The Texas Tax Lawyer

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CHAIR'S MESSAGE

Greetings from the wet Texas town of El Paso.

I believe that clearly articulated goals are an important first step to the success of an organization. Goals remind the organization's leadership where to direct the organization's time, talent, and treasures. Goals also enable a person to look at the purpose and direction of an organization so that he can decide whether the organization is a worthy recipient of his time, talent, and treasures.

Our goals, which I first set forth a few months ago in an email to the Tax Section membership, are simple. They are:

- *Education* – The Section will provide world-class education to its members through accessible and relevant CLE.
- *Better Laws* – The Section will work towards improving the substance and administration of state and federal tax laws.
- *Pro Bono* – The Section will work towards delivering the knowledge and experience of its members to those people who cannot afford the services of tax lawyers.
- *Enhanced Profile* – The Section will work towards enhancing the profile of its members within the tax community, including Treasury, the Internal Revenue Service, the Comptroller, and practitioners. The enhanced profile will benefit Section members by furthering the national respect for, and credibility of, Texas tax lawyers.
- *Having Fun* – The practice of law is difficult enough. The stuff we do with the Section should be fun.

The mere act of putting our goals on paper will not make the Tax Section a better organization. The Section will only become a better organization when more members step forward to give of their time and talent to the Section's activities. Towards that end, I want to use my three Chair's Messages to explain three ways you can get involved with the Section. In my first Chair's Message, I want to focus on how you can get involved in the Section by participating in regulatory commenting projects.

A commenting project is simply a means by which we as a Section provide direction and guidance to lawmakers as they consider tax policy or as they draft tax rules and regulations. A commenting project is undertaken in response to a request for comments by the governmental body responsible for drafting particular rules. For example, when Treasury issues proposed regulations, it seeks comments on those regulations from the public.

Participating in commenting projects serves two goals of the Tax Section. First, the projects help to improve the substance and administration of state and federal tax laws by giving Texas tax lawyers a platform to share their knowledge and experience with lawmakers. Second, because these commenting projects are published, the projects help to enhance the profile of Texas tax lawyers in all facets of the tax community.

Each commenting project undertaken by the Tax Section must be handled in a manner that complies with strict rules imposed by the State Bar of Texas. Each project must also be a work product that the Tax Section can stand behind—in other words, it must be excellent. To oversee our commenting process we have formed a Government Submissions Committee (COGS). Patrick O'Daniel (with Jenkins & Gilchrist in Austin, Texas) is the Chair of COGS. COGS is not responsible for the drafting of commenting projects. It simply provides coordination and oversight. COGS is currently putting together a guidebook on how to do a commenting project. Actual responsibility for the drafting of commenting projects has been placed on the following committees, each of which is tasked with identifying and putting together commenting projects in its area of tax law:

- Corporate Tax
- Employee Benefits
- Energy and Natural Resources
- Estate and Inheritance Tax
- General Tax
- International Tax
- Partnership and Real Estate Tax
- Property Tax
- State and Local Tax
- Tax Controversy
- Tax-Exempt Finance
- Tax-Exempt Organizations

Over the past year we as a Section have submitted three commenting projects. According to former Section Chair Stanley Blend, who is now the Chair-Elect of the ABA Section of Taxation, our projects have generated a lot of positive feedback from tax practitioners across the country. Our projects have also generated positive feedback from government officials, including Eric Solomon, Acting Deputy Assistant Secretary for Tax Policy, US Department of the Treasury.

I had the good fortune of participating in one of our three projects, which focused on the proposed regulations under section 409A of the Internal Revenue Code. *See Tax Notes*, Jan. 23, 2006, p. 347. It was a lot of work, but it was fun and well worth the time. It also gave me the opportunity to work with and get to know a world-class group of tax lawyers from across this great state. If you have an interest in participating in a commenting project, I urge you to contact the Chair of the appropriate Committee. Each Chair's contact information is found on page 46 of the *Texas Tax Lawyer*.

As a final matter, it's time again to start thinking about the people who will serve as officers next year and who will fill the expiring Council positions. Towards that end, if you would like the Nominating Committee (made up of Robert Gibson, Jack Taylor, and David Wheat) to consider someone for the position of Chair-Elect, Secretary, or Treasurer or for one of the expiring Council positions, please submit that name to Robert Gibson either by email (rgibson@gordonmottpc.com) or hardcopy (fax number 915-545-4433). If your candidate wishes to be considered for nomination, he or she must also complete and submit to the Nominating Committee no later than December 15, 2006, the Nomination Form found on page 3 of the *Texas Tax Lawyer*.

I hope you decide to get plugged in.

Gene Wolf, Chair

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2006-2007 CALENDAR

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

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

CALL FOR NOMINATIONS FOR
OUTSTANDING TEXAS TAX LAWYER AWARD

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

Nominations should be submitted to Gene Wolf, either by email (gwolf@kempsmith.com) or hardcopy (fax number 915-546-5360) no later than January 12, 2007.

NOMINATION FOR OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Mailing Address: ____

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

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

CANDIDATE QUESTIONNAIRE
FOR OFFICER OR COUNCIL MEMBER - STATE BAR OF TEXAS TAX SECTION

Any person who wishes to be considered for nomination to the office of Chair-Elect, Secretary, or Treasurer or for nomination to an expiring Council position must complete and return this questionnaire to Robert Gibson, either by email (rgibson@gordonmotpc.coom) or hardcopy (fax number 915-545-4433) no later than December 15, 2006.

Name: ______________________________

Firm Name: ______________________________

Address: ______________________________

City, State, Zip: ______________________________

Email address: ______________________________

Position: ______________________________

Describe your involvement in the State Bar of Texas:

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Describe your involvement in other Bar activities:

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Describe other relevant experience for the position:

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JOIN THE PRO BONO COMMITTEE

If you think pro bono work is for only family law and trial lawyers, you are wrong. There are a wide variety of pro bono projects that are better suited for tax lawyers. The State Bar of Texas Tax Section has a Pro Bono Committee that is committed to providing a venue for tax lawyers to participate in pro bono activities.

We need your help.

We are investigating some new and exciting opportunities for pro bono participation on the part of tax attorneys.

Some of the projects that we will continue to focus on include:

❖ The Volunteer Income Tax Assistance (VITA) program

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

❖ The Texas Community Building with Attorney Resources (C-BAR) program

Texas C-Bar is a statewide pro bono initiative for transactional attorneys. Texas C-Bar provides free legal representation and other legal resources for community-based nonprofits working to improve the lives of low-income persons and transform distressed neighborhoods into healthy communities. The types of matters that Texas C-BAR refers to volunteer attorneys include: drafting articles of incorporation and bylaws; applying for and maintaining tax-exempt status; establishing joint ventures; drafting and reviewing contracts; and reviewing financing documents.

To learn more about participating in these pro bono activities or being a member of the Pro Bono Committee, please contact Janet Jardin, Chair, at janet.jardin@tklaw.com or 214.969.1535.

"THE UPIA TWINS: ARE THEY EVIL OR SIMPLY CONJOINED"?

Alvin J. Golden[1]
Austin, Texas

I. On January 1, 2004, the Texas versions of the Uniform Principal and Income Act (Texas Probate Code Ann. Chapter 116) and the Uniform Prudent Investor Act (Texas Probate Code Chapter 117) became the law of Texas. The Uniform Principal and Income Act ("UPAIA") has been adopted in 39 states and the U. S. Virgin Islands, and the Uniform Prudent Investor Act ("UPIA") has been adopted in 41 states, the District of Columbia and the U.S. Virgin Islands. Both Acts represent a sea of change in the law of trusts in this state. They are sometimes collectively referred to as the "Acts". UPAIA is designed to allow changes in accounting required by the investment changes dictated by UPIA. It is important to remember that these Acts are default rules, which may be overridden by the terms of the instrument, and are designed to work together.

II. **SCOPE.** This article analyzes selected provisions of the Uniform Acts (as adopted by Texas) that change the way trusts are drafted and administered. It also explores the duties and responsibilities now imposed *by statute* on trustees, which formerly existed under the common law. Because of the change in basic philosophies, new issues of trustee liability and how a trustee may avoid liability also will be explored. While drafting issues may be mentioned, drafting suggestions are beyond the scope of this article as are detailed discussions of accounting issues raised by UPAIA.

III. **PRINCIPAL CHANGES (NO PUN INTENDED).** There are several changes wrought by these Acts that require a change in attitude by estate planners, trustees, and those who become involved in fiduciary litigation. In an attempt to aid in interpreting the Acts, the Real Estate Probate and Trust Law Section of the Bar (with the invaluable assistance of Professor Stanley M. Johanson) was able to persuade West Publishing Company to publish the Comments of the National Conference of Commissioners on Uniform State Laws and the comments of the Real Estate, Probate and Trust Law Section (the "Section") where the Bar made changes or where peculiarities of Texas law required explanation beyond the Uniform Laws Comments. These Comments are *usually* helpful in interpreting the statute. They are somewhat like Revenue Rulings in that they have no force of law, but may aid practitioners, trustees and the courts in applying these new laws uniformly.

A. UPIA. Although UPIA's dictate that the Trustee invest for overall return in keeping with Modern Portfolio Theory[2] is probably its central change, it is important to note that UPIA implements that dictate by requiring the trustee to focus on the terms and purposes of ***the*** specific trust being administered rather than on a list of approved trust investments.

1. Application. UPIA applies *only* to trusts and it applies to trusts existing on January 1, 2004, and those created thereafter. Thus it applies to all trusts, but only to the extent of acts or decisions after the effective date.

2. Fundamental Changes. The Uniform Act Prefatory Note lists five fundamental changes made by UPIA.

   a. Standard of prudence is applied to any investment as part of the overall portfolio, rather than to individual investments. This represents a change to the common law that determined whether a trustee had breached his duty of prudence on an asset by asset basis.[3]

   b. Tradeoff in all investing between risk and return is identified as the trustee's central consideration.[4]

   c. Trustee may invest in anything that meets risk/return objectives and the other elements of prudence. There are no prohibited investments. Thus, as part of a portfolio, a trustee may invest in derivatives, hedge funds, and other investments which might have been prohibited before.[5]

   d. Diversification has been integrated into prudent investing and is central to the risk/return balance.[6]

   e. Delegation of trustee investment and management functions is now permitted, with certain safeguards. Texas has departed from the uniform act and has strengthened the safeguards.[7]

3. About Process. Because investment for overall return for any particular trust is extremely subjective, UPIA is more about process than results

B. UPAIA. According to the Uniform Act Prefatory Note, UPAIA "deals conservatively with the tension between modern investment theory and traditional income allocation."

1. Application. UPAIA applies to both trusts and estates (with a key exception noted below). As with UPIA, it applies to trusts existing on January 1, 2004, and estates still under administration at that date, and to trusts created and administrations opened after such date. It only applies to acts or decisions after the effective date.[8]

2. Power to Adjust. The centerpiece of UPIA is the power to adjust (discussed in detail below).[9] This allows the trustee to adjust distributions so that the trustee may invest for overall return and still fulfill its duty of impartiality (now codified as a fiduciary duty) between the income beneficiary and the remainder beneficiary. A detailed section deals with the liability of a trustee for exercising or not exercising the power to adjust, and here again Texas departs from the Uniform Act. Texas Trust Code §116.006.

3. Other Texas Departures. Texas also departs from the Uniform Act with respect to oil and gas (Texas Trust Code §116.174) and retirement plan distributions (Texas Trust Code §116.172).

IV. **INVESTMENT STANDARDS.** UPIA lays out investment standards for trustees and the Texas Probate Code sets out investment standards for executors. As will be seen below, the standards are very different because the purpose of each fiduciary is different.

A. TRUSTEE. The trustee is directed to invest "as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of *the* trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution."[10] The trustee's investment horizon is, in most cases, long term, and usually must take into account more than one generation of beneficiaries.

1. Circumstances to Be Considered.[11] Texas Trust Code § 117.004(c) mandates that "among circumstances" to be considered by a trustee "are such of the following *as* are relevant to the trust or to its beneficiaries" (emphasis added):

a. general economic conditions;

b. possible effects of inflation or deflation;

c. expected tax consequences of investment decisions or strategies;

d. the role that each investment (*e.g.*, closely held business, personal property, real estate, minerals) or course of action plays within the overall trust portfolio;

e. expected total return from income and appreciation of capital;

f. other resources of the beneficiary;

g. needs for liquidity, regularity of income, and preservation or appreciation of capital; and

h. an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

As an illustration of the difficulties inherent in this kind of decision making, it has been suggested that the duty to diversify is different depending upon the identity of the income beneficiary. If the income beneficiary is elderly and in need of steady income, should the trustee adopt an investment program that produces a steady stream of income rather than the maximum overall return? Does it depend on whether the power to adjust is available?

2. Matter of Process and Standard of Liability. As noted earlier, UPIA is all about the *process* of the decision making by the trustee. It is impossible to construct a universal decision matrix: First, the list in Texas Trust Code §117.004(c) is clearly *not* exclusive ("among circumstances"). Second, not all of the listed considerations will be relevant in every trust. Thus, one would expect that different trustees in the same set of circumstances would arrive at what may be very different decisions and investments.

a. How is a trier of fact to determine whether a trustee has properly exercised prudence in making investments when the investments do not perform to the satisfaction of one or more beneficiaries? The answer should be that the judge or jury should not consider the results of the investments, nor should it consider whether it would have invested differently. Rather, it should consider whether the trustee failed to exercise its discretion properly in determining the factors to be considered as relevant to the trust, and the application of those factors to the trust.

b. The trustee's compliance "is determined in light of the facts and circumstances existing at the time of the trustee's decision or action, *and not by hindsight*."[12]

c. A trustee who has "special skills or expertise, or is named trustee in reliance on the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise."[13] Thus a professional trustee is held to a higher standard than an individual trustee.

3. Diversification. Texas Trust Code §117.005 requires the trustee to diversify investments "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." What kind of assets would justify a trustee in failing to diversify? It depends on the trust and the specific circumstances. For example, an interest in a closely held business or a family farm or ranch could be assets which should not be sold to achieve diversification. The draftsman should explore with the testator or settlor whether he or she wishes the duty to diversify to be waived based upon the creator's desire and knowledge of the assets to be held in the trust.

4. Duties at Inception. In a 180° departure from prior Texas law, Texas Trust Code § 117.006 mandates that a trustee "within a reasonable time after accepting the trusteeship or receiving trust assets" review the assets in the trust and determine whether or to what extent the assets received are appropriate to retain considering the "purposes, terms, distribution requirements and other circumstances of the trust, and the requirements of this chapter." Of course, one key question is what is a reasonable time for retention purposes. While some commentators have speculated that one year maybe reasonable, it is more likely that it depends on circumstances, and that in many cases a reasonable time may be substantially shorter. This duty, of course, is part and parcel of the duty to diversify.

5. Impartiality. Texas Trust Code §117.008 requires the trustee to act impartially among beneficiaries in investing and managing the trust assets. This duty has not been previously codified in Texas. While this duty is not *per se* an investment standard, it certainly affects the asset mix.

B. EXECUTOR OR ADMINISTRATOR. Unlike the trustee, the personal representative of a decedent's estate (the "PR") is not subject to the prudent investor standard and is in office for a finite amount of time. In larger estates, this period may be extended, but in many estates, the PR serves for two years or less. Additionally, the PR looks only to the current beneficiaries of the estate.

1. Prudence. The PR's duty of prudence is set out in Texas Probate Code Ann. § 230. The PR is directed to "take care of the property of the estate of his testator or intestate as a prudent man would take of his own property...." Note that this is even less precise than the common law prudent man rule or the Texas version of the prudent man rule.[14]

2. Caretaker. The PR is really more a caretaker charged with conserving the assets, and to some extent with maintaining the assets themselves so that the beneficiaries inherit what the decedent owned at death. However, this does not allow a PR to hold on to an asset just because it was in the estate if prudence dictates that such asset be disposed of (*e.g.*, Enron stock or an offer for an asset from a third party which is well above market value). Great tension exists between the desire to maintain the asset and exercising prudence in its disposition.

V. **POWER TO ADJUST.** The "power to adjust" is set forth in Texas Trust Code §116.005 and is the necessary power to allow the trustee to invest for total return. This power is not available to a PR. This power, simply stated, is the power to convert principal to income and *vice-versa*. It is generally accepted that the power to convert principal to income is not limited to principal receipts of the current year, but may also include unrealized gains.

A. PURPOSE OF THE POWER TO ADJUST. Since the trustee is mandated under UPIA to invest for overall return, the trustee must be given some method of treating the beneficiaries impartially. That method is the power to adjust distributions so that the income beneficiary receives a fair return from the trust, while the remainder beneficiary can be assured of some protection of principal.

1. Historical Perspective. While the power to adjust is statutorily new, trustees have historically exercised this power from a different perspective. Before UPIA mandated investing for overall return, the trustee would adjust its investment policy to produce what was hopefully a reasonable amount of income. In other words, the trustee would "adjust" between income and principal by investing to produce the desired amount of income.

