxpayers must apply for DOE certification on or before June 30, 2006. After a taxpayer receives certification from the DOE (by October 1, 2006), a taxpayer must apply for an allocation of credits under Section 48B with the IRS before October 3, 2006. The IRS will accept or reject the taxpayer's application for Section 48B certification by November 30, 2006.

Application for DOE Certification

The application for DOE certification must include: (i) the name, address, and taxpayer identification number of the taxpayer; (ii) the name and telephone number of a contact person; (iii) the name and address (or other unique identifying designation) of the project; (iv) a statement specifying the projected placed-in-service date of the project; (v) the estimated total cost of the project and the estimated total qualified investment in the eligible property that will be part of the project; (vi) the amount of the credit requested for the project; (vii) a statement specifying the credit that the taxpayer prefers to receive (if the taxpayer is or will be requesting an amount of the qualifying advanced coal project credit under Section 48A for the same project); (viii) the amount of nameplate capacity; and (ix) documentation or other evidence establishing that the taxpayer is financially viable without the receipt of additional federal funding associated with the project. Appendix B of Notice 2006-25 provides more specific criteria and format information required for the application, including the required description of the gasification technology employed, site control and ownership requirements, and details relating to use of project output, project contract structure, and project schedule, as well as other information. The taxpayer must also submit financial reports to the project prepared by an independent financial analyst.

Application for Section 48B Certification

The application for Section 48B certification by the IRS must include: (i) the name, address, and taxpayer identification number of the taxpayer; (ii) the name and telephone number of a contact person; and (iii) a paper copy of the completed application for the DOE certification submitted with respect to the project. The amount of the qualifying gasification project credits allocated to a project will be determined at the time the IRS accepts the application for Section 48B certification. Qualified investment eligible for the Section 48B credit is limited to $650 million per project. Thus, the maximum amount of qualifying gasification project credits that will be allocated to a project is $130 million. The taxpayer will be required to execute a closing agreement with the IRS that will provide for reduction or forfeiture of tax credits in certain circumstances specified therein. A taxpayer that receives an acceptance letter from the IRS has seven years from the date of the acceptance letter to place the project in service and, if the project is not placed in service by the end of that period, the acceptance letter is void.

Effect and Review of Acceptance, Allocation, or Certification

An acceptance, allocation, or certification by the IRS of a project is not a determination that the project satisfies the requirements of Section 48B. The IRS may, upon examination (and consultation with the DOE), determine that a project does not qualify for Section 48B tax credits. A taxpayer does not have the right to a conference or to appeal any decisions of the IRS or the DOE under Notice 2006-25.

A copy of Notice 2006-25 can be obtained at *http://www.irs.gov/pub/irs-drop/n-06-25.pdf*. In addition, the National Energy Technology Laboratory has established a website for the submission of questions relating to the Notice at *http://www.netl.doe.gov/business/faq/tax_credit.html*.

IRS ISSUES GUIDANCE REGARDING CLEAN RENEWABLE ENERGY BONDS

On February 16, 2006, the IRS issued Notice 2006-7, 2006-10 I.R.B. 559, providing guidance with respect to facilities that may be financed with the proceeds of clean renewable energy bonds under Section 54(a). In addition, Notice 2006-7 provides guidance with respect to the entities that may own facilities financed with the proceeds of clean

renewable energy bonds and the entities that may issue clean renewable energy bonds. Notice 2006-7 supplements Notice 2005-98, 2005-52 I.R.B. 1211, which was published on December 27, 2005.

The Baucus Bill proposes the extension of the program for clean renewable energy bonds for three years through the end of 2010 and an additional allocation of $800 million in tax credit bonds each calendar year to be issued from January 1, 2008 through December 31, 2010. The Grassley bill contains a similar provision. In addition, the Conrad bill would provide an additional allocation of $1,000,000,000 in tax credit bonds each calendar year to be issued from January 1, 2008 through December 31, 2012.

Clean Renewable Energy Bonds

Section 1303 of the Energy Tax Incentives Act of 2005, Pub. L. No. 109-58, added Section 54 to the Code. In general, Section 54 authorizes up to $800 million of tax credit bonds to be issued by qualified issuers to finance certain renewable energy projects described in Section 45(d) of the Code.