2. Same Power, Different Approach. After the adoption of the power to adjust contained in UPAIA, the trustee is free to follow UPIA and invest for optimum results and simply recharacterize the components of the trust to produce a fair result for all beneficiaries. In other words, rather than affecting income by investment policy, the trustee now ignores income in investing and determines income by the power to adjust.

B. REQUIREMENTS TO EXERCISE POWER TO ADJUST. Texas Trust Code §116.005(a) lays out the conditions precedent to the trustee's exercise of the power to adjust to the extent the trustee deems necessary if:

a. The trustee invests and manages the trust assets as a prudent investor;

b. The terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income; and

c. The trustee determines that it is unable to administer the trust impartially based upon what is fair and reasonable to all the beneficiaries unless the document directs otherwise. Texas Trust Code §116.004(b), which also states that a "determination in accordance with this chapter is presumed to be fair and reasonable to all the beneficiaries."

This power to adjust includes the power to allocate all or part of a capital gain to trust income.

C. CONSIDERATIONS IN EXERCISING THE POWER TO ADJUST. The trustee is directed to consider "*all* factors relevant to the trust and its beneficiaries, *including* the following factors to the extent they are relevant." (Emphasis added.) Note that the trustee is not required even to consider all of the listed factors, and must consider other factors to the extent they are relevant, whatever that means. As with the investments, the decision concerning the power to adjust is more about process than result. The listed factors are:

a. The nature, extent and duration of the trust;

b. The intent of the settlor (obviously only to the extent it can be ascertained, but the trustee, unlike the court, should be allowed to go outside the four corners of the document in certain cases);

c. The identity and circumstance of beneficiaries;

d. Need for liquidity, regularity of income, and preservation and appreciation of capital;

e. The nature of the assets in the trust and, somewhat strangely in light of the trustee's duty to evaluate the assets received, whether the asset was purchased by the trustee or received from the settlor;

f. The net amount allocated to income under other provisions of this chapter and the increase or decrease in the principal value of the assets, which the trustee may estimate if market values are not readily available;

g. Whether and to what extent the terms of the trust contain the power to invade principal or accumulate income or prohibit the trustee from invading income or accumulating principal and the extent to which the trustee has from time to time exercised such powers;

h. The actual and *anticipated* effect of economic conditions and effects of inflation and deflation; and,

i. The anticipated tax consequences of an adjustment.

D. HOW THE POWER MIGHT BE EXERCISED. Initially it was thought that the trustee would probably see how much income was actually realized and then adjust at the end of the year. The impracticalities of this approach soon became evident, and the trust industry determined that it would exercise the power to adjust by using a unitrust approach; *i.e.*, distributions would be made based upon a percentage of the value of the trust, determined at the beginning of the year so that the beneficiaries would be able to plan on distributions. (For a further discussion of unitrusts, see below.) The trustee should review this policy at reasonable intervals, and change the percentage or go to a different form of adjustment when circumstances dictate.

E. CIRCUMSTANCES IN WHICH ADJUSTMENT PROHIBITED. Texas Trust Code §116.005(c) lists those circumstances in which the power to adjust may not be available to one or more of the trustees. Almost all of the prohibitions are tax driven and designed to avoid loss of the marital deduction, gift tax issues, or estate inclusion issues. Some of the more important and/or controversial are discussed below.

1. Loss of Marital Deduction. Texas Trust Code § 116.005(c)(1) prohibits the trustee from making an adjustment that diminishes the income interest of a spouse in a trust that qualifies for the marital deduction. Prior to the issuance of final Treasury Regulations § 20.2056(b)-5(f), recognizing the new, flexible definitions of income under state law, this provision was necessary to assure that the marital deduction would not be lost. The Section has proposed a repeal of this section now that the Treasury Regulations specifically recognize the availability of the power to adjust without loss or diminution of the marital deduction.

2. Trustee as Beneficiary. Texas Trust Code § 116.005(c)(7) prohibits a trustee-beneficiary from exercising the power to adjust. This restriction, again tax driven, is designed to prevent the trustee from being treated as having a general power of appointment and thus causing both income and estate tax problems. There is also, of course, the fiduciary duty problem of a trustee using his office to benefit himself.

3. Trustee not a Beneficiary. Texas Trust Code § 116.005(c)(8) prohibits a trustee from exercising the power to adjust, even though not a beneficiary, if the exercise would benefit the trustee, directly or indirectly. This is an extension of subsection (c)(7).

4. Exercise by Co-Trustee. If there is a disinterested co-trustee, then restrictions on the ability of a trustee to exercise the power to adjust contained in subsections (c)(5) through (c)(8) do not apply to the independent co-trustee.

5. Restriction in Instrument Not a Bar. Texas Trust Code §116.005(f) states that terms of a trust that limit the power of a trustee to make adjustments between principal and income will not affect the power to adjust unless it is clear from the instrument that the settlor intended to restrict the power to adjust. For example, a provision in the trust prohibiting invasion of principal would not prevent the exercise of the power to adjust, since that is not an invasion of principal, but merely a determination of income. (But see Example 4 of the Comments discussed below.)

F. OTHER CONSIDERATIONS.

1. When Power to Adjust Is Available. While the power to adjust is probably not necessary in most trusts that permit invasion of principal, it is the nonetheless available. For example, if a trust allows invasion of principal for the support of the beneficiary but requires that the trustee consider other resources available to the beneficiary, no invasion of principal would be available where the beneficiary had more than ample other resources. Yet, the amount of income produced by investing for overall return might be unreasonably low, and an adjustment may be necessary to meet the trustee's duty of impartiality.

2. Example 4. This Example in the comments is very curious in that it suggests that where there is a limitation on the amount of principal to be distributed (in this case 6% of the initial value of the trust over the life of the beneficiary, but only for "dire emergencies"), the trustee may exercise the power to adjust from principal to income only to the extent that a reduction in income resulted from the change to investing for overall return. There is no support in the statutory language for this interpretation unless it is construed as being a "clear" provision meant to deny the trustee the power to adjust. The facts in Example 4 state that the trust was existing on the effective date of the statute, and was invested in a 50% bond - 50% equity mix. The trustee elected to go to a 90%-10% formulation to achieve overall return and "dividend and interest income" was reduced. [Query how dividend income is reduced if the investment in equities almost doubled.] The example concludes, "Thereafter, even though [the beneficiary] does not experience a dire emergency, T may exercise the power to adjust...to the extent that T determines that the adjustment is from only the capital appreciation resulting from the change in the portfolios asset allocation." This is an absurd conclusion, and clearly so because it depends on what the allocation was before UPIA.

G. JUDICIAL CONTROL OF DISCRETIONARY POWER. Texas Trust Code §116.006 is based upon a provision added to the Uniform Act in 2000, after corporate trustees expressed concern about potential liability for exercising (or not exercising) the power to adjust. Much of this section is simply a restatement of the common law. The Texas law substantially follows the Uniform Act in subsections (a) through (c), but departs in subsection (d) by denying trustees access to the courts unless there is a *bona fide* probability of controversy. The feeling of the Section was that court approval should not be available where the sole interest of the trustee was assuring that it had a security blanket.

1. Abuse of Discretion. A court may not substitute its judgment for the judgment of the trustee unless the court finds that the trustee abused its discretion. This standard is very difficult and specifically directs a court not to substitute its judgment merely because it would have acted differently than the trustee.[15]

2. Application. This abuse of discretion standard applies not only to the decision itself but to the process used in reaching that decision,

illustrating once again that the Uniform Acts are about process.[16]

3. Remedies. If the court determines that the trustee has abused its discretion, it must first attempt to correct that abuse by placing the various beneficiaries in the same position as they would have been had the abuse not occurred *by using the trust funds to achieve that result*. If, for example, the income beneficiary had not received sufficient distributions, then additional distributions are made from the trust. If there were excessive distributions, then the trustee may withhold future distributions or the court may direct the beneficiary to return all or part of the excess distribution. If the abuse cannot be remedied from within the trust or distributions, the trustee may be personally liable.[17]

4. Availability of Instructions. Texas Trust Code § 116.006(d) departs dramatically from the Uniform Act. If the trustee "reasonably believes" that any beneficiary will object to the exercise or non-exercise of the power to adjust in Texas Trust Code §116.005, then the trustee may ask the court to determine whether such exercise or non-exercise would be an abuse of discretion.

   a. Trustee must state in its petition "the basis for its belief that a beneficiary would object," and the refusal of a beneficiary to sign a release does not, by itself, form such a reasonable basis. The Section felt that many times a beneficiary would refuse to sign a release, but have no intention of suing the trustee.

   b. If the petition is sufficient to inform the beneficiary what the trustee intends to do and why, then the burden of proof is on the challenging beneficiary to show that such action or inaction would constitute a breach of trust.

   c. The trustee advances all costs (including attorney's fees) from the trust, and the court determines how the fees and expenses should be apportioned at the end of the case. This method was adopted to cure what Frank Ikard calls the "paradox of trust litigation" – that the trustee has the funds with which to defend itself, but the beneficiaries who may be harmed are often unable to fund an action.

H. NON-CHARITABLE UNITRUSTS. A unitrust is a trust in which distributions are measured by the value of the trust assets without regard to income or principal allocations. The current (or "income") beneficiary receives a fixed percentage of the value of the trust each year.[18] Many states that enacted UPAIA also enacted a "unitrust conversion" statute, allowing the trustee to modify the trust to change the distribution standard in an existing trust from an all income measure to a unitrust distribution. The argument for this approach was that many trusts allowed only income distributions and did not provide for invasion of principal, and that prevented the trustee from investing for overall return. These statutes vary widely from state to state, and many contain complex notice provisions. The Section felt that (i) there were few trusts drafted in Texas that did not permit principal invasion; (ii) that in many (if not most) of those trusts, the power to adjust could be used to allow principal distributions where necessary; (iii) that the complexity added did not warrant a conversion statute; and (iv) in extreme cases, there was probably a judicial remedy.

1. Texas Permits Unitrusts But Not Conversion. The final regulations under I.R.C. §643 (and related sections) adopt state law as a determinant of what constitutes "income" for trust accounting purposes and for income, gift, estate tax, and generation skipping transfer tax purposes. Thus, if a draftsman in Texas wanted to use a unitrust, the draftsman would be unable to do so and achieve desired tax results unless state law specifically defined "income" as a unitrust amount.[19] Texas Trust Code §116.007 now supplies that definition of income.

2. "Ordering" Provision. Unless the terms of the trust direct otherwise, the statute dictates what kind of income makes up the unitrust distribution for federal income tax purposes.[20]

VI. **TEXANIZATION OF UPAIA.** The drafters of the Uniform Principal and Income Act had a definite bias toward the remainder beneficiary, feeling that the preservation of principal ultimately benefitted both the current beneficiary and the remainder beneficiary. While this may be true, The Section felt that it might create great injustice and instability in existing trusts and new trusts that did not override certain income and principal allocations.

A. MINERAL INTERESTS. The Uniform Act treats 10% of the receipts from minerals as income and 90% of the receipts as principal.[21] For income beneficiaries who had been used to receiving 72-1/2% of the revenues from extracted minerals, this change in approach would represent a dramatic shock.

1. Royalties, *etc*. The Texas version of UPAIA requires the trustee to allocate receipts from royalties, shut-in-well payments, take-or-pay payments, bonuses or delay rentals "equitably."[22]

2. Working Interests. Likewise, the Texas version of the Act requires the trustee to allocate receipts from working interests or other interests not otherwise provided for "equitably."

3. Safe Harbors. Since the Act applies to existing trusts, the trustee is required to allocate according to this Act, but for interests existing on January 1, 2004, the trustee may additionally continue to use "any lawful manner used by the trustee before January 1, 2004."[23] Further, a receipt allocated to principal is assumed to be equitable if it is equal in amount to the depletion allowance under the Internal Revenue Code.[24]

4. Allocation of Expenses. Texas Trust Code §116.201(1) instructs the trustee to allocate the trustee's regular compensation 50% to income. In a trust primarily consisting of oil and gas properties, this may place an unfair burden on the principal account that receives substantially less than 50% of the receipts. Prior Texas law allocated these receipts equitably. Likewise, prior Texas law allocated 100% of accounting expenses and judicial proceedings to

income, while the Uniform Act, as adopted in Texas, allocates those expenses equally between the principal and income accounts.

B. PAYMENTS FROM RETIREMENT PLANS. Prior Texas law treated 5% of the "inventory value" of the plan account as income.[25] The Uniform Act provides that 90% of each distribution from IRAs or retirement plans should be allocated 90% to principal and 10% to income. This would come as a rude awakening to those beneficiaries who had been receiving 100% of those distributions. Because of that, Texas adopted its own version dealing with payments from retirement plans.[26]

1. Dividends, Interest and Equivalent Payments. If any part of a payment is characterized by the payor as interest, dividends, or an equivalent payment, then that portion is treated as income and the balance of the payment is treated as principal. Under current accounting practices of fund sponsors and IRA custodians, this characterization almost never happens.[27]

2. Payments Required to be Made. Although the term, "payments required to be made" is not defined, it most likely means required minimum distributions or substantially equal payments made to avoid the 10% early withdrawal penalty under IRC §72(t). If none of the payment is characterized as interest, dividends, or an equivalent payment, 4% of the value of the account (a "deferred payment right") is allocated to income and the balance is allocated to principal.[28]

3. Other Payments. Payments other than those defined in subsections (b) and (c) are to be allocated to principal.[29] However, if such payments must be allocated to income to protect the estate tax marital deduction, then it is required to be so allocated.[30]

VII. **AUTHORITY TO DELEGATE.** Under common law, the trustee had no ability to delegate any of his fiduciary responsibilities. In the modern world of very complex financial structures and investment markets, the ability to delegate some or all investment functions may be a necessity. Additionally, the ability to delegate some management functions, such as mineral properties or timber management, may be very valuable.

A. PRIOR TEXAS LAW. While the common law did not permit delegation, prior Texas law (now repealed Texas Trust Code §113.060) did permit delegation of the investment function, but caused the trustee to remain liable unless the trustee met certain strict standards for selection and monitoring of the investment agent, and the investment agent agreed to follow the prudent man standard of the Trust Code and be liable if it failed to do so.

B. DELEGATION UNDER PRESENT LAW. The Uniform Prudent Investor Act allows the delegation of both investment and management functions, and relieves the trustee of liability for the acts and omissions of the agent under certain circumstances.

1. The Uniform Act. Portions of the UPIA were adopted in Texas Trust Code §117.011. The trustee must exercise prudence in selecting and monitoring the agent, and the agent must exercise "reasonable care to comply with the terms of the delegation." Likewise, the agent, by accepting the delegation, submits to the jurisdiction of the courts of Texas.

2. Texanization. Texas adopted additional protections for the trust before relieving the trustee of liability for acts or omissions of the agent. The trustee is not relieved of liability if, under Texas Trust Code §117.011(c):

a. the agent is an affiliate of the trustee;

b. the trustee or a beneficiary is required to arbitrate disputes with the agent under the terms of the delegation; or

c. the statute of limitations is shortened under the terms of the delegation.

3. Reasons for Texanization. The Section felt that the trustee should not be relieved of liability for delegation if the trustee and/or the beneficiary was forced to arbitrate and thus denied access to the courts under what was essentially a contract of adhesion if a major brokerage firm were chosen as the agent. Because of federal rules and law, it was uncertain that a provision of Texas law would override, and thus this approach was chosen. The reasoning behind the statute of limitations restriction is obvious.

C. DUTY TO DELEGATE? With the power to delegate, is there now a duty to delegate? Can an unsophisticated individual trustee continue to manage a substantial trust without seeking help in the investment function? And would not that trustee be better off delegating and relieving itself of responsibility, rather than just using an agent for advice? In the case of a corporate trustee, there may be market segments in which that trustee has no in-house expertise (*e.g.*, hedge funds, other derivatives), and in which it would be appropriate for a portion of the trust to be invested. Does the trustee have to seek out an agent to whom to delegate that function, especially in light of the higher standard of liability for a professional trustee?

VIII. **CONCLUSION.** The foregoing discussion of the theory behind the adoption of the Uniform Acts and select provisions of the Uniform Acts, is but a glimpse into the issues that are presently perceived and other issues which may exist in the future. Even in those states that have had the Uniform Acts since shortly after their promulgation, they have not been around long enough to allow the mature reflection necessary to fully appreciate their complexity and nuances. Only time can provide that.

ENDNOTES

1 Alvin J. Golden, Ikard & Golden, P.C., 400 W. 15th Street, Suite 975, Austin, Texas 78701.

2 For a discussion of Modern Portfolio Theory, see Golden, "Total Return Unitrusts; Is this a Solution in Search of a Problem," 28 ACTEC Journal 121 (Fall 2002).

3 Texas Trust Code §117.004(b). Texas law apparently already had the "total portfolio test" in determining prudence. Texas Trust Code §113.056(a) contained the following provision prior to its repeal: "In determining whether a trustee has exercised prudence with respect to an investment decision, such determination shall be made taking into consideration the investments of all the assets of the trust...over which the trustee had management and control, rather than a consideration as to the prudence of the single investment of the trust...."

4 Texas Trust Code §117.004(b).

5 Texas Trust Code §117.004(e).

6 Texas Trust Code §117.005.

7 Texas Trust Code § 117.011.

8 Texas Probate Code Ann. §378B, which governed allocations between income and principal was not repealed *in toto*, but defers to Texas Trust Code Chapter 116.

9 Texas Trust Code §116.005.

10 Texas Trust Code §117.004(a) (emphasis added).

11 These are strikingly similar to those contained in Texas Trust Code §116.005, dealing with the power to adjust.

12 Texas Trust Code §117.010 (emphasis added).

13 Texas Trust Code §117.004(f).

14 Prior to its partial repeal, Texas Trust Code §113.056(a) required a trustee to "exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income from *as well as the probable increase in value and* the safety of their capital." (The italicized portion was not part of the common law prudent man standard.)

15 Texas Trust Code § 116.006(a).

16 Texas Trust Code § 116.006(b).

17 Texas Trust Code § 116.006(c).

18 Many unitrusts also contain a power in the trustee to invade the trust beyond the unitrust amount if the unitrust amount is insufficient for the health, support or maintenance of the current beneficiary. This kind of provision, in effect, converts the unitrust to a support trust with a minimum required distribution. A discussion of the economics and an analysis of the effect of choosing a unitrust is well beyond the scope of this paper. *See*, Golden, *supra* at n.1.

19 The final regulations provide a safe harbor for unitrusts ranging from 3%-5%, and the Texas statute adopts that range. Parenthetically, although the 3% floor may be justified in assuring that the income beneficiary receives some sort of minimum return to qualify as income, there is no rational basis for a ceiling. Charitable remainder trusts, for example, have a 5% minimum, but no ceiling on distributions to the beneficiary. There is some concern that the 3% minimum for a unitrust will be interpreted to be a measure of the minimum amount of income which should be earned or distributed by a trustee. This would imply that a trustee could be liable for earning less or that creditors could reach accumulations in the trust if distributions were less than 3%. While both of these propositions are essentially unsound, NCCUSL is concerned enough that it is working on an amendment to the UPAIA to clarify this.

20 Texas Trust Code § 116.007(d).

21 One of the Commissioners argued that 100% of receipts should be allocated to principal since it really was a use of principal.

22 Texas Trust Code § 116.174(a)(3).

23 Texas Trust Code § 116.174(d).

24 Texas Trust Code § 116.174(e).

25 The Texas Bar Comment stated that this approach was "fairer" than the Uniform Act approach, but that it was "confusing, difficult to apply, and did not adequately take into account changes in the value of the underlying asset."

26 Texas Trust Code § 116.172.

27 Texas Trust Code §116.172(b).

28 Texas Trust Code §116.172(c).

29 Texas Trust Code §116.172(g).

30 Texas Trust Code §116.172(h).

COMPETENT AUTHORITY ASSISTANCE

Mark R. Martin[1]

I. Introduction

The competent authority process is a treaty-based tax dispute resolution procedure that allows taxpayers to resolve tax controversies arising from cross border business and financial arrangements. The United States' tax treaties, as well as most other tax treaties, contain mutual agreement procedures, which allow taxpayers to request competent authority assistance when tax disputes arise from cross border arrangements. This article focuses on the United States competent authority process. However, many of the comments on the United States competent authority process contained herein apply equally to the competent authority process for other countries.

A. Background

U.S. tax treaties generally permit taxpayers to request competent authority assistance when the actions of the United States, a treaty country, or both, result or will result in taxation that is contrary to the provisions of a treaty.

1. Potential Double Tax Cases

The United States' tax treaties generally permit taxpayers to request competent authority assistance in order to relieve economic double taxation arising from an allocation under section 482 of the Internal Revenue Code (the "Code") or an equivalent provision under the laws of a treaty country.[2]

Illustration #1

A Canadian company ("CanCo") claims a deduction for management fees paid to its U.S. parent company ("USCo"). The Canadian Revenue Agency determines that these deductions are not allowable. Since USCo included the management fees in income, the disallowance of CanCo's deduction for such fees creates the potential for double tax.

When examining the risks and functions of CanCo, it is apparent that CanCo is a routine distributor. However, CanCo's average operating margin for its most recent three years is 25%. USCo manufacturers the products distributed by CanCo, and USCo owns all intangible property related to the manufacturing process and the product distributed by CanCo. USCo's operating margin for its most recent three years is 9%. When the channel of profit between CanCo and USCo is evaluated, the disallowance of CanCo's management fee deduction would cause USCo to recognize a loss for the years at issue.

Illustration #1 is an example of potential double taxation and demonstrates when competent authority assistance may be required. Under these facts, it appears the Internal Revenue Service (the "IRS") would support USCo's position that the deduction in Canada should be allowed, as the margins earned by the CanCo already appear to be too high for a routine distributor. Moreover, in this fact pattern, it appears appropriate to make further adjustments to the pricing arrangements between USCo and CanCo in order to put CanCo's operating margin in line with operating margins normally earned by routine distributors.

2. Permanent Establishment Cases

Competent authority assistance may also be available with respect to issues specifically dealt with in other provisions of a treaty. For example, many tax treaties contain provisions permitting competent authorities to resolve issues of fiscal residence.[3]

Illustration #2

Australian company ("AusCo") is a distributor for USCo in Australia. AusCo and USCo have entered into a commissionaire agreement, where AusCo receives a commission of 5% of Australian sales. The Australian tax authority takes the position that USCo has a permanent establishment ("PE") in Australia and that a portion of USCo's profits should be attributed to such PE.

Illustration #2 involves a question of both fiscal residence and potential double taxation and demonstrates when competent authority assistance may be required. In recent years, many countries have aggressively asserted PE theories in order to expand local revenues or, stated alternatively, combat perceived tax base erosion.

B. Authority

The IRS Director (International) acts as the U.S. competent authority in administering the mutual agreement provisions of tax treaties and in interpreting and applying such treaties. This authority is exercised through the Tax Treaty Division of the IRS. In interpreting and applying tax treaties, the Director (International) acts only with the concurrence of the Associate Chief Counsel (International).[4]

C. Standard Applied in Transfer Pricing Competent Authority Cases

With respect to requests for competent authority assistance involving transfer pricing issues between a U.S. taxpayer and a related person, the U.S. competent authority and its counterparty in the other treaty country will be bound by the arm's length standard provided by the applicable provisions of the relevant treaty. In such cases, the U.S. competent authority will be guided by the arm's length standard consistent with the regulations under section 482 of the Code and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.[5]

In this regard, it is interesting to note that, in the case of a U.S. initiated transfer pricing adjustment under Section 482 of the Code, the U.S. will need to convince the treaty partner that a U.S. adjustment (and, therefore, a foreign adjustment) is necessary. Thus, in this context, the U.S. is in the unusual position of having, in essence, the burden of proof.

D. U.S. Policy in Competent Authority Cases

With respect to U.S. initiated transfer pricing adjustments under section 482 of the Code, the primary goal of the U.S. competent authority is to obtain a correlative adjustment from the treaty country. That is, the U.S. competent authority will defend the IRS' proposed adjustment, but it will try to obtain a foreign adjustment to eliminate double taxation. Therefore, a taxpayer's request for unilateral withdrawal or reduction of U.S. initiated adjustments generally will not be considered.[6] This is true even if the period of limitations has expired in the foreign country and the foreign competent authority has declined to grant any relief.[7]

If the period provided by the foreign statute of limitations has expired, the U.S. competent authority may take into account other relevant facts to determine whether withdrawal or reduction of its position is appropriate and may, in extraordinary circumstances and as a matter of discretion, provide such relief with respect to the adjustment to avoid exposing the taxpayer to actual or economic double taxation. However, no such relief will be granted where there is fraud or negligence with respect to the relevant transactions. Also, in keeping with the U.S. Government's view that tax treaties should be applied in a balanced and reciprocal manner, the United States normally will not withdraw or reduce an adjustment where the treaty country does not grant similar relief in equivalent cases.[8]

II. Initiating the Competent Authority Process

The U.S. competent authority process begins when the taxpayer files a request for competent authority assistance (discussed below). The taxpayer may request a pre-filing conference with the U.S. competent authority to discuss the mutual agreement process with respect to matters covered under a treaty, including discussion of the proper time for filing, the practical aspects of obtaining relief and actions necessary to facilitate the proceedings.[9] Such pre-filing conferences are normally very helpful, particularly when a thorough pre-filing submission is provided to the competent authority analyst prior to the pre-filing conference.

If a taxpayer's request for competent authority assistance is accepted, the U.S. competent authority will prepare a position paper and consult with the foreign competent authority and attempt to reach a mutual agreement that is acceptable to all parties.[10]

III. Conditions for Obtaining Competent Authority Assistance

A. Eligible Transactions

U.S. Competent Authority can only resolve cases arising under U.S. tax treaties.[11] Thus, if a U.S. taxpayer has a potential double tax situation arising from a transaction with a related party in a non-treaty jurisdiction, U.S. competent authority assistance will not be available. In such a circumstance, the taxpayer should consider negotiating a unilateral Advance Pricing Agreement ("APA") with the United States.[12]

B. Eligible Taxpayers

Unless a treaty indicates otherwise, the U.S. competent authority will only consider requests for assistance from U.S. persons, as defined in section 7701(a)(30) of the Code.[13] As such, non-U.S. persons generally must present their initial request for assistance to the relevant foreign competent authority.

C. Closed Cases

The U.S. competent authority may, but is not required to, accept a taxpayer's request for competent authority assistance that will require the reopening of a case closed after examination.[14] With respect to an IRS request to open a case closed after examination, the U.S. competent authority will not reopen such a case in order to make an adjustment unfavorable to the taxpayer unless the exceptional circumstances described in Rev. Proc. 2005-32,[15] are present (*e.g.*, fraud, malfeasance, collusion, concealment, or misrepresentation of material fact).[16]

D. Foreign Initiated Competent Authority Request

When a foreign competent authority refers a request from a foreign taxpayer to the U.S. competent authority for consultation under the mutual agreement procedure of a treaty, the U.S. competent authority generally will require the U.S. related taxpayer to file a request for competent authority assistance under Rev. Proc. 2002-52.[17]

IV. Procedures for Requesting Competent Authority Assistance

Requests by U.S. taxpayers for U.S. competent authority assistance must be submitted in accordance with Rev. Proc. 2002-52 and the provisions of the pertinent treaty.[18]

A. Time for Filing

In a case involving a U.S. initiated adjustment of tax or income resulting from an IRS examination, a request for competent authority assistance may be submitted as soon as practicable after the amount of the proposed adjustment is communicated in writing to the taxpayer (*e.g.*, after the taxpayer receives a notice of proposed adjustment).[19] In a case involving a foreign examination, a request may be submitted as soon as the taxpayer believes such filing is warranted based on the actions of the country proposing the adjustment (*e.g.*, potential double taxation arising from a transfer pricing determination).[20] In cases not involving an examination, a request for competent authority assistance can be made when the taxpayer believes that an action or potential action warrants the assistance of the U.S. competent authority (*e.g.*, a ruling by a foreign tax authority concerning a taxation matter or the withholding of tax by a withholding agent).

B. Form of Request

A request for competent authority assistance must be in writing, dated, and addressed to the Tax Treaty Division Director (International).[21] It must be signed by a person having the authority to sign the taxpayer's federal tax returns.[22] In addition, the request must contain the following information:[23]

(1) a reference to the specific treaty and the provisions therein pursuant to which the request is made;

(2) the names, addresses, U.S. taxpayer identification number and foreign taxpayer identification number (if any) of the taxpayer and, if applicable, all related persons involved in the matter;

(3) if applicable, a description of the control and business relationships between the taxpayer and any relevant related person for the years in issue, including any changes in such relationship to the date of filing the request;

(4) a brief description of the issues for which competent authority assistance is requested, including a brief description of the relevant transactions, activities or other circumstances involved in the issues raised and the basis for the adjustment, if any;

(5) the years and amounts involved with respect to the issues in both U.S. dollars and foreign currency;

(6) the IRS office that has made or is proposing to make the adjustment or has examination jurisdiction over the taxpayer;

(7) an explanation of the nature of the relief sought or the action requested in the United States or in the treaty country with respect to the issues raised, including a statement as to whether the taxpayer wishes to avail itself of the relief provided under Rev. Proc. 99-32, 1999-2 C.B. 296;

(8) a statement whether the period of limitations for the years for which relief is sought has expired in the United States or in the treaty country;

(9) a statement of relevant domestic and foreign judicial or administrative proceedings that involve the taxpayer and related persons;

(10) to the extent known by the taxpayer, a statement of relevant foreign judicial or public administrative proceedings that do not involve the taxpayer or related persons, but involve the same issue for which competent authority assistance is requested;

(11) a statement whether the request for competent authority assistance involves issues that are currently, or were previously, considered part of an Advance Pricing Agreement proceeding or other proceeding relevant to the issue under consideration in the United States or part of a similar proceeding in the foreign country;

(12) if applicable, powers of attorney with respect to the taxpayer;

(13) a statement whether the taxpayer is requesting the Simultaneous Appeals procedure;

(14 on a separate document, a statement that the taxpayer consents to the disclosure to the competent authority of the treaty country (with the name of the treaty country specifically stated) and that competent authority's staff, of any or all of the items of information set forth or enclosed in the request for U.S. competent authority assistance within the limits contained in the tax treaty under which the taxpayer is seeking relief. The taxpayer may request, as part of this statement, that its trade secrets not be disclosed to a foreign competent authority. This statement must be dated and signed by a person having authority to sign the taxpayer's federal tax returns and is required to facilitate the administrative handling of the request by the U.S. competent authority for purposes of the record-keeping requirements of section 6103(p) of the Code. Failure to provide such a statement will not prevent the U.S. competent authority from disclosing information under the terms of a treaty;

(15) a penalties of perjury statement in the following form:

> Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of the request for competent authority assistance are true, correct and complete.[24]

If the request for competent authority assistance is made in connection with a pending APA or Pre-Filing Agreement matter, the request must also include the information required under Rev. Proc. 2006-9 and Rev. Proc. 2005-12, respectively.[25] Moreover, the request must include any other information or documentation deemed necessary by the U.S. or foreign competent authority for purposes of reaching an agreement (*e.g.*, translations of any documentation required in connection with the competent authority request).[26] Finally, the taxpayer must keep the U.S. competent authority updated on any material developments in connection with the request for competent authority assistance, including providing any updated documents.[27]

A sample form of a request for U.S. competent authority assistance is attached hereto as ***Exhibit A***.

C. Conferences

The U.S. competent authority will generally consult with the taxpayer regarding the status and progress of the mutual agreement proceedings. Also, as noted above, the taxpayer may request a pre-filing conference with the U.S. competent authority to discuss the mutual agreement process with respect to matters covered under a treaty, including discussion of the proper time for filing, the practical aspects of obtaining relief and actions necessary to facilitate the proceedings. Moreover, after a matter is resolved by the competent authorities, a taxpayer may also request a conference with the U.S. competent authority to discuss the resolution.[28]

D. Persuasive Information

In transfer pricing/double tax cases, taxpayers may be indifferent as to where the income is reported, as the tax rate in the respective jurisdictions may be similar. In such cases, the taxpayer is simply a stakeholder, as it simply wants to avoid double taxation. Also, in such cases, taxpayers typically would like to have their initial arrangements respected.

In many transfer pricing/double tax cases, taxpayers are not indifferent as to where the income is reported, as one jurisdiction may have a higher rate than the other jurisdiction or the taxpayer may have a loss it can utilize in one jurisdiction. In these circumstances, the taxpayer will want to provide the tax authorities information that supports their initial arrangements.

Like any transfer pricing case, the taxpayer must support its position with evidence and analysis that indicates that the arrangements in question are arm's length. Obviously, some of the more routine information that should be provided would include contracts, risk/function charts, economic data and a technical memorandum. In addition, we have found that the following information can be very helpful: (i) results in other jurisdictions; (ii) profit channel analysis; and (iii) a confirmatory residual profit split analysis.

Illustration #3

USCo provides distribution services for a Chinese manufacturer ("Manufacturer"). USCo earns an operating margin of 1.0%, which translates to a cost plus 10% return to USCo. The IRS asserts that USCo should earn an operating margin of 3.8%, as the IRS believes that USCo has developed significant marketing intangibles in the United States.

As background for competent authority discussions between the United States and China, the taxpayer could provide, for example, the negotiated results in other jurisdictions where the same, or similar, fact pattern was involved (*e.g.*, competent authority resolutions or final APAs). In addition, the taxpayer could provide a profit channel analysis that demonstrates that, if the United States' position was sustained, the other parties in the channel of commerce, including the Manufacturer, would not earn an adequate return for their risks and functions or, perhaps, would lose money. Finally, a residual profit split analysis is often helpful.[29] In Illustration #3, a profit split analysis may demonstrate that, after an allocation for routine distribution by USCo and contract manufacturing by Manufacturer, there is no residual profit to split. Thus, assuming the margins of the Manufacturer were reasonable, this would demonstrate that an additional allocation to the U.S. distribution function is inappropriate.