Section 54(a) provides that a taxpayer that holds a "clean renewable energy bond" on one or more credit allowance dates of the bond occurring during any taxable year is allowed as a nonrefundable credit against federal income tax for the taxable year an amount equal to the sum of the credits determined under Section 54(b) with respect to such dates. Section 54(d) provides that a "clean renewable energy bond" means any bond issued as part of an issue if: (1) the bond is issued by a qualified issuer pursuant to an allocation by the Secretary of the Treasury to the issuer of a portion of the national clean renewable energy bond limitation under Section 54(f)(2); (2) 95% or more of the proceeds of the issue are to be used for capital expenditures incurred by qualified borrowers for one or more qualified projects; (3) the qualified issuer designates the bond for purposes of Section 54, and the bond is in registered form; and (4) the issue meets certain requirements described in Section 54(h) with respect to the expenditure of bond proceeds.

Section 54(j)(4) defines a "qualified issuer" as: (1) a clean renewable energy bond lender (as defined in Section 54(j)(2)); (2) a cooperative electric company (as defined in Section 54(j)(1)); or (3) a governmental body (defined as any State, territory, possession of the United States, the District of Columbia, Indian tribal government, or any political subdivision thereof). Section 54(j)(5) provides that a "qualified borrower" is: (1) a mutual or cooperative electric company described in Section 501(c)(12) or Section 1381(a)(2)(C); or (2) a governmental body. Section 54(d)(2)(A) defines the term "qualified project" as any of the qualified facilities described in Sections 45(d)(1) through (d)(9) (determined without regard to any placed in service date) owned by a qualified borrower.

Notice 2005-98 solicits applications for allocations of the $800 million clean renewable energy bond limitation and provides guidance on certain other matters under Section 54.

Temporary Regulations

As stated in Notice 2006-7, the Treasury Department and the IRS intend to issue temporary and proposed regulations (the "Temporary Regulations") under Section 54 to provide guidance to holders and issuers of clean renewable energy bonds. It is anticipated that the Temporary Regulations will provide, in part, as follows:

1. For purposes of Section 54, the term "qualified project" includes any facility owned by a qualified borrower that is functionally related and subordinate (as determined under Section 1.103-8(a)(3) of the Income Tax Regulations) to any qualified facility described in Sections 45(d)(1) through (d)(9) (determined without regard to any placed in service date) and owned by such borrower.

2. For purposes of Section 54, the term "political subdivision" will have the same meaning as in Section 1.103-1 of the Income Tax Regulations.

3. A clean renewable energy bond may be issued on behalf of a state or political subdivision within the meaning of Section 1.103-1(b) of the Income Tax Regulations under rules similar to those for determining whether a bond issued on behalf of a State or political subdivision constitutes an obligation of that state or political subdivision for purposes of Section 103.

4. For purposes of Section 54, the term "qualified borrower" includes an instrumentality of a state or political subdivision (as determined for purposes of Section 103).

A copy of Notice 2006-7 can be obtained at *http://www.irs.gov/irb/2006-10_IRB/as07.html*.

ENDNOTES

1 Hunton & Williams LLP, 1601 Bryan Street, 30th Floor, Dallas, Texas 75201, (214) 979-3041, (214) 880-0011(fax), amcgeoch@hunton.com.

2 Hunton & Williams LLP, 951 East Byrd Street, Richmond, Virginia 23219, (804) 788-8746, (804) 343-4661(fax), ljones@hunton.com.

3 Hunton & Williams LLP, 951 East Byrd Street, Richmond, Virginia 23219, (804) 788-8513, (804) 788-8218(fax), dlamb@hunton.com.