V. Coordination with Other Administrative or Judicial Proceedings

A. Suspension of Administrative Action

When a request for competent authority assistance is accepted with respect to a U.S. initiated adjustment, the IRS will generally postpone further administrative action with respect to the issues under competent authority consideration. However, the normal administrative procedures continue to apply to all other issues not under U.S. competent authority consideration.[30]

B. Coordination with Appeals

Taxpayers that disagree with a proposed U.S. examination adjustment either may pursue their right of administrative review with IRS Appeals before requesting competent authority assistance or may request competent authority assistance immediately. If a taxpayer decides to make a competent authority request, it may choose to make a request pursuant to the Simultaneous Appeals procedures discussed below.[31]

C. Coordination with Litigation

Without the consent of IRS Associate Chief Counsel (International), the U.S. competent authority will not accept (or continue to consider) a taxpayer's request for competent authority assistance if the request involves a taxable period pending in a U.S. court. If the case is pending in the United States Tax Court, the taxpayer may, in appropriate cases, be asked to join the IRS in a motion to sever issues or delay trial pending completion of the competent authority proceedings. If the case is pending in any other court, the IRS Associate Chief Counsel (International) will consult with the Department of Justice about appropriate action, and the taxpayer may, in appropriate cases, be asked to join the U.S. Government in a motion to sever issues or delay trial pending completion of the competent authority proceedings. Of course, the final decision on severing issues or delaying trial rests with the court. The filing of a competent authority request does not, however, relieve the taxpayer from taking any action that may be necessary or required with respect to litigation.[32]

VI. Simultaneous Appeals Procedure

A taxpayer filing a request for competent authority assistance may also, at the same time or at a later date, request IRS Appeals' consideration of the competent authority issue under the procedures and conditions provided in Rev. Proc. 2002-52. The benefit of getting the U.S. competent authority involved in the IRS Appeals process is that the U.S. competent authority typically has a broader perspective of the results that would likely be achieved in a competent authority negotiation.

A. Time for Requesting the Simultaneous Appeals Procedure

The Simultaneous Appeals procedure may be invoked at any of the following times:[33]

(1) When the taxpayer applies for competent authority assistance with respect to an issue for which the examining IRS office has proposed an adjustment and before the protest is filed;[34]

(2) When the taxpayer files a protest with Appeals and decides to sever the competent authority issue and seek competent authority assistance while other issues are referred to Appeals; and

(3) When the case is in Appeals and the taxpayer later decides to request competent authority assistance with respect to the competent authority issue. The taxpayer may sever the competent authority issue for referral to the U.S. competent authority and invoke the Simultaneous Appeals procedure at any time when the case is in Appeals but before settlement of the issue. Taxpayers, however, are encouraged to invoke the Simultaneous Appeals procedure as soon as possible, preferably as soon as practicable after the first Appeals conference.

B. Request for Simultaneous Appeals Procedure

The taxpayer's request for the Simultaneous IRS Appeals procedure should be addressed to the U.S. competent authority either as part of the initial competent authority assistance request or, if made later, as a separate letter to the U.S. competent authority. The request should state whether the issue was previously protested to IRS Appeals for the periods in competent authority or for prior periods (in which case a copy of the relevant portions of the protest and an explanation of the outcome, if any, should be provided). The U.S. competent authority has jurisdiction of the issue when the Simultaneous Appeals procedure is invoked.[35]

C. Role of Appeals in the Simultaneous Appeals Procedure

The IRS Appeals representative assigned to the case will consult with the taxpayer and the U.S. competent authority for the purpose of reaching a resolution of the unagreed issue under competent authority jurisdiction before the issue is presented to the foreign competent authority. For this purpose, IRS Appeals procedures generally apply. The IRS Appeals representative will consult with the U.S. competent authority during this process to ensure appropriate coordination of the Appeals process with the competent authority procedure, so that the terms of a tentative resolution and the principles and facts upon which it is based are compatible with the position that the U.S. competent authority intends to present to the foreign competent authority with respect to the issue. Any resolution reached with the IRS under this procedure is subject to the competent authority process and, therefore, is tentative and not binding on the IRS or the taxpayer. The IRS will not request the taxpayer to conclude the Appeals process with a written agreement. The conclusions of the tentative resolution, however, generally will be reflected in the U.S. position paper used for negotiating a mutual agreement with the foreign competent authority. However, these procedures do not give taxpayers the right to receive reconsideration of the issue by IRS Appeals where the taxpayer applied for competent authority assistance after having received substantial IRS Appeals consideration. Rather, the IRS may rely upon, but necessarily will not be bound by, such previous consideration by IRS Appeals when considering the case under the Simultaneous Appeals procedure.[36]

The U.S. competent authority is responsible for developing a U.S. position paper with respect to the issue and for conducting the mutual agreement procedure. Generally, requesting IRS Appeals' consideration of an issue under competent authority jurisdiction will not affect the manner in which taxpayers normally are involved in the competent authority process.[37]

D. Denial or Termination of Simultaneous Appeals Procedure

The taxpayer may, at any time, withdraw its request for the Simultaneous Appeals procedure. Similarly, the U.S. competent authority, the Chief of IRS Appeals or the appropriate IRS Area Director may decide to deny or terminate the Simultaneous Appeals procedure if the procedure is determined to be prejudicial to the mutual agreement procedure or to the administrative appeals process.[38]

E. Returning to Appeals

If the competent authorities fail to agree or, if the taxpayer does not accept the mutual agreement reached by the competent authorities, the taxpayer will be permitted to refer the issue to Appeals for further consideration.[39]

VII. Accelerated Competent Authority Procedure ("Roll Forward")

A taxpayer requesting competent authority assistance with respect to an issue raised by the IRS also may request that the competent authorities attempt to resolve the issue for subsequent taxable periods ending prior to the date of the request for assistance if the same issue continues in those periods. In such circumstances, the U.S. competent authority will consider the request and will contact the appropriate IRS field office to consult on whether the issue should be resolved for subsequent taxable periods. If the IRS field office consents to this procedure, the U.S. competent authority will address with the foreign competent authority the request for such subsequent taxable periods.[40]

VIII. Effect of Agreements or Judicial Determinations on Competent Authority

If a taxpayer either executes a closing agreement with the IRS (whether or not contingent upon competent authority relief) with respect to a potential competent authority issue or reaches a settlement on the issue with IRS Appeals or with IRS Chief Counsel pursuant to a closing agreement or other written agreement, the U.S. competent authority will endeavor only to obtain a correlative adjustment from the treaty country and will not undertake any actions that would otherwise change such agreements. However, the U.S. competent authority will, in appropriate cases, consider actions necessary for the purpose of providing treatment similar to that provided in Rev. Proc. 99-32 (*e.g.*, cash repatriation without negative tax consequences).[41]

Similarly, once a taxpayer's tax liability for the taxable periods in issue has been determined by a U.S. court (including settlement of the proceedings before or during trial), the U.S. competent authority will only endeavor to obtain correlative relief from the treaty country and will not undertake any action that would otherwise reduce the taxpayer's federal tax liability for the taxable periods in issue as determined by a U.S. court.[42]

Foreign jurisdictions typically have similar rules regarding administrative or judicial determinations. Thus, in both the United States and in foreign countries, it is critical to request competent authority assistance, or to thoroughly consider making such a request, prior to the time litigation is commenced.

IX. Protective Measures

The United States will seek to secure an agreement with its treaty partner that any competent authority agreement reached with the treaty partner will be implemented notwithstanding any time limits or other procedural limitations in the domestic law of either country. However, not all countries will operate in this manner. Moreover, mutual agreement treaty provisions may not give tax authorities the discretion to waive statutes of limitation in the event that a request for competent authority assistance is declined or the competent authorities are unable to reach an agreement.[43]

As a result of the foregoing, the taxpayer or a related person must take protective measures with the U.S. and foreign tax authorities so that the implementation of any agreement reached by the competent authorities or alternative remedies outside of the competent authority process are not barred by administrative, legal or procedural barriers. It is important to remember that such barriers may arise after a competent authority request is filed.

The protective measures that should be considered include, but are not limited to: (a) filing protective claims for refund or credit; (b) staying the expiration of any period of limitations on the making of a refund or other tax adjustment; (c) avoiding the lapse or termination of the taxpayer's right to appeal any tax determination; (d) complying with all applicable procedures for invoking competent authority consideration, including applicable treaty provisions dealing with time limits within which to invoke such remedy; and (e) contesting an adjustment or seeking an appropriate correlative adjustment with respect to the U.S. or treaty country tax.

Taxpayers must be vigilant to take protective measures in a timely manner (*e.g.*, in a manner that allows sufficient time for appropriate procedures to be completed and effective before barriers arise). This requires planning before a request for competent authority assistance is submitted and vigilance with respect to protective measures during the course of the competent authority proceeding. Taxpayers may consult with the U.S. competent authority to determine the need for, and timing of, such protective measures in their particular case.[44]

X. Application of Rev. Proc. 99-32

Although a complete discussion of Rev. Proc. 99-32[45] is beyond the scope of this article, it is important to note that Rev. Proc. 99-32 generally provides a means to conform a taxpayer's accounts and allow repatriation of certain amounts following an allocation of income between related U.S. and foreign corporations under section 482 of the Code without the federal income tax consequences of the adjustments that would otherwise have been necessary to conform the taxpayer's accounts in light of such an allocation of income. In situations where a Code section 482 allocation is the subject of a request for competent authority assistance, any Rev. Proc. 99-32 treatment relating to such allocation must be disposed of by the competent authority. As such, if a taxpayer intends to seek Rev. Proc. 99-32 treatment in connection with competent authority assistance relating to a Code section 482 allocation, the taxpayer must request Rev. Proc. 99-32 treatment in conjunction with its request for competent authority assistance. If a taxpayer has already requested Rev. Proc. 99-32 treatment at the time it submits a request for competent authority assistance, consideration of Rev. Proc. 99-32 treatment must be transferred to competent authority and a copy of the pending Rev. Proc. 99-32 request forwarded along with the request for competent authority assistance.[46]

XI. Determination of Creditable Foreign Taxes

For purposes of determining foreign tax credits under sections 901 and 902 of the Code, any amounts paid to foreign tax authorities that would not have been due if the treaty country had made a correlative adjustment may not constitute a creditable foreign tax.[47] In such situations, a failure to request competent authority assistance or diligently pursue such assistance if requested may constitute failure to exhaust all effective and practical remedies for purposes of sections 901 and 902 of the Code, making any taxes paid to a foreign country voluntary and, therefore, not creditable foreign taxes.[48]

XII. Denial of Competent Authority Assistance

The U.S. competent authority generally will not accept a request for competent authority assistance or will cease providing assistance to the taxpayer if:[49]

(a) the taxpayer is not entitled to the treaty benefit or safeguard in question or to the assistance requested;

(b) the taxpayer is willing only to accept a competent authority agreement under conditions that are unreasonable or prejudicial to the interests of the U.S. government;

(c) the taxpayer rejected the competent authority resolution of the same or similar issue in a prior case;

(d) the taxpayer does not agree that competent authority negotiations are a government-to-government activity that does not include the taxpayer's participation in the negotiation proceedings;

(e) the taxpayer does not furnish upon request sufficient information to determine whether the treaty applies to the taxpayer's facts and circumstances;

(f) the taxpayer was found to have acquiesced in a foreign initiated adjustment that involved significant legal or factual issues that otherwise would be properly handled through the competent authority process and then unilaterally made a corresponding correlative adjustment or claimed an increased foreign tax credit, without initially seeking U.S. competent authority assistance;

(g) the taxpayer: (i) fails to comply with Rev. Proc. 2002-52; (ii) fails to cooperate with the U.S. competent authority (including failing to provide sufficient facts and documentation to support its claim of double taxation or taxation contrary to the treaty); or (iii) failed to cooperate with the IRS during the examination of the periods in issue and such failure significantly impedes the ability of the U.S. competent authority to negotiate and conclude an agreement (*e.g.*, significant factual development is required that cannot effectively be completed outside the examination process);

(h) the transaction giving rise to the request for competent authority assistance: (i) includes an issue pending in a U.S. Court, or designated for litigation, unless competent authority consideration is concurred in by the U.S. competent authority and the Associate Chief Counsel (International); or (ii) involves fraudulent activity by the taxpayer; or

(i) the taxpayer refuses to execute a consent extending the period of limitations for assessment of tax for the taxable periods in issue.[50]

XIII. Finalizing a Competent Authority Case

A. Notification

The U.S. competent authority will notify a taxpayer requesting competent authority assistance of any agreement that the U.S. and the foreign competent authorities reach with respect to the request. If the taxpayer accepts the resolution reached by the competent authorities, the agreement shall provide that it is final and is not subject to further review (administrative or judicial). If the competent authorities fail to agree, or if the agreement reached is not acceptable to the taxpayer, the taxpayer may withdraw the request for competent authority assistance and may then pursue its rights otherwise available under the laws of the United States and the treaty country. When the competent authorities fail to reach an agreement, no further competent authority remedies generally are available, except with respect to treaties that provide for arbitration of the dispute.[51]

B. Closing Agreement.

When appropriate, the taxpayer will be asked to reflect the terms of the mutual agreement and of the competent authority assistance provided in a closing agreement.

XIV. Conclusion

When a U.S. taxpayer finds itself in a tax dispute involving a cross border business or financial arrangement between the United States and a tax treaty partner country, the competent authority process under the pertinent treaty and Rev. Proc. 2002-52 must be carefully considered. In such circumstances, the taxpayer should strongly consider requesting competent authority assistance as a means of eliminating potential double taxation. By invoking the competent authority process, the United States and the treaty partner will, under the mutual agreement procedure provision of the treaty, endeavor to reach a settlement that eliminates double taxation. In order to take advantage of this beneficial process, taxpayers must make sure the procedures outlined in Rev. Proc. 2002-52 are carefully followed.

Exhibit A

Sample Request for U.S. Competent Authority Assistance

Assistant Commissioner (International)
Attn: Tax Treaty Division
Internal Revenue Service
P.O. Box 23598
Washington, D.C. 20006-359

Re: Request for U.S. Competent Authority Assistance

Taxpayer: [NAME]

Identification Number [EIN NUMBER]

Dear U.S. Competent Authority:

This letter sets forth the request of the above-referenced taxpayer for Competent Authority assistance pursuant to Revenue Procedure 2002-52.

1. [REFERENCE THE SPECIFIC TREATY AND THE PROVISIONS THEREIN PURSUANT TO WHICH THE REQUEST IS MADE]

2. [LIST NAMES, ADDRESSES, U.S. TAXPAYER IDENTIFICATION NUMBER, AND FOREIGN TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF THE TAXPAYER AND, IF APPLICABLE, ALL RELATED PERSONS INVOLVED IN THE MATTER]

3. [DESCRIBE THE CONTROL AND BUSINESS RELATIONSHIPS BETWEEN THE TAXPAYER AND ANY RELEVANT RELATED PERSON FOR THE YEARS IN ISSUE, INCLUDING ANY CHANGES IN SUCH RELATIONSHIP TO THE DATE OF FILING THE REQUEST]

4. [GIVE A DESCRIPTION OF THE ISSUES FOR WHICH COMPETENT AUTHORITY ASSISTANCE IS REQUESTED, INCLUDING A BRIEF DESCRIPTION OF ANY RELEVANT TRANSACTIONS, ACTIVITIES, OR OTHER CIRCUMSTANCES INVOLVED IN THE ISSUES RAISED AND THE BASIS FOR THE ADJUSTMENT]

5. [STATE YEARS AND AMOUNTS INVOLVED WITH RESPECT TO THE ISSUES IN BOTH U.S. DOLLARS AND FOREIGN CURRENCY]

6. [NAME IRS DISTRICT OFFICE THAT HAS MADE OR IS PROPOSING TO MAKE THE ADJUSTMENT]

7. [EXPLAIN THE NATURE OF THE RELIEF SOUGHT OR THE ACTION REQUESTED IN THE UNITED STATES OR IN THE TREATY COUNTRY WITH RESPECT TO THE ISSUES RAISED, INCLUDING A STATEMENT AS TO WHETHER THE TAXPAYER WISHES TO AVAIL ITSELF OF THE RELIEF PROVIDED UNDER REV. PROC. 99-32]

8. [STATE WHETHER THE PERIOD OF LIMITATIONS FOR THE YEARS FOR WHICH RELIEF IS SOUGHT HAS EXPIRED IN THE UNITED STATES OR IN THE TREATY COUNTRY]

9. [STATE ANY DOMESTIC AND FOREIGN JUDICIAL OR ADMINISTRATIVE PROCEEDINGS INVOLVING THE TAXPAYER OR RELATED PERSON]

10. [STATE ANY RELEVANT FOREIGN JUDICIAL OR PUBLIC ADMINISTRATIVE PROCEEDINGS WHICH DO NOT INVOLVE THE TAXPAYER OR RELATED PERSONS, BUT INVOLVE THE SAME ISSUE FOR WHICH COMPETENT AUTHORITY ASSISTANCE IS REQUESTED]

11. [STATE WHETHER THE REQUEST FOR COMPETENT AUTHORITY ASSISTANCE INVOLVES ISSUES THAT ARE CURRENTLY, OR WERE PREVIOUSLY, CONSIDERED AS PART OF AN APA PROCEEDING IN THE UNITED STATES OR IN A SIMILAR PROCEEDING IN THE FOREIGN COUNTRY; INCLUDE ANY INFORMATION REQUIRED UNDER REV. PROC. 2006-9, WHICH IS THE REVENUE PROCEDURE FOR APA PROCEEDINGS]

12. [IDENTIFY POWERS OF ATTORNEY WITH RESPECT TO THE TAXPAYER]

13. [STATE WHETHER THE TAXPAYER IS REQUESTING THE SIMULTANEOUS APPEALS PROCEDURE]

14. [ATTACH A SEPARATE DOCUMENT, STATING THAT THE TAXPAYER CONSENTS TO THE DISCLOSURE TO THE COMPETENT AUTHORITY OF THE TREATY COUNTRY (WITH THE NAME OF THE TREATY COUNTRY SPECIFICALLY STATED) AND THE COMPETENT AUTHORITY'S STAFF OF ANY OR ALL OF THE ITEMS OF INFORMATION SET FORTH OR ENCLOSED IN THE REQUEST FOR U.S. COMPETENT AUTHORITY ASSISTANCE WITHIN THE LIMITS CONTAINED IN THE TAX TREATY UNDER WHICH THE TAXPAYER IS SEEKING RELIEF. THIS STATEMENT MUST BE DATED AND SIGNED BY A PERSON HAVING AUTHORITY TO SIGN THE TAXPAYER'S FEDERAL TAX RETURNS AND IS REQUIRED TO FACILITATE THE ADMINISTRATIVE HANDLING OF THE REQUEST BY THE U.S. COMPETENT AUTHORITY FOR PURPOSES OF THE RECORDKEEPING REQUIREMENTS OF SECTION 6103(p)]

15. [INCLUDE ANY OTHER INFORMATION OR DOCUMENTATION DEEMED NECESSARY BY THE U.S. OR FOREIGN COMPETENT AUTHORITY FOR PURPOSES OF REACHING AN AGREEMENT—FOR EXAMPLE, ENGLISH TRANSACTIONS OF ANY DOCUMENTATION REQUIRED IN CONNECTION WITH THE COMPETENT AUTHORITY REQUEST]

16. [PROVIDE UPDATES AS TO MATERIAL CHANGES IN THE INFORMATION OR DOCUMENTATION PREVIOUSLY SUBMITTED]

17. [FOR U.S. INITIATED ADJUSTMENTS, A COPY OF THE REQUEST MUST BE FILED WITH THE SERVICES OFFICE WHERE THE TAXPAYER'S CASE IS PENDING]

18. [FOR MATTERS PENDING IN A U.S. COURT OR DESIGNATED FOR LITIGATION, A COPY OF THE REQUEST MUST BE FILED WITH THE ASSOCIATE CHIEF COUNSEL (INTERNATIONAL) WITH A STATEMENT IDENTIFYING THE COURT WHERE THE SUIT IS PENDING AND DOCKET NUMBER]

19. [IF THE MATTER IS INCLUDED IN THE IRS PRE-FILING AGREEMENT PROGRAM, INCLUDE INFORMATION REQUIRED UNDER REV. PROC. 2005-12]

Respectfully submitted,

By:___________________________

Name:_________________________

Title:__________________________

ATTESTATION

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of the request for competent authority assistance are true, correct and complete.

ENDNOTES

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

2 *See* Art. 25 Technical Explanation of U.S. Model Income Tax Convention (Sept. 20, 1996).

3 *See Id.*.

4 Rev. Proc. 2002-52, 2002-2 C.B. 242, at ¶ 2.03.

5 *Id.*. at ¶ 3.03. "OECD" stands for Organization for Economic Cooperation and Development.

6 *Id.*. at ¶ 12.07.

7 *Id.*.

8 *Id.*.

9 *Id.*. at ¶ 4.09.

10 *Id.*. at ¶ 2.04.

11 *Id.*. at ¶ 3.02.

12 *See* Rev. Proc. 2006-9, 2006-2 I.R.B. 278.

13 *Id.*. at ¶ 3.04.

14 *Id.*. at ¶ 3.05.

15 2005-23 IRB 1206 (May 20, 2005).

16 Rev. Proc. 2002-52 at ¶ 3.05.

17 *Id.*. at ¶ 3.06.

18 2002-2 C.B. 242 (July 12, 2002). The IRS recently announced that it plans to update Rev. Proc. 2002-52. Netram, "U.S., OECD Officials Consider Dispute Resolution Techniques," Tax Analyst Doc. No. 2005-1088 (Jan. 18, 2006) (quote from Robert Green, U.S. Competent Authority).

19 *Id.*. at ¶ 4.01.

20 *Id.*.

21 *Id.*. at ¶ 4.04.

22 *Id.*.

23 *Id.*. at ¶ 4.05.

24 The declaration must be signed by the person or persons on whose behalf the request is being made and not by the taxpayer's representative. The person signing for a corporate taxpayer must be an authorized officer of the taxpayer who has personal knowledge of the facts. The person signing for a trust, an estate or a partnership must be respectively, a trustee, an executor or a partner who has personal knowledge of the facts. *Id.*. at ¶ 4.05(o).

25 *Id.*. at ¶ 4.06.

26 *Id.*. at ¶ 4.07.

27 *Id.*. at ¶ 4.08.

28 *Id.*. at ¶ 4.09.

29 *See* Treas. Reg. § 1.482-6.

30 *Id.*. at ¶ 7.01.

31 *Id.*. at ¶ 7.02.

32 *Id.*. at ¶ 7.03.

33 *Id.*. at ¶ 8.02.

34 A taxpayer's request for the Simultaneous Appeals procedure generally will be denied if made after the date the U.S. position paper is communicated to the foreign competent authority, unless the U.S. competent authority determines that the procedure would facilitate an early resolution of the competent authority issue or otherwise is in the best interest of the IRS. *Id.*.

35 *Id.*. at ¶ 8.04.

36 *Id.*. at ¶ 8.05.

37 *Id.*.

38 *Id.*. at ¶ 8.06.

39 *Id.*. at ¶ 8.07.

40 *Id.*. at ¶ 7.06.

41 *Id.*. at ¶ 7.05.

42 *Id.*.

43 *Id.*. at ¶ 9.

44 *Id.*.

45 1999-2 C.B. 296.

46 *Id.*. at ¶ 10.

47 *See* Treas. Reg. § 1.901-2(e)(5)(i) and Rev. Rul. 92-75, 1992-2 C.B. 197.

48 Rev. Proc. 2002-52 at ¶ 11.

49 *Id.*. at ¶ 12.

50 *Id.*. at ¶ 12.03.

51 *Id.*. at ¶ 12.05.

RECENT DEVELOPMENTS APPLICABLE TO TAX-EXEMPT ORGANIZATIONS

Tyler Collier[1]
Dallas, Texas

The following is a summary of selected recent developments in the law applicable to tax-exempt organizations. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "Code").

I. Pension Protection Act of 2006. In August 2006, Congress enacted the Pension Protection Act of 2006 ("PPA"), which contains many of the exempt organization reform measures that have been considered and proposed by the Senate Finance Committee and other legislative committees over the last several years. Following are the provisions applicable to exempt organizations.

A. Increase in Penalty Taxes Imposed on Private Foundations (Sec. 1212 of PPA).

1. The Section 4941 initial self-dealing tax on disqualified persons is increased from 5% per year to 10% per year.

2. The Section 4941 initial tax on foundation managers is increased from 2.5% per year to 5% per year and the maximum initial tax on managers per violation is increased from $10,000 to $20,000. The maximum additional Section 4941 tax (*i.e.*, when there is not a timely correction) on managers per violation is also increased from $10,000 to $20,000.

3. The Section 4942 initial tax on a failure to distribute is increased from 15% to 30%.

4. The Section 4943 initial tax on excess business holdings is increased from 5% per year to 10% per year.

5. The Section 4944 initial tax on a private foundation for making a jeopardy investment is increased from 5% per year to 10% per year.

6. The Section 4944 initial tax on foundation managers for making a jeopardy investment is increased from 5% per year to 10% per year and the maximum initial tax on managers per violation is increased from $5,000 to $10,000. The maximum additional Section 4944 tax (*i.e.*, when there is not a timely correction) on managers per violation is increased from $10,000 to $20,000.

7. The Section 4945 initial tax on a private foundation for a taxable expenditure is increased from 10% to 20%.

8. The Section 4945 initial tax on foundation managers for a taxable expenditure is increased from 2.5% to 5% and the maximum initial tax on managers per violation is increased from $5,000 to $10,000. The maximum additional Section 4945 tax (*i.e.*, when there is not a timely correction) on managers per violation is increased from $10,000 to $20,000.

B. Increase in Penalty Cap for Managers of Public Charities (Sec. 1212 of PPA). Section 4958 is amended to increase the maximum tax on managers from $10,000 to $20,000.

C. Expansion of Items Subject to Section 4940 Excise Tax Imposed on Private Foundations (Sec. 1221 of PPA). The definition of income subject to the Section 4940 tax is amended to increase the types of income subject to the tax. Currently, only income from interest, dividends, rents, payments with respect to securities loans, royalties, and capital gains on the sale of such properties and on the sale of UBIT property, is subject to the tax. Section 4940 is amended also to tax income from sources similar to the listed sources and capital gains from the sale of any such assets.

D. Notification Requirement for Small Exempt Organizations (Sec. 1223 of PPA).

1. Adds new Subsection 6033(i), which requires small organizations not ordinarily required to file Form 990 to file a notification with the IRS each year with certain information, including "evidence of the continuing basis" for exemption.

2. Adds new Subsection 6033(j), which revokes an exemption for failure over three consecutive years to file a Form 990 or the required notice for smaller organizations (discussed above). Any reinstatement requires a new application.

E. Increased Information That Can Be Disclosed to State Officials (Sec. 1224 of PPA). In the case of organizations exempt under Section 501(a) by reason of being described in Section 501(c)(3) or that have applied for a Section 501(c)(3) exemption, Section 6104(c)(1) currently requires the IRS to notify state officials of certain events. Events requiring such notification are (i) an IRS refusal to recognize an organization as exempt under Section 501(c)(3); (ii) the operation of a 501(c)(3) organization in a non-exempt manner; and (iii) when the IRS mails a notice of deficiency under Section 507 or Chapter 41 or 42 of the Code.

The PPA adds new Section 6104(c)(2), which expands the types of information that may be disclosed to a state official in the case of an organization to which Section 6104(c)(1) applies. The disclosure may only be made upon the written request of such state official and only for the purpose of, and to the extent necessary in, the administration of state laws regulating charitable organizations. The additional information that may be disclosed to state officials includes: (i) a proposed refusal to recognize 501(c)(3) status; (ii) a proposed revocation of 501(c)(3) exemption; (iii) the issuance of a letter of proposed deficiency of tax under Section 507 or Chapter 41 or 42 of the Code; and (iv) certain returns and return information.

F. Disclosure of Form 990-T (Sec. 1225 of PPA). The PPA requires Forms 990-T filed by 501(c)(3) organizations after the enactment of the PPA to be subject to public disclosure by the organization. This does not appear to include disclosure by the IRS itself, so these returns may not be as readily available as other Forms 990.

G. Report on Donor Advised Funds and Supporting Organizations (Sec. 1226 of PPA). The PPA requires the Treasury to conduct a study of donor advised funds and supporting organizations and prepare a report no later than one year after the enactment of the PPA discussing (i) whether the charitable contribution rules for such organizations are appropriate; (ii) whether donor advised funds should be required to pay out a specified amount each year; (iii) whether the retention of rights by donors to such organizations, including advisory rights, is consistent with treating their gifts as completed gifts that qualify for a deduction; and (iv) whether any above issue is also relevant to other charitable organizations.

H. Donor Advised Funds Prohibitions and Excise Taxes (Sec. 1231 of PPA).

1. Adds new Section 4966 to the Code.

2. Section 4966(d) adds four important definitions.

   a. Sponsoring Organization. A Sponsoring Organization is any charity that is not a private foundation and that maintains one or more donor advised funds.

   b. Donor Advised Fund. A donor advised fund means a fund or account (i) that is separately identified by reference to contributions of a donor or donors; (ii) which is owned and controlled by a Sponsoring Organization; and (iii) with respect to which a donor (or person appointed by a donor) has, or reasonably expects to have, advisory privileges regarding distributions or investments by reason of such status as a donor. However, a donor advised fund does not include any fund or account (i) which makes distributions only to a single identified organization or governmental entity, or (ii) which has donor advisors only in the capacity of serving as a minority of a committee that selects individuals as recipients of travel, study, or similar grants which comply with certain additional rules. The Treasury may also exempt certain other funds or accounts from status as donor advised funds.

   c. Fund Manager. A Fund Manager is any officer, trustee, or director of a Sponsoring Organization (or a person having similar powers or responsibilities) and, with respect to a specific act or failure to act, the employees of the Sponsoring Organization having authority or responsibility with respect to such act or failure to act.

   d. Disqualified Supporting Organization. A Disqualified Supporting Organization means, with respect to any distribution, (i) any Type III supporting organization that is not a functionally integrated Type III supporting organization, (ii) any Type I or II supporting organization or functionally integrated Type III supporting organization where a donor or donor appointee who advises regarding distributions directly or indirectly controls a supported organization of such supporting organization, and (iii) any other supporting organization that the Treasury determines by regulations to be a Disqualified Supporting Organization.

3. Section 4966 imposes a 20% tax on the taxable distributions made by any Sponsoring Organization (and a possible 5% tax, capped at $10,000, on Fund Managers who knowingly agree to the taxable distributions). A taxable distribution is defined as any distribution from a Donor Advised Fund (a) to a natural person, (b) for any non-charitable purpose, or (c) where the Sponsoring Organization does not exercise expenditure responsibility in accordance with Section 4945(h). However, a taxable distribution does not include a distribution (a) to a public charity other than a Disqualified Supporting Organization, (b) to the Sponsoring Organization, or (c) to any other Donor Advised Fund.

4. Section 4967 imposes a tax when a Donor, Donor Advisor, or Related Person of a Donor Advised Fund receives a non-incidental benefit from a distribution made by the Donor Advised Fund pursuant to the advice of a Donor, Donor Advisor, or Related Person. The tax is 125% of the benefit and is imposed on both the person who advised as to the distribution and the person who received the benefit.

   a. The 125% tax on the benefit received applies to persons described in Subsection 4967(d), which describes Donors, Donor Advisors, and Related Persons. This term includes (i) any donor (or person appointed by a donor) who has, or reasonably expects to have, advisory privileges regarding distributions or investments by reason of such status as a donor; (ii) a member of the family of any such individual; and (iii) a 35% controlled entity as defined in Section 4958(f)(3).

   b. A 10% tax, capped at $10,000, is imposed on a Fund Manager who knowingly agreed to the distribution (knowing it would confer such a benefit).

   c. No tax shall be imposed under Section 4967 if a tax has been imposed with respect to such distribution under Section 4958.

I. Excess Benefit Transactions of Donor Advised Funds and Sponsoring Organizations (Sec. 1232 of PPA).

1. Adds Donors, Donor Advisors, and Related Persons to any Donor Advised Fund to the definition of a Disqualified Person under Section 4958.

2. Adds investment advisors and related persons with respect to a Sponsoring Organization to the definition of a Disqualified Person under Section 4958. An investment advisor is a person (other than an employee of the Sponsoring Organization) paid to manage or provide investment advice regarding assets maintained in donor advised funds owned by the Sponsoring Organization.

3. Amends the definition of an "Excess Benefit Transaction" under Section 4958(c) to include any grant, loan, compensation, or similar payment from a Donor Advised Fund to a person who is a Donor, Donor Advisor, or Related Person to such fund. The entire amount of any such grant, loan, compensation, or similar payment is defined as an "excess benefit" subject to tax.

J. Application of Excess Business Holdings Rules to Donor Advised Funds (Sec. 1233 of PPA). The excess business holdings rules of Section 4943 shall apply to all Donor Advised Funds as if such organizations were private foundations. Disqualified Persons for such purposes includes (i) any donor (or person appointed by a donor) who has, or reasonably expects to have, advisory privileges regarding distributions or investments by reason of such status as a donor; (ii) a member of the family of any such individual; and (iii) a 35% controlled entity as defined in Section 4958(f)(3).

K. Elimination of Deductions for Contributions to Certain Donor Advised Funds (Sec. 1234 of PPA).

1. Subsection 170(f)(18) is added to the Code.

2. Subsection 170(f)(18) denies a deduction under Section 170(a) for any contribution to a Donor Advised Fund unless the taxpayer obtains a contemporaneous written acknowledgment from the Sponsoring Organization of such fund that it has exclusive legal control over the assets contributed.