4 All Section references are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.

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TAX SECTION LEADERSHIP ROSTER

Officers

William P. Bowers (Chair)
Fulbright & Jaworski, L.L.P.
2200 Ross Avenue, Suite 2800
Dallas, Texas 75201
(214) 855-8219
(214) 855-8200 (fax)
bbowers@fulbright.com

Gene Wolf (Chair-Elect)
Kemp Smith LLP
221 North Kansas, Suite 1700
El Paso, Texas 79901
(915) 533-4424
(915) 546-5360 (fax)
gwolf@kempsmith.com

Kevin J. Thomason (Secretary)
Thompson & Knight LLP
1700 Pacific Avenue, Suite 3300
Dallas, Texas 75201
(214) 969-1700
(214) 969-1751 (fax)
kevin.thomason@tklaw.com

Allen B. Craig III (Treasurer)
Gardere Wynne Sewell LLP
1000 Louisiana, Suite 3400
Houston, Texas 77002-5007
713-276-5570
713-276-5555 (fax)
acraig@gardere.com

Michelle M. Kwon (Publication Editor)
Internal Revenue Service
4050 Alpha Road
Mail Code 2000 NWSAT
Dallas, Texas 75244
972-308-7431
972-308-7960 (fax)
michelle.m.kwon@irscounsel.treas.gov

R. David Wheat (Immediate Past Chair)
Thompson & Knight LLP
1700 Pacific Avenue, Suite 3300
Dallas, Texas 75201
(214) 969-1468
(214) 880-3181 (fax)
david.wheat@tklaw.com

Council Members

Josh O. Ungerman
Term expires 2006
Meadows, Owens, Collier, Reed, Cousins & Blau, L.L.P.
901 Main Street, Suite 3700
Dallas, Texas 75202
214-744-3700
214-747-3732 (fax)
jungerman@meadowsowens.com

E. Rhett Buck
Term expires 2006
3730 Kirby Drive, Suite 1200
Houston, Texas 77098
713-868-9447
713-868-6157 (fax)
erhettbuck@aol.com

Daniel J. Micciche
Term expires 2006
Akin Gump Strauss Hauer & Feld LLP
1700 Pacific, Suite 4100
Dallas, Texas 75201
214-969-2800
214-969-4343 (fax)
dmicciche@akingump.com

Christi Mondrik
Term expires 2007
James F. Martens & Associates
301 Congress Avenue, Suite 1950
Austin, Texas 78701
512-542-9898
512-542-9899 (fax)
cmondrik@textaxlaw.com

Elizabeth Copeland
Term expires 2007
Oppenheimer Blend Harrison & Tate, Inc.
711 Navarro, Suite 600
San Antonio, Texas 78205-1796
210-224-2000
210-224-7540 (fax)
ecopeland@obht.com

G. Walter McCool
Term expires 2007
McCool Law Firm, P.C.
203 Lake Ridge Village #106
Dallas, Texas 75238
214-256-3673
214-206-1081 (fax)
walt@mccoollaw.com

Dan G. Baucum
Term expires 2008
Law Offices of Daniel G. Baucum
16950 Dallas Parkway, LB 11
Dallas, Texas 75248
214-248-1900
214-248-1901 (fax)
dbaucum@baucumlaw.com

Tina R. Green
Term expires 2008
Patton, Roberts, McWilliams & Capshaw, LLP
400 Century Plaza
2900 St. Michael Drive
Texarkana, Texas 75503
903-334-7000
903-334-7007 (fax)
tgreen@pattonroberts.com

Mary A. McNulty
Term expires 2008
Thompson & Knight LLP
1700 Pacific Ave., Suite 3300
Dallas, Texas 75201
214-969-1187
214-880-3182 (fax)
mary.mcnulty@tklaw.com

Ex Officio Members

Christopher Hanna
Ex officio Member
SMU Dedman School of Law
P. O. Box 750116
Dallas, Texas 75275-0116
214-768-2621
214-768-2182 (fax)
channa@mail.smu.edu

Abbey B. Garber
Ex officio Member
Internal Revenue Service
4050 Alpha Road
Mail Code 2000 NWSAT
Dallas, Texas 75244
972-308-7913
972-308-7970 (fax)
abbey.b.garber@irscounsel.treas.gov

Nancy L. Prosser
Ex officio Member
Comptroller of Public Accounts
Tax Policy Division
P. O. Box 13528
Austin, Texas 78711-3528
512-463-3723
512-475-0900 (fax)
nancy.prosser@cpa.state.tx.us

2005 - 2006
TAX SECTION LEADERSHIP ROSTER

COMMITTEE	CHAIR	VICE CHAIR
1. **Continuing Legal Education** <u>Council Liaison:</u> Elizabeth Copeland 210-224-2000 ecopeland@obht.com	William D. Elliott 2626 Cole, Suite 60 Dallas, Texas 75204 214-922-9893 214-853-4177 (fax) bill@wdelliott.com	Daniel J. Micciche Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 214-969-2800 214-969-4343 (fax) dmicciche@akingump.com
2. **Corporate Tax** <u>Council Liaison:</u> Mary A. McNulty 214-969-1178 mary.mcnulty@tklaw.com	Vicki L. Martin Haynes and Boone, LLP 901 Main Street, Suite 3100 Dallas, Texas 75202-3789 214-651-5674 214-200-0460 (fax) vicki.martin@haynesboone.com	Glenn T. Leishner Senior Tax Counsel Shell Oil Company U. S. Tax Organization P. O. Box 2463 Houston, Texas 77252-2463 713-241-3286 713-241-2162 (fax) glenn.leishner@shell.com
3. **Energy and Natural Resources Tax Committee** <u>Council Liaison:</u> Mary A. McNulty 214-969-1178 mary.mcnulty@tklaw.com	Katrina H. Welch Tax Counsel Texas Instruments 7839 Churchill Way, M/S 3998 Dallas, Texas 75251 972-917-6923 972-917-6006 (fax) katrina@ti.com	Janet Jardin Thompson & Knight LLP 1700 Pacific Ave., Suite 3300 Dallas, Texas 75201 214-969-1535 214-969-1630 (fax) janet.jardin@tklaw.com
4. **Estate and Inheritance Tax** <u>Council Liaison:</u> Rhett Buck 713-868-9447 erhettbuck@compuserv.com	Frances Bennett Bennett Smith, L.L.P. 3307 Northland Dr., Suite 470 Austin, Texas 78731 512-407-8888 512-407-8588 (fax) fhbennett@bennettsmithlaw.com	William R. Mureiko Thompson & Knight LLP 1700 Pacific Ave., Suite 3300 Dallas, Texas 75201 214-969-1424 214-969-1751 (fax) bill.mureiko@tklaw.com
5. **International Tax** <u>Council Liaison:</u> Josh O. Ungerman 214-744-3700 jungerman@meadowsowens.com	David S. Peck Vinson & Elkins LLP Trammell Crow Center 2001 Ross Avenue, Suite 3700 Dallas, Texas 75201-2975 214-220-7937 214-999-7937 (fax) dpeck@velaw.com	Mark Martin Gardere Wynne Sewell LLP 1000 Louisiana, Suite 3400 Houston, Texas 77002-5007 713-276-5391 713-276-6391 (fax) mmartin@gardere.com
6. **Partnership/Real Estate** <u>Council Liaison:</u> Dan G. Baucum 972-248-1900 dbaucum@baucumlaw.com	James Howard Locke, Liddell & Sapp, LLP 600 Travis Street, Suite 3400 Houston, Texas 77002-3095 713-226-1424 713-223-3717 (fax) jhoward@lockeliddell.com	Brandon Jones Haynes and Boone, LLP 901 Main St., Suite 3100 Dallas, TX 75202 214-651-5809 214-200-0744 (fax) jonesbr@haynesboone.com Robert W. Phillpott, Jr. Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5151 713-651-5246 (fax) rphillpott@fulbright.com
7. **Property Tax Committee** <u>Council Liaison:</u> Walt McCool 214-256-3673 walt@mccoollaw.com	Sandra Griffin Perdue, Brandon, Fielder, Collins & Mott, L.L.P. 6300 La Calma Dr., Suite 450 Austin, Texas 78752 512-302-0190 512-323-6963 (fax) sgriffin@pbfcm.com	Amy Reilly Sallusti Geary, Porter & Donovan P.C. 16475 Dallas Parkway Suite 500 Addison, Texas 75001-6837 972-931-9901 972-931-9108 (fax) asallusti@gpd.com