3. Subsection 170(f)(18) also denies a deduction under Section 170(a) for any contribution to a Donor Advised Fund if the Sponsoring Organization of such fund is a Type III supporting organization that is not a functionally integrated Type III supporting organization.

4. A deduction is also disallowed for a contribution to a donor advised fund where the Sponsoring Organization is a veterans organization, fraternal organization, or cemetery company (which are the only organizations other than governmental entities and 501(c)(3) organizations that can receive tax-deductible contributions under Section 170).

5. Similar rules are created for estate tax deductions under 2055(e) and gift tax deductions under 2522(c).

L. Returns and Exemption Applications of Sponsoring Organizations (Sec. 1235 of PPA).

1. Sponsoring Organizations must include information on their Forms 990 regarding the total number of donor advised funds they own and the aggregate value of assets, contributions, and grants for such funds.

2. An organization applying for exemption after the enactment of PPA must notify the IRS (in such manner as the Treasury provides) whether it maintains or intends to maintain donor advised funds and the manner in which it plans to operate such funds.

M. Supporting Organizations (Sec. 1241 of PPA).

1. Adds Subsection 509(f)(1), which prohibits a Type III supporting organization from supporting foreign organizations (with a three year transition period in certain situations) and allows the Treasury to require Type III supporting organizations to provide specific information to each supported organization.

2. Adds Subsection 509(f)(2), which provides that an organization will not satisfy the relationship requirement for a Type I or Type III supported organization if it accepts any gift or contribution from a person described in Subsection 509(f)(2)(B). A person is described in Subsection 509(f)(2)(B) if such person is (i) a person (other than a public charity described in subsection 509(a)(1), (2), or (4)) who directly or indirectly controls (either alone or together with persons described in clauses (ii) and (iii) below) the governing body of a supported organization; (ii) a member of the family (determined under Section 4958(f)(4)) of an individual described in clause (i) above; or (iii) a 35% controlled entity (as defined in Section 4958(f)(3)) with respect to persons described in clause (i) or (ii) above.

3. Provides that a supporting organization that is a charitable trust shall not be regarded as satisfying the relationship test for a Type III organization solely because of the state law right of a supported organization that is a beneficiary to enforce the provisions of the trust. Provides a one-year grace period from date of enactment of PPA for existing exempt trusts.

4. Provides that the Treasury shall promulgate payout requirements for Type III supporting organizations that are not functionally integrated Type III supporting organizations.

N. Excess Benefit Transactions of Supporting Organizations (Sec. 1242 of PPA).

1. The definition of disqualified person in Section 4958(f)(1) is amended to include, with respect to a supported organization, any person who is a disqualified person to a supporting organization.

2. The definition of an excess benefit transaction is amended to include, in the case of any supporting organization, any loan provided to a disqualified person and any grant, loan, or compensation or other similar payment provided by the supporting organization to any person who is a substantial contributor to it (which term can apparently include a private foundation and another supporting organization), a family member (as defined in section 4958(f)(4)) of a substantial contributor, or a 35% controlled entity (as defined in section 4958(f)(3) regarding control by a substantial contributor or family member of a substantial contributor). The definition of excess benefit is amended to include the full amount of any such grant, loan, or compensation or other similar payment.

O. Excess Business Holdings of Supporting Organizations (Sec. 1243 of PPA).

1. Amends Section 4943 to treat certain supporting organizations as if they are private foundations for purposes of Section 4943.

2. Supporting organizations subject to 4943 are (i) Type III supporting organizations other than a functionally integrated Type III supporting organization, and a Type II supporting organization that accepts a gift or contribution from a person described in Subsection 509(f)(2)(B); (ii) a member of the family (determined under Section 4958(f)(4)) of an individual described in clause (i) above; or (iii) a 35% controlled entity (as defined in Section 4958(f)(3)) with respect to persons described in clause (i) or (ii) above. A person is described in Subsection 509(f)(2)(B) if such person is (i) a person (other than a public charity described in subsection 509(a)(1), (2), or (4)) who directly or indirectly controls (either alone or together with persons described in clauses (ii) and (iii) below) the governing body of a supported organization

3. In applying Section 4943 to such supporting organizations, the term disqualified person is defined to include (i) any person who, at any time in last five years, was in a position to exercise substantial influence over the affairs of the organization; (ii) a family member (as defined under section 4958(f)(4)) of an individual described in clause (i) above; (iii) a 35% controlled entity (as defined by section 4958(f)(3)); (iv) a substantial contributor (which term can apparently include a private foundation and another supporting organization), a family member (as defined in section 4958(f)(4)) of a substantial contributor, or a 35% controlled entity (as defined in section 4958(f)(3) regarding control by a substantial contributor or family member of a substantial contributor); and (v) any organization that is effectively controlled by the same persons who control the organization in question, or substantially all the contributions to which were made directly or indirectly by the same person or persons (within a described set of persons) or a family member (within the meaning of section 4946(d)) of such a person.

4. A functionally integrated Type III supporting organization is defined as a Type III supporting organization that is not required to make payments to supported organizations due to its activities related to performing the functions of, or carrying out the purposes of, such supported organizations.

5. Grandfather rules apply to present holdings.

P. Amounts Paid to Supporting Organizations by Private Foundations (Sec. 1244 of PPA).

1. Section 4942 is amended to provide that the term "qualifying distribution" shall not include any amount paid by a private non-operating foundation to (i) a Type III supporting organization that is not a functionally integrated Type III supporting organization; and (ii) a Type I or II supporting organization or a functionally integrated Type III supporting organization if a disqualified person to the private foundation directly or indirectly controls such organization or a supported organization of such organization or if the Treasury Regulations otherwise provide that a distribution to such organization is inappropriate.

2. Section 4945 is amended to provide that the term "taxable expenditure" includes, unless expenditure responsibility is exercised, grants to the same supporting organizations that cannot receive qualifying distributions (*i.e.*, grants to (i) a Type III supporting organization that is not a functionally integrated Type III supporting organization; and (ii) a Type I or II supporting organization or a functionally integrated Type III supporting organization if a disqualified person to the private foundation directly or indirectly controls such organization or a supported organization of such organization or if the Treasury Regulations otherwise provide that a distribution to such organization is inappropriate).

Q. Returns of Supporting Organizations (Sec. 1245 of PPA). For years ending after the enactment of PPA, a supporting organization's Form 990 must (i) list the supported organizations with respect to which it provides support; (ii) indicate which relationship it satisfies; and (iii) certify that it is not controlled by disqualified persons.

R. Other Provisions in the PPA Applicable to Exempt Organizations.

1. The following other provisions of the PPA impact charitable contributions:

(a) Sec. 1201 allows tax-free charitable distributions from individual retirement plans through 2007;

(b) Sec. 1202 modifies the deduction for food inventory contributions;

(c) Sec. 1203 impacts basis adjustments when an S corporation contributes property;

(d) Sec. 1204 modifies the deduction for book inventory contributions;

(e) Sec. 1206 modifies the deduction for conservation contributions;

(f) Sec. 1213 reforms contribution deduction rules for easements in historic districts and impacted by rehabilitation credits;

(g) Sec. 1214 modifies deduction rules for taxidermy contributions;

(h) Sec. 1215 adds a recapture provision for contributions of exempt use property not actually used for an exempt use;

(i) Sec. 1216 limits the deduction for contributions of clothing and household items;

(j) Sec. 1217 modifies recordkeeping requirements for charitable contributions;

(k) Sec. 1218 modifies rules for contributions of fractional interests in tangible personal property; and

(l) Sec. 1219 modifies rules for penalizing certain valuation misstatements.

2. Other provisions in the PPA that are narrowly targeted to impact certain exempt organizations include the following:

   a. Sec. 1201 impacts returns by certain trusts;

   b. Sec. 1205 impacts payments made under certain pre-2006 contracts to certain controlled organizations;

   c. Sec. 1207 impacts excise taxes on blood collector organizations;

   d. Sec. 1211 impacts acquisitions of interests in certain insurance contracts;

   e. Sec. 1220 adds additional standards for credit counseling organizations; and

   f. Sec. 1222 clarifies the definition of a convention or association of churches.

ENDNOTES

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TAX CONTROVERSY: RECENT DEVELOPMENTS

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The following summary of selected current developments in the law applicable to tax controversies was prepared by David H. Peck for the Tax Controversy Committee of the Section of Taxation. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986 ("Code"), as amended.

Statute of Limitations

Amended Refund Claim. In *Parker Hannifin Corp. v. United States*,[2] the Court of Federal Claims held that Parker Hannifin's amended refund claim was not barred by the statute of limitations, even though it was beyond the original limitations period and was 400 times the amount of the original refund claim. The original refund claim was timely filed for Parker Hannifin's fiscal year 1987 when it paid most of the $14 million assessed deficiency in 1995 and paid the remainder of the principal deficiency and all of the deficiency interest in 1999 by crediting part of the overpayment for the 1988 tax year. Parker Hannifin's original refund claim was $9,107. The amended claim was $3.6 million and was asserted by letter. The amendment was germane to the original claim and was presented before the original claim was resolved. Both claims were for refunds of deficiency interest. The Claims Court ruled the amendment should not have surprised the IRS once it analyzed the data.

3 or 6-Year Limitations. In *Wachovia Bank, N.A. v. United States*,[3] the Eleventh Circuit of Appeals reversed a district court decision[4] that had held the statute of limitations did not bar a refund of mistakenly paid taxes. According to the Eleventh Circuit, the statute of limitations bars claims for refunds even if the taxpayer requesting the refund was not required to file a return. The court held that a trustee's refund claim was governed by the three-year limitations for tax refund claims, not by the general six-year statute of limitations for claims against the United States, even though the trustee was never required to file a tax return.

The taxpayer was the trustee of a charitable remainder trust that was exempt from federal income tax. The taxpayer mistakenly filed income tax returns and paid taxes out of the trust from 1991 to 2001. In 2003, the taxpayer realized the mistake and filed amended tax returns requesting a refund of the taxes mistakenly paid for 1997 and 1998. The IRS denied the refund claims which totaled $111,823, contending that those tax years were barred by the three-year statute of limitations under Section 6511(a).

The taxpayer sued for a refund in district court. The taxpayer contended that the three-year limitations period under Section 6511, which admittedly had expired, did not apply because it was never required to file a tax return in the first place. Wachovia's position was that only the general six-year limitations period under 28 U.S.C. § 2401(a), outside the Tax Code, applied to its refund claim. The district court granted Wachovia's motion for summary judgment and concluded that the three-year limitations period in Section

6511 only applied to taxpayers who are required to file tax returns. The IRS appealed.

Section 6511(a) states that the limitations period for refund claims is the later of three years from the time the return was filed or two years from the time the tax was paid. Under Section 6401(c), a tax payment may be considered an "overpayment" even when no tax liability exists. Wachovia's argument against the three-year limitations period focused on the statutory language: "in respect of which tax the taxpayer is required to file a return."[5] The Eleventh Circuit rejected Wachovia's argument that Section 6511 only applied to taxpayers who are required to file tax returns and the reference in the language to "the taxpayer" applies only to the specific refund claimant, not to taxpayers generally. The Eleventh Circuit agreed with the IRS that the word "taxpayer" referred to taxpayers generally, which was consistent with the rest of the Tax Code. Accordingly, Wachovia's refund claims were barred by the three-year limitations period.

25% Omission of Gross Income. In *Benson v. Comm'r*,[6] the Tax Court held that an amended return that underreported less than 25% of gross income did not act to shorten the six-year statute of limitations applicable when the original return omitted more than 25% of gross income. The normal three-year period of limitations in Section 6501(a) can be extended to six years when the taxpayer omits more than 25% of the gross income stated in the return.[7] Although the taxpayers omitted more than 25% of gross income from their original return, they filed an amended return that omitted less than 25% of gross income. Code Section 6501(e)(1)(A)(ii) provides that any amount disclosed in a return, or in an attached statement, shall not be considered omitted gross income, so long as it is disclosed in a manner adequate to apprise the IRS as to the nature and amount of the items. The taxpayers argued that the amended return of their S corporation adequately disclosed items of gross income and should not be considered omitted income under Section 6501(e)(1)(A)(ii). The Tax Court disagreed and held that amended returns do not correct the omission of gross income from the original return. The six-year statute of limitations applied.

Tax Court Jurisdiction

Innocent Spouse. In *Billings v. Comm'r*,[8] the Tax Court held that it lacked jurisdiction to consider a claim for equitable innocent spouse relief when the IRS had not issued a notice of deficiency against the party seeking relief. This decision effectively ends the Tax Court's practice since 2002. In *Fernandez v. Comm'r*,[9] the Tax Court ruled that it had jurisdiction to review the denial of equitable innocent spouse relief under Section 6015(f) in a stand-alone proceeding. But Congress changed the law in 2001 to limit the Tax Court's jurisdiction to only those cases where a deficiency notice had been issued.[10]

The Tax Court held in 2002 in *Ewing v. Comm'r*,[11] that it had jurisdiction over nondeficiency stand-alone petitions under Section 6015(e). A stand-alone petition is a claim for innocent spouse relief under Section 6015, but not as part of a deficiency action or in response to an IRS decision to begin collecting a tax debt through liens or levies. However, the Ninth Circuit Court of Appeals reversed the Tax Court's decision in *Ewing I*.[12] The Eight Circuit has adopted the Ninth Circuit's position[13] and the Second Circuit has questioned the Tax Court's decision.[14]

In *Billings*, the taxpayer's wife had been embezzling money from her employer. Her husband was unaware that the ill-gotten income had not been reported on their joint return. After she was caught in 2000, she confessed her theft to him, and together they signed an amended joint return that reported the stolen income and showed a hefty increase in tax owed. The husband requested innocent spouse relief, but the Commissioner refused his request because he knew about the embezzled income when he signed the amended return and also knew that the additional tax was not going to be paid.

The husband filed a nondeficiency stand-alone petition to review the administrative denial of innocent spouse relief with the Tax Court. The court held the plain meaning of Section 6015(e), after the 2001 amendment, limits the court's jurisdiction to only those cases where a statutory notice of deficiency had been issued to the taxpayer. The court overruled its decision in *Ewing I*, concluding that Section 6015(e) does not give the court jurisdiction over nondeficiency stand-alone innocent spouse petitions. Several judges dissented.

Credit for Offset. In *Jordan v. Comm'r*,[15] the Tax Court held it lacked jurisdiction to determine whether the IRS improperly applied an overpayment to nontax unpaid federal debt. The IRS paid over a prior year's overpayment to the Department of Education under Section 6402(d), which the taxpayer claimed was improper because he had no outstanding debts with DOE. The court held that Section 6402(f) prevented it from exercising jurisdiction to restrain or review any claim of an improper payment to the DOE.

Prison Mailbox Rule. In an unpublished Tenth Circuit opinion, the court refused to apply the "prison mailbox rule" to the filing of Tax Court petitions.[16] The federal prison mailbox rule provides that a *pro se* prison inmate's pleading is deemed filed at the time that it is delivered to prison authorities for mailing to the court.[17] The prison mailbox rule is codified in Rules 4(c)(1) and 25(c)(2)(A) of the Federal Rules of Appellate Procedure.

On August 28, 2003, the IRS sent the taxpayer a notice of deficiency for the 2000 tax year. The taxpayer was incarcerated at the time and did not receive the notice until late September. On April 6, 2004, the Tax Court received a letter from the taxpayer, inquiring as to the status of his petition for redetermination. The letter was dated March 31, 2004, and postmarked on April 1, 2004. The Tax Court filed the letter as a petition for redetermination of the deficiency. The Service moved to dismiss the case for lack of jurisdiction because the petition was not filed within the 90-day period prescribed by Section 6213(a), which expired on November 26, 2003. In response, the taxpayer asserted that he placed a petition in the prison mail system on November 12, 2003, and thus had timely filed under the prison mailbox rule. The Tax Court disagreed and dismissed the case for lack of jurisdiction.

The Tenth Circuit acknowledged that the prison mailbox rule has been extended to apply to the filing of many civil matters by prison inmates in district court,[18] but the rule does not apply when there is a specific statutory regime governing the filing at issue. Under the Tax Court rules, timely mailing is generally considered to be timely filing. When a document is received late, the taxpayer must prove it was timely mailed. Timely mailing can be proven by either a postmark within the 90-day period and actual receipt[19] or by sending the document by registered mail.[20] Although the various circuit courts of appeal disagree as the evidence required or permitted to prove timely mailing, no court has relied solely on the uncorroborated testimony of the taxpayer.

Here, the only evidence as to the mailing of the petition was the taxpayer's own uncorroborated assertion that he did so. The taxpayer neither provided evidence as to the actual postmark date, nor did he assert that he used registered mail. Furthermore, the taxpayer did not produce the prison mail logs, which could have corroborated the date of mailing. Accordingly, the petition was not filed within the 90-day period and the case was dismissed.