8. Small Firm/Solo Committee

Council Liaison
E. Rhett Buck
713-868-9447
erhettbuck@compuserve.com

David Adler
Adler, Mitchell & Jenkins
One Turtle Creek Village
3878 Oak Lawn, Suite 330
Dallas, Texas 75219
214-521-5058
214-521-5062 (fax)
adlerpc@swbell.net

Stephen D. Willey
1414 W. Randol Mill Rd.
Suite 203
Arlington, Texas
817-265-2711
817-801-5418 (fax)
swilley@attorney-cpa.com

9. State & Local Tax Committee

Council Liaison:
Daniel J. Micciche
214-969-2800
dmicciche@akingump.com

Geoff Polma
Locke Liddell & Sapp LLP
Suite 2200
2200 Ross Avenue
Dallas, Texas 75201
214-740-8644
214-740-8800 (fax)
gpolma@lockeliddell.com

David D. White
Corporate Tax Department
SBC Headquarters Building
175 E. Houston St., Rm. 8-K-03
San Antonio, Texas 78205
210-351-3918
210-351-3960
dwhite@corp.sbc.com

10. Tax Controversy

Council Liaison:
Christi Mondrik
512-542-9898
cmondrik@texaxlaw.com

Emily A. Parker
Thompson & Knight LLP
1700 Pacific Ave., Suite 3300
Dallas, Texas 75201
214-969-1502
214-880-3184 (fax)
emily.parker@tklaw.com

Larry Jones
Townsend & Jones L.L.P.
8100 Lomo Alto
Dallas, Texas 75225-6545
214-696-2661
214-764-3320 (fax)
larry@tjtaxlaw.com

11. Tax-Exempt Finance

Council Liaison:
Walt McCool
214-256-3673
walt@mccoollaw.com

Bob Griffo
Andrews Kurth LLP
1717 Main Street, Suite 3700
Dallas, Texas 75201
214-659-4651
214-659-4860 (fax)
bgriffo@andrewskurth.com

Faust N. Bowerman
McCall, Parkhurst & Horton L.L.P.
717 N. Harwood, Suite 900
Dallas, Texas 75201-6514
214-754-9228
214-754-9250 (fax)
fbowerman@mphlegal.com

12. Tax-Exempt Organizations

Council Liaison:
Tina Green
903-334-7000
tgreen@pattonroberts.com

Bruce E. Bernstien
Bruce E. Bernstien & Assoc. P.C.
10440 N. Central Expwy., Suite 1130
Lock Box 402
Dallas, Texas 75231
214-706-0837
214-706-0848 (fax)
bbernstien@plusassociates.com

13. Pro Bono

Council Liaison:
Tina Green
903-334-7000
tgreen@pattonroberts.com

Daniel J. Micciche
Akin Gump Strauss Hauer & Feld LLP
1700 Pacific, Suite 4100
Dallas, Texas 75201
214-969-2800
214-969-4343 (fax)
dmicciche@akingump.com

Janet Jardin
Thompson & Knight LLP
1700 Pacific Ave., Suite 3300
Dallas, Texas 75201
214-969-1535
214-969-1630 (fax)
janet.jardin@tklaw.com

14. Publication Editor

Michelle M. Kwon
Internal Revenue Service
4050 Alpha Road
Mail Code 2000 NWSAT
Dallas, Texas 75244
972-308-7431
972-308-7960 (fax)
michelle.m.kwon@irscounsel.treas.gov

Alyson Outenreath
Thompson & Knight LLP
1700 Pacific Ave., Suite 3300
Dallas, Texas 75201
214-969-1741
214-880-3276 (fax)
alyson.outenreath@tklaw.com

15. Website/E-Communications

Tyree Collier
Jenkens & Gilchrist
1445 Ross Avenue, Suite 3200
Dallas, Texas 75202-2799
214-855-4342
214-855-4300 (fax)
tcollier@jenkens.com

16. Governmental Submissions

Patrick O'Daniel
Jenkens & Gilchrist
401 Congress Ave., Suite 2500
Austin, Texas 78701
512-499-3800
512-499-3810 (fax)
podaniel@jenkens.com

COMMITTEE SELECTION FORM
Section of Taxation
State Bar of Texas

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CITY STATE ZIP CODE

TELEPHONE NO: (______)____________________ E-MAIL: ________________________

BAR CARD NO.: ________________________

COMMITTEE SELECTION (PLEASE CHECK BOX)