District Court Jurisdiction

Interest Abatement. In *Hinck v. United States*,[21] the Federal Circuit affirmed the Court of Federal Claims and held that the Tax Court has exclusive subject matter jurisdiction over interest abatement claims against the IRS. The taxpayers filed a claim for refund contending that the interest erroneously assessed from 1989 to 1993 should be abated. The IRS denied their claim and the taxpayers filed suit in the Court of Federal Claims seeking review of the IRS's refusal to abate the interest. In 1986, Congress amended Section 6404 by adding a new section authorizing the IRS to abate a tax or liability assessment in certain circumstances. In 1996, Congress enacted the Taxpayer Bill of Rights II,[22] adding Section 6404(b), which provides for review of abatement determinations made by the IRS in the Tax Court. The Federal Circuit agreed with the Claims Court that Section 6404(h) grants the Tax Court exclusive jurisdiction over interest abatement claims and dismissed the action.

Fifth Amendment Privilege

In *United States v. Arizechi*,[23] the IRS Special Agent served two summonses upon the taxpayer as custodian of records for two companies owned by the taxpayer. The taxpayer invoked his Fifth Amendment privilege against self-incrimination and refused to comply. The government filed suit to enforce compliance. The district court held that the Fifth Amendment did not apply to corporations (but applied only individuals) and a custodian of records cannot assert the Fifth Amendment to prevent production of corporate records. Although the "act of production doctrine" may have a compelled testimonial aspect,[24] a corporate custodian cannot refuse to produce the requested records because it would be a personally incriminating act.[25] Further, the taxpayer cannot make a blanket assertion of a Fifth Amendment privilege to refuse to provide testimony, but he must instead appear before the agent and assert his privilege on a question-by-question basis.

Collection Due Process (CDP)

No Jurisdiction in District Court. In *Wagenknecht v. United States*,[26] a federal district court held that it did not have subject matter jurisdiction over the procedural due process claims arising from the taxpayer's request for a redetermination of an IRS notice of determination involving his collection due process hearing. The Tax Court has exclusive jurisdiction over collection due process claims.

CDP Follows First Lien. In *Investment Research Associates, Inc. v. Comm'r*,[27] the Tax Court held that when a taxpayer receives two IRS lien notices, the statutory limitations period for requesting a collection due process (CDP) hearing began to run following the first notice, and expired after 30 days. The IRS filed a federal tax lien against the taxpayer's property in Florida and then three months later filed a second tax lien against the taxpayer's property in Illinois. The taxpayer did not request an administrative hearing after the first lien but did request a hearing after the second lien was filed in Illinois. The IRS determined the request for a CDP hearing was untimely and instead conducted an equivalent hearing and mailed a decision letter to the taxpayer who then appealed the decision letter to the Tax Court. The court dismissed the case for lack of jurisdiction because the decision letter was not a notice of determination that would give the court jurisdiction. The taxpayer was only entitled to one CDP hearing, even if it received multiple lien notices.[28] Based on the legislative history of Section 6320, the court concluded that the right to a hearing arises only after the first lien notice. Because the taxpayer did not submit a request for a hearing after the first lien in Florida, the IRS was only required to grant the equivalent hearing, which does not grant the right of judicial review, so again the court did not have jurisdiction to review the decision letter.

Penalties

Reliance Defense. Tax professionals have a difficult time to persuade the IRS and the courts that they should be excused from penalties because they relied in good faith on the advice of a tax professional. In *Kovacevich v. Comm'r*,[29] the taxpayer argued that he relied in good faith on the advice of outside tax professionals in structuring his business activities. The Ninth Circuit rejected the taxpayer's claim that he relied in good faith on the advice of a tax professional, noting the taxpayer's reputation as a competent tax attorney and self-avowed expert in the field of tax law.

IRS Policies and Positions

Fast Track Settlement. The IRS has announced a fast track settlement (FTS) opportunity for small business/self-employed taxpayers within the IRS's Small Business/Self-Employed organization (SB/SE).[30] The purpose of the SB/SE FTS is to enable SB/SE taxpayers that currently have unagreed issues in at least one open year under examination to work together with SB/SE and Appeals to resolve outstanding disputed issues while the case is still in SB/SE jurisdiction. SB/SE FTS will be available to taxpayers for a test period of up to two years, beginning on the date of the publication of the Announcement (SB/SE FTS is effective beginning September 5, 2006). Within this period, there will be an initial focused test of six months during which the program will only be available for taxpayers under examination in Chicago, Houston and St. Paul, Minnesota. If the program proves successful, then it will be available nationwide.

The program is similar to the Large and Mid-Size Business (LMSB) Fast Track Settlement Dispute Resolution Program described in Rev. Proc. 2003-40.[31] The SB/SE FTS process is designed to be completed within 60 days of acceptance of the SB/SE-Appeals FTS Application. The SB/SE FTS is <u>not</u> available for: Collection Appeals Program, Collection Due Process, Offer-In-Compromise and Trust Fund Recovery cases except as provided in any guidance issued by the Service; cases in which the taxpayer has failed to respond to Service communications and no documentation has been previously submitted for consideration by Compliance; TEFRA partnership cases; issues designated for litigation; frivolous issues as identified in Rev. Proc. 2006-2[32]; whipsaw issues; and certain other issues that have been identified in a Chief Counsel Notice or equivalent publication. To apply for the SB/SE FTS program, the taxpayer and the SB/SE Group Manager should submit a SB/SE-Appeals FTS Application to the local Appeals Team Manager. The SB/SE FTS program employs various alternative dispute resolution techniques to promote case resolution. An Appeals Officer, trained in mediation, will serve as a neutral party (not in a traditional Appeals role) to facilitate settlement between the parties.

Offers in Compromise. An offer in compromise is an agreement between a taxpayer and the IRS that resolves the taxpayer's tax debt. The IRS has the authority to settle or "compromise" federal tax liabilities by accepting less than full payment in certain circumstances. On July 11, 2006, the IRS announced that under a new federal law, taxpayers submitting new offers in compromise (OIC) must make a 20% nonrefundable, up-front payment in many cases.[33] The recently-enacted Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) made major changes to the OIC program, tightening the rules for lump-sum offers and periodic-payment offers. These changes became effective for all offers received by the IRS starting July 16, 2006.

Under the new law, taxpayers submitting requests for lump-sum OICs must include a payment equal to 20% of the offer amount. The payment is nonrefundable, that is, it will not be returned if the OIC request is later rejected. A lump-sum OIC means any offer of payments made in five or fewer installments. Taxpayers submitting requests for periodic-payment OICs must include the first proposed installment payment with the taxpayer's application. A periodic payment OIC is any offer of payments made in six or more installments. The taxpayer is required to pay additional installments while the offer is being evaluated by the IRS. All installment payments are nonrefundable. Under the new law, taxpayers qualifying as low-income or filing an offer based solely on doubt as to liability qualify for a waiver of the new partial payment requirements.

If the IRS cannot make a determination on an offer within two years, then the offer will be deemed accepted. If a liability included in the offer amount is disputed in any court proceeding, that time period is excluded from calculating the two-year time frame.

OIC requests are submitted using the Form 656, Offer in Compromise. When submitting Form 656, taxpayers must include an application fee of $150 unless they qualify for the low-income exemption or are filing a doubt-as-to-liability offer. Complete information on the entire collection process and the OIC program are on IRS.gov.

Miscellaneous

Closing Agreements. In *Manko v. Comm'r*,[34] the Tax Court held that a closing agreement did not obviate the requirement for a notice of deficiency prior to collection, even though the assessments arose solely from the IRS's application of the agreement to the returns. The taxpayer was a partner in a non-TEFRA partnership. The IRS examined certain items on the partnership returns and the taxpayer's individual returns. After reaching an agreement as to the treatment of the partnership items on the taxpayer's returns, the parties memorialized their agreement on Form 906, Closing Agreement on Final Determination Covering Specific Matters. After executing the closing agreement, the IRS prepared an Income Tax Examination Changes, reflecting the IRS's computation of the taxpayer's tax liabilities, and sent it to the taxpayer. The IRS then assessed the deficiencies shown in the Income Tax Examination Changes without issuing a notice of deficiency. The IRS then proceeded to collect the unpaid deficiency. The taxpayer filed a petition with the Tax Court.

The Tax Court held the IRS cannot proceed with collection if it did not issue a notice of deficiency to the taxpayer, unless it determined that the closing agreement eliminated the need for the notice. The court's decision turned on the type of closing agreement. There are two types of closing agreements: Form 866 and Form 906. The Form 906, which was used here, determines one or more separate items of the taxpayer's liability. On the other hand, the Form 866, Agreement as to Final Determination of Tax Liability, is a final determination of a taxpayer's liability for past tax years. Both agreements are final as to the matters agreed upon.

Here, the Tax Court determined that the Form 906 only covered specific items and did not determine the total tax liability for the applicable tax years. The IRS still needed to issue a notice of deficiency because the closing agreement only pertained to certain items and did not conclusively determine the tax liability for that year. For example, the Form 906 does not bar the IRS from subsequently determining that a taxpayer is liable for penalties. The Tax Court held that the IRS could not assess the tax and proceed to collection without first issuing a statutory notice because the Form 906 closing agreement did not come down to a bottom line figure as to the taxpayer's liability. However, if the parties had instead entered into a closing agreement on Form 866, then a deficiency notice would not have been required before assessment.

Attorney-Client Privilege/Work Product. In *United States v. Roxworthy*,[35] the Court of Appeals for the Sixth Circuit agreed with a corporate taxpayer that two memoranda were protected by the work product privilege from an IRS administrative summons. The two memoranda were prepared by KPMG analyzing the tax consequences of certain transactions entered by Yum! Brands, Inc. pertaining to the creation of a captive insurance company and related stock transfers. The district court adopted the magistrate's ruling that the summons should be enforced, concluding that the KPMG memoranda were created not in anticipation of litigation but rather to assist Yum in the preparation of its taxes and yearly audits.

The Sixth Circuit reversed the district court and held that the work product doctrine protected the KPMG memoranda from discovery. The work product doctrine, as set forth in Federal Rule of Civil Procedure 26(b)(3), protects from discovery documents and tangible things prepared in anticipation of litigation by or for a party or that party's representative. The Sixth Circuit defined the phrase "in anticipation of litigation" by asking whether a document was prepared or obtained because of the prospect of litigation. Yum anticipated litigation because it planned to claim a $112 million tax loss with no corresponding book loss. KPMG had advised the company that the law surrounding captive insurance companies was unsettled, and further advised Yum that the IRS had a history of attacking transactions and litigating cases where a loss was only recognized for tax purposes. Yum did not use KPMG to prepare its tax returns; Yum prepared its returns in-house.

Litigation Costs. In *Jondahl v. Comm'r*,[36] a letter sent to the IRS before trial was sufficient to be deemed a qualified offer to settle the taxpayer's deficiency litigation. Consequently, the taxpayer could recover his subsequent litigation costs. In a letter sent to the IRS before trial, the taxpayer stated that he agreed to pay $12,000 (exclusive of interest) to establish his liability "as his qualified offer," which was in addition to the $42,873 he had already paid to the government as restitution in a criminal tax proceeding for the same years. The Tax Court ruled that the letter's inclusion of a tax year not at issue was merely a typographical error and the taxpayer did not intend to include that year in trying to settle the matter.

Tax Shelter Litigation

Economic Substance Doctrine. In *Coltec Industries, Inc. v. United States*,[37] the Court of Appeals for the Federal Circuit ruled that the economic substance doctrine trumps the Code, at least in the context of contingent liability tax shelters. In reversing the Court of Federal Claims, the Federal Circuit ruled the tax-sheltered strategy complied with the literal language of the Code, but held for the IRS because the transaction lacked economic reality. Coltec desired to generate capital losses to offset a $241 million capital gain from the sale of one its businesses. To that end, Coltec used a three-step transaction proposed by Arthur Anderson to generate capital losses. First, the taxpayer would reorganize a dormant subsidiary into a special purpose entity. Second, the taxpayer would transfer property and contingent liabilities to the newly reorganized subsidiary in exchange for stock in that subsidiary. Finally, the taxpayer would sell the stock to a third-party for a nominal sum. The taxpayer would treat its basis in its subsidiaries stock as equal to the property it transferred to the subsidiary but not reduced by the liabilities the subsidiary assumed. The taxpayer would then suffer a significant loss from the sale of the stock because the sale price of the stock would be significantly lower that its basis in the stock.

Coltec implemented the three-step transaction by transferring $14 million to a newly reorganized subsidiary (Garrison) in exchange for stock in Garrison. In a separate transaction, Garrison issued stock to another subsidiary (Garlock) in exchange for a promissory note from one Garlock's other subsidiaries in the amount of $375 million and Garrison's assumption of Garlock's and its subsidiary's asbestos liabilities. The $375 million note was calculated to cover the estimated future asbestos liabilities of Garlock and its subsidiary. Coltec then sold the Garrison stock to two banks for $500,000 and agreed to indemnify the banks against any veil-piercing claims for asbestos liabilities. Coltec reported nearly a $380 million loss on its consolidated return. Coltec claimed that its basis in the Garrison stock was almost $380 million (representing the $375 million note plus the other property given to Garrison valued at about $4 million, but not reduced by the liabilities assumed by Garrison). Thus, Coltec claimed to suffer almost a $379 million loss when it sold the stock for only $0.5 million. This nearly $379 million loss more than offset Coltec's gains for the tax year.

The critical issue was Garlock's basis in the Garrison stock. The underlying transaction between Garlock and Garrison was governed by Section 351. Under the general rule, the transferor's basis in the stock received is equal to the basis of the property transferred decreased by the money received by the transferor and increased by the amount of gain recognized.[38] Liabilities that are assumed in a Section 351 exchange are generally treated as money received by the transferor for basis purposes.[39] However, the Federal Circuit agreed with Coltec that Garlock did not have to reduce its basis in its Garrison stock by the amount of liabilities Garrison assumed, because these liabilities fell under the Section 358(d)(2) exception and thus escaped "money received" basis-reduction treatment. After ruling that "contingent liabilities" are "liabilities" under Section 358(d), the Section 358(d)(2) exception to the "money received" treatment (basis-reduction) applied because the liability was excluded under Section 357(c)(3). But Coltec's victory was short-lived.

The Federal Circuit held that the economic substance doctrine was well-established binding precedent of the Supreme Court.[40] The Court of Federal Claims had rejected the economic substance doctrine on the basis that the judge viewed the doctrine as judicially-created law, rather than legislatively enacted, and therefore unconstitutional. The Federal Circuit ruled that a lack of economic substance is sufficient to disqualify a transaction without proof that the taxpayer's sole motive is tax avoidance. Coltec had the burden to prove that the transaction had economic substance. The transaction must be viewed objectively, rather than subjectively. The transaction to be analyzed is the one that gave rise to the alleged tax benefit. Arrangements with subsidiaries that do not affect the economic interest on independent third parties deserve particularly close scrutiny. Coltec admitted that tax avoidance was one reason for entering into the transaction. The critical transaction was Garrison's assumption of Garlock's asbestos liabilities in exchange for the $375 million note. It was this exchange that provided Garlock with the high basis in the Garrison stock and the critical exchange whose tax consequences was in dispute. The Federal Circuit rejected Coltec's argument that the transaction was designed to strengthen Coltec's position against veil-piercing claims. The Federal Circuit concluded that the transfer of liabilities in exchange for the note served no business purpose other than to artificially inflate Garlock's basis in its Garrison stock. When that transaction was disregarded, the basis in the Garrison stock was not increased by the assumption of Garlock's asbestos liabilities.

Contingent Liability Shelter. In *Klamath Strategies Investment Fund, LLC v. United States*,[41] the United States District Court for the Eastern District of Texas allowed bond-linked investment premium structure benefits (BLIPS) to the taxpayer. The court rejected the IRS's attempt to deny the favorable BLIPS treatment by retroactively applying Treas. Reg. § 1.752-1 issued in 2003 to a 2000 transaction. Since the regulation did not apply retroactively, contingent obligations consisting of loan premiums and repayment penalties were not liabilities under Section 752. Thus, the liabilities did not increase basis for each partner who then could claim a larger tax loss.

Two LLCs had various repayment obligations associated with their interest in two partnerships. One of the obligations arose from loan premiums which the lender had made to the partnerships in return for an agreement to pay a higher interest rate than the market rate over the life of the loans (a variation of the BLIPS structure). The other obligation arose from the partnerships' agreement to pay a penalty if they repaid the loans before they matured. The court rejected the IRS's argument that the obligations were liabilities under Treas. Reg. § 1.752-1 and therefore increased basis. The regulation was issued after the transactions had occurred and could not be given retroactive effect. Hence, the loan premium and prepayment penalty did not increase basis.

ENDNOTES

1 David H. Peck is an Assistant United States Attorney for the Southern District of Texas. The views and opinions expressed herein are solely the author's. The author's views and opinions do not represent the views and opinions of the Department of Justice or the United States Attorney's Office for the Southern District of Texas. The author is not authorized and does not intend to speak for the Department of Justice or the United States Attorney's Office for the Southern District of Texas.