	COMMITTEE	CHAIR
❑	**Continuing Legal Education**	William D. Elliott 2626 Cole, Suite 60 Dallas, Texas 75204 214-922-9893 214-853-4177 (fax) bill@wdelliott.com
❑	**Corporate Tax**	Vicki L. Martin Haynes and Boone, LLP 901 Main Street, Suite 3100 Dallas, Texas 75202-3789 214-651-5674 214-200-0460 (fax) vicki.martin@haynesboone.com
❑	**Energy and Natural Resources Tax**	Katrina H. Welch Texas Instruments 7839 Churchill Way, M/S 3998 Dallas, Texas 75251 972-917-6923 972-917-6006 (fax) katrina@ti.com
❑	**Estate & Inheritance Tax**	Frances Bennett Bennett Smith, L.L.P. 3307 Northland Drive., Suite 470 Austin, Texas 78731 512-407-8888 512-407-8588 (fax) fhbennett@bennettsmithlaw.com
❑	**International Tax**	David S. Peck Vinson & Elkins LLP Trammell Crow Center 2001 Ross Avenue, Suite 3700 Dallas, Texas 75201-2975 214-220-7937 214-999-7937 (fax) dpeck@velaw.com
❑	**Partnership/Real Estate**	James Howard Locke, Liddell & Sapp, LLP 600 Travis Street, Suite 3400 Houston, Texas 77002-3095 713-226-1424 713-223-3717 (fax) jhoward@lockeliddell.com
❑	**Property Tax**	Sandra Griffin Perdue, Brandon, Fielder, Collins & Mott, L.L.P. 6300 La Calma Drive, Suite 450 Austin, Texas 78752 512-302-0190 512-323-6963 (fax) sgriffin@pbfcm.com

	COMMITTEE	CHAIR
	Small Firm/Solo	David Adler Adler, Mitchell & Jenkins One Turtle Creek Village 3878 Oak Lawn, Suite 330 Dallas, Texas 75219 214-521-5058 214-521-5062 (fax) adlerpc@swbell.net
	State & Local Tax	Geoff Polma Locke Liddell & Sapp LLP Suite 2200 2200 Ross Avenue Dallas, Texas 75201 214-740-8644 214-740-8800 (fax) gpolma@lockeliddell.com
	Tax Controversy	Emily A. Parker Thompson & Knight LLP 1700 Pacific Avenue, Suite 3300 Dallas, Texas 75201 214-969-1502 214-880-3184 (fax) emily.parker@tklaw.com
	Tax-Exempt Finance	Bob Griffo Andrews Kurth LLP 1717 Main Street, Suite 3700 Dallas, Texas 75201 214-659-4651 214-659-4860 (fax) bgriffo@andrewskurth.com
	Tax-Exempt Organizations	Bruce E. Bernstien Bruce E. Bernstien & Assoc. P.C. 10440 N. Central Expwy, Suite 1130 Lock Box 402 Dallas, Texas 75231 214-706-0837 214-706-0848 (fax) bbernstien@plusassociates.com
	Pro Bono	Daniel J. Micciche Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 214-969-2800 214-969-4343 (fax) dmicciche@akingump.com
	Publication Editor	Michelle M. Kwon Internal Revenue Service 4050 Alpha Road, Mail Code 2000 NWSAT Dallas, Texas 75244 972-308-7431 972-308-7960 (fax) michelle.m.kwon@irscounsel.treas.gov
	Website/E-Communications	Tyree Collier Jenkens & Gilchrist 1445 Ross Avenue, Suite 3200 Dallas, Texas 75202-2799 214-855-4342 214-855-4300 (fax) tcollier@jenkens.com
	Government Submissions	Patrick O'Daniel Jenkens & Gilchrist 401 Congress Ave., Suite 2500 Austin, Texas 78701 512-499-3800 512-499-3810 (fax) podaniel@jenkens.com

Please complete form and forward to the Committee Chair(s).

NOTES

NOTES

STATE BAR OF TEXAS
P.O. Box 12487
Austin, Texas 78711-2487

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