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13 *Bartman v. Comm'r*, 446 F.3d 785, 787 (8th Cir. 2006), *aff'g in part and vacating in part*, T.C. Memo. 2004-93.

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17 *Houston v. Lack*, 487 U.S. 266, 270, 276 S.Ct. 2379 (1998).

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24 *United States v. Doe*, 465 U.S. 605, 612 (1984).

25 *Braswell v. United States*, 487 U.S. 99, 117 (1988).

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35 457 F.3d 590, 2006 WL 2285975 (6th Cir. Aug. 10, 2006).

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38 I.R.C. § 358(a)(1)(A).

39 I.R.C. §§ 358(a)(1)(A), 358(d)(1).

40 Various attempts have been made to codify the economic substance doctrine, most recently in the *Taxpayer Protection and Assistance Bill* (Sen. 832). Senator Charles Grassley, R.-Iowa, one of the bill's sponsors, pointed out at Eric Solomon's confirmation hearing to be Assistant Treasury Secretary for Tax Policy, that the doctrine was not being applied uniformly in all courts.

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ENERGY AND NATURAL RESOURCES TAX: RECENT DEVELOPMENTS

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The following is a summary of selected current developments in the law relating to the energy and natural resources tax area. The summary focuses on federal tax law. It has been prepared by Keith Rogers, an associate at Thompson & Knight LLP, and Janet Jardin,[2] Chair of the Energy and Natural Resources Committee and an associate at Thompson & Knight LLP, as a project of the Energy and Natural Resources Tax Committee. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "Code").

A. <u>IRS Rules That Contracts Covering Nuclear Power Plant Decommissioning Costs are Not "Insurance"</u>

In *Chief Counsel Advice 200629028*[3] and *Chief Counsel Advice 200629029*,[4] the IRS ruled that contracts covering nuclear power plant decommissioning costs would not constitute insurance for federal income tax purposes.

The operator of a nuclear power plant is required to obtain a license from the U.S. Nuclear Regulatory Commission ("NRC"). A licensee must periodically report to the NRC evidence that funds will be available to decommission the plant. The certification of assurance of adequate funding may be based on an estimate.

In the facts of the memoranda, an entity issued contracts covering decommissioning costs incurred by entities responsible for decommissioning an operating nuclear power plant. The contracts entitled the holder to reimbursement of decommissioning costs. Estimates of decommissioning costs were included in the formula used to determine the charge for each contract; however, the charge would be reduced (but not increased) if the assurance amount required by regulators were subsequently revised.

The IRS ruled that the contracts did not constitute insurance because no risk was transferred. There was no risk regarding whether decommissioning would incur; rather, it was inevitable that a licensee would one day incur the cost of decommissioning the plant. The risk covered by the contracts was the risk of inaccurate cost estimation, which is a business risk rather than an insurance risk.

B. IRS Rules That Proceeds From Sale of Electric Utility's Generating Assets are Includible in Gross Income in the Year of Sale

In *Technical Advice Memorandum 200631023*,[5] the IRS ruled that proceeds from the sale of an electric utility owner's generating assets were received under a claim of right, and therefore were includible in gross income under Section 61 in the year of sale.

The taxpayer owned operating electric utilities, including two subsidiaries (the "Companies"). The state in which the taxpayer was located enacted a law that restructured its electric utility industry to create direct access by retail customers to the competitive market for electricity. As a result of the new competitive market, the public utilities would be unable to recover certain costs (known as "transition" or "stranded" costs) incurred in entering into long-term investments and long-term power supply agreements.

The new law authorized the state's Public Utilities Commission (the "Commission") to permit each electric utility to recover an appropriate amount of transition or stranded costs through a "competitive transaction charge" ("CTC") applied to the bill of every customer.

As a result of a settlement with the Commission, the Companies were permitted to recover certain stranded costs but were required to use the net proceeds from the sale of generation assets to offset such costs. The settlement also required the utilities to establish and maintain "NUG Trusts" into which they were to deposit net proceeds from the sale of generating assets. The NUG Trusts were to be used to recover non-utility generating ("NUG") costs.

The IRS concluded that the sales proceeds were includible in income in the year of sale because the taxpayer received the right to receive and retain the gain proceeds from plant sales, including the money placed in the NUG Trusts and earmarked for use in meeting its obligations to pay operating NUG costs. The IRS noted that the taxpayer was not specifically required by the statute to repay or return the sales proceeds to taxpayers.

The field office had argued that the gain proceeds should not be included in gross income in the year of sale because the trust imposed substantial restrictions on the taxpayer's access to the funds. The IRS rejected this argument, noting that the taxpayer was not required to obtain the Commission's permission to withdraw funds or pay its operating NUG obligations. The IRS concluded that the fact that the earnings on the funds in the NUG Trusts were applied to the taxpayer's stranded costs did not constitute a substantial restriction, but instead resulted in an additional source of income out of which the taxpayer could satisfy its NUG obligations. Further, the IRS did not view the taxpayer's agreement to place a portion of the gain proceeds in trust as a substantial restriction on the taxpayer's access to the funds, as the funds in the NUG Trusts inured to the benefit of the taxpayer by being earmarked for use in the payment of the taxpayer's existing operating NUG obligations.

Thus, the IRS concluded that the gain proceeds from the taxpayer's sale of generation plants were received under a claim of right and were includible in the taxpayer's gross income in the year of sale.

The IRS reached a similar conclusion in *Technical Advice Memorandum 200630018*.[6]

C. IRS Concludes that Revenues from Proposed Rate Increases are Includible in Income in the Year Received

In *Technical Advice Memorandum 200632015*,[7] the IRS concluded that, under the claim of right doctrine, public utilities' revenues attributable to proposed rate increases were includible in gross income in the year of receipt, even though an appeal of the rate increases was pending.

Public utilities imposed rate increases and billed their customers accordingly, subject to refund pending agency review of the rate increases. The IRS noted that its longstanding position was that proceeds from contingent utility rate increases were includible in income under the claim of right doctrine. The IRS noted that the utilities collected and deposited the additional funds in their accounts with unlimited control over their use and disposition and without segregation from other funds. Such unrestricted receipt triggered taxation because the utilities did not, in the year in which such funds were received, recognize a liability under an existing and fixed obligation to repay the proceeds received. According to the IRS, income does not lose its taxable character merely because it may have to be returned at some later time.

The IRS further distinguished prior cases on the grounds that the utilities were not required to increase rates for conservation purposes, to create stable billing rates, or to perform any other measures that benefited the general public. Instead, the rate increases benefited the utilities themselves by allowing them to pass on cost increases to their customers.

D. IRS Concludes That Refinery Process Units Are Included in Asset Class 13.3, not Asset Class 28.0

In *Technical Advice Memorandum 200629031*,[8] the IRS concluded that, for depreciation purposes, process units (the "Units") located at the taxpayer's oil refinery were properly classified under Revenue Procedure 87-56[9] as assets in Asset Class 13.3 (Petroleum Refining) rather than Asset Class 28.0 (Manufacture of Chemicals and Allied Product).

The taxpayer owned and operated refineries, producing gasoline and other petroleum-based products. The taxpayer owned and operated the Facility that separates crude oil into fractions by distillation, processes the fractions by physical and chemical operations, separates the products by distillation, and further processes the product streams. The Facility's Units included crude distillation, vacuum distillation, fluid catalytic cracking, hydrocracking, catalytic reforming, and coking.

The IRS noted that, under Revenue Procedure 87-56, property is classified according to its primary use even if the activity in which such property is primarily used is insubstantial in relation to all the activities of the taxpayer. Asset Class 13.3 includes assets used for the distillation, fractionation, and catalytic cracking of crude petroleum into gasoline and its other components. Asset Class 28.0 includes assets used to manufacture basic organic and inorganic chemicals; chemical products to be used in further manufacture, such as synthetic fibers and plastics materials; and finished chemical products.

The taxpayer argued that Asset Class 13.3 is limited just to those assets that were used for the named processes of distillation, fractionation, and catalytic cracking, and that the identified Units were not used functionally in the refining activity, but rather were used in the manufacture of chemicals. Accordingly, the taxpayer believed that the Units were properly categorized in the Asset Class 28.0 because they did not perform a process specifically listed in Asset Class 13.3.

The IRS noted that the description of Asset Class 13.3 is not limited to the three named processes (*i.e.*, distillation, fractionation, and catalytic cracking). Rather, those processes are illustrative of processes used in and necessary for the operation of a modern integrated refinery. The distinction between the manufacture of chemicals and petroleum refining activities is determined by the products of the activity. Applying this use-driven functional standard, the Units were dedicated to producing gasoline and other petroleum products and were an integral part of this function. At the Facility, the taxpayer was engaged in only this industrial activity. Thus, its primary and only use was the production of gasoline and other petroleum products. The Units functioned as integral parts of the activity of refining crude petroleum into gasoline and other petroleum products. Although many of the processing steps at the taxpayer's refinery were similar, or identical to, the processing steps that take place in the manufacture of chemicals at the taxpayer's refinery, the primary purpose of those processing steps was the production of gasoline and other products of crude petroleum.

E. IRS Provides Guidance on Credit for Nonbusiness Energy Property

In *Notice 2006-26*,[10] the IRS provided interim guidance, pending the issuance of regulations, relating to the credit for nonbusiness energy property under Section 25C. The IRS specified the procedures manufacturers may follow to certify property as either an "Eligible Building Envelope Component" (section 4 of Notice 2006-26) or a "Qualified Energy Property" (section 5 of Notice 2006-26), both of which qualify for the credit. The IRS also explained the conditions under which taxpayers may rely on a manufacturer's certification.

Notice 2006-53[11] amended section 4.04 of Notice 2006-26 to clarify that exterior siding does not qualify as an Eligible Building Envelope Component. Notice 2006-53 applies to siding purchased after June 26, 2006, and to certifications that a manufacturer provided after that date to purchasers of siding.

In *Notice 2006-71*,[12] the IRS modified Notice 2006-53 by revising its effective date. In general, Notice 2006-53 remains effective with respect to siding purchased and certifications provided after June 26, 2006. In addition, in the case of siding installed before December 1, 2006, taxpayers (including manufacturers, distributors, contractors, and homeowners), may rely on the provisions of section 4.04 of Notice 2006-26, as in effect before the issuance of Notice 2006-53, in providing certifications and claiming credits.

F. IRS Concludes Taxpayer is Not Entitled to Fuel Tax Refunds

In *Technical Advice Memorandum 200627026*,[13] the IRS concluded that a taxpayer was not entitled to a credit or payment on fuel used in the taxpayer's buses. The taxpayer was a private bus operator that purchased taxed diesel fuel and gasoline for its bus business. The taxpayer contracted with the state to provide bus services to transport state employees between state facilities and their parking lots. The taxpayer maintained the buses at its own expense.

Because the taxpayer's buses were not made available to the general public, and because the taxpayer was not compensated directly by its passengers, the IRS determined that the taxpayer was not entitled to a credit or payment under Section 6427(b).

Further, the IRS determined the taxpayer was not entitled to either (1) the Section 6427(l) payment for diesel fuel sold for the exclusive use of a state or local government, or (2) the Section 6421(c) credit or payment for gasoline used for the exclusive use of a state or local government. There was no sale for the exclusive use of a governmental entity under the test of Revenue Ruling 79-306[14] because the taxpayer retained control of the busing operation and bore all losses from operating the buses. Also, there was no such sale under Revenue Ruling 79-112[15] because the state paid a fixed monthly amount for the taxpayer's services that was not dependent on any increase or decrease in the cost of fuel. Thus, as the taxpayer bore the burden of any increase in fuel prices, it could not be said that the taxpayer sold fuel to the state for the state's exclusive use.

G. IRS Publishes Percentage Depletion Rates for Marginal Properties

In *Notice 2006-61*,[16] the IRS announced the applicable percentage to be used in determining percentage depletion for marginal properties for the 2006 calendar year, under Section 613A. The following table shows the applicable percentages for marginal production for calendar years 1991 through 2006:

Calendar Year	*Applicable Percentage*
1991	15 percent
1992	18 percent
1993	19 percent
1994	20 percent
1995	21 percent
1996	20 percent
1997	16 percent
1998	17 percent
1999	24 percent
2000	19 percent
2001	15 percent
2002	15 percent
2003	15 percent
2004	15 percent
2005	15 percent
2006	15 percent

G. IRS Publishes EOR Credit Inflation Adjustment Factors

In *Notice 2006-62*,[17] the IRS published inflation adjustment factors used to determine the Section 43 enhanced oil recovery ("EOR") credit.

Under Section 43(b)(3)(B), the IRS is required to publish an inflation adjustment factor. The EOR credit under Section 43 for a taxable year is reduced if the "reference price" for the preceding calendar year is greater than $28 million multiplied by the "inflation adjustment factor." The inflation adjustment factor is a fraction, the numerator of which is the GNP implicit price deflator for the preceding calendar year, and the denominator of which is the GNP implicit price deflator for 1990. Because the reference price for 2005 ($50.26) exceeds $28 million multiplied by the inflation adjustment factor for 2005 by $11.28, the enhanced oil recovery credit for qualified costs paid or incurred in 2006 is phased out completely.

The following table details the GNP Implicit Price Deflator for calendar years 1990 through 2006:

Calendar Year	*GNP Implicit Price Deflator*	
1990	112.9	(used for 1991)
1991	117.0	(used for 1992)
1992	120.9	(used for 1993)
1993	124.1	(used for 1994)
1994	126.0	(used for 1995)
1995	107.5	(used for 1996)
1996	109.7	(used for 1997)
1997	112.35	(used for 1998)
1998	112.64	(used for 1999)
1999	104.59	(used for 2000)
2000	106.89	(used for 2001)
2001	109.31	(used for 2002)
2002	110.63	(used for 2003)
2003	105.67	(used for 2004)
2004	108.23	(used for 2005)
2005	112.129	(used for 2006)

H. <u>IRS Issues Interim Guidance on Deduction for Energy Efficient Commercial Buildings</u>

In *Notice 2006-52*,[18] the IRS provided guidance, pending the issuance of regulations, pertaining to the Section 179D deduction for energy efficient commercial buildings. Before claiming a Section 179D deduction, taxpayers must obtain certification that required energy savings will be achieved. Notice 2006-52 established a process by which a taxpayer can obtain a certification that certain property satisfies the energy efficiency requirements of Section 179D(c)(1) and (d). The IRS clarified that the certification process is open to both owners or lessees of a commercial building who install property as part of the commercial building's interior lighting systems, heating, cooling, ventilation, and hot water systems, or building envelope.

The certification, which must be provided by a "qualified individual" and satisfy the requirements to be energy efficient commercial building property, must contain the following information:

1. The name, address, and telephone number of the "qualified individual";

2. The address of the building to which the certification applies;

3. One of the following statements by the qualified individual:

   (a) For energy efficient commercial building property: "The interior lighting systems, heating, cooling, ventilation and hot water systems, and building envelope that have been, or are planned to be, incorporated into the building will reduce the total annual energy and power costs with respect to combined usage of the building's heating, cooling, ventilation, hot water, and interior lighting systems by 50 percent or more as compared to a Reference Building that meets the minimum requirements of Standard 90.1-2001."

   (b) For energy efficient lighting property that satisfies the requirements of the permanent rule: "The interior lighting systems that have been, or are planned to be, incorporated into the building will reduce the total annual energy and power costs with respect to combined usage of the building's heating, cooling, ventilation, hot water, and interior lighting systems by 16 2/3 percent or more as compared to a reference building that meets the minimum requirements of Standard 90.1-2001."

   (c) For energy efficient lighting property that satisfies the requirements of the interim rule: "The interior lighting systems that have been, or are planned to be, incorporated into the building satisfy the requirements of the interim rule of section 2.03(1)(b) of Notice 2006-52."

   (d) For energy efficient heating, cooling, ventilation, and hot water property: "The heating, cooling, ventilation, and hot water systems that have been, or are planned to be incorporated into the building will reduce the total annual energy and power costs with respect to combined usage of the building's heating, cooling, ventilation, hot water, and interior lighting systems by 16 2/3 percent or more as compared to a Reference Building that meets the minimum requirements of Standard 90.1-2001."

   (e) For energy efficient building envelope property: "The building envelope that has been, or is planned to be, incorporated into the building will reduce the total annual energy and power costs with respect to combined usage of the building's heating, cooling, ventilation, hot water, and interior lighting systems by 16 2/3 percent or more as compared to a Reference Building that meets the minimum requirements of Standard 90.1-2001."

4. A statement by the "qualified individual" that the amount of the reduction has been determined under the rules of Notice 2006-52.

5. A statement by the "qualified individual" that field inspections of the building performed by a qualified individual after the property has been placed in service have confirmed that the building has met, or will meet, the energy-saving targets contained in the design plans and specifications, and that the field inspections were performed in accordance with any inspection and testing procedures that have been prescribed by the National Renewable Energy Laboratory as Energy Savings Modeling and Inspection Guidelines for Commercial Building Federal Tax Deductions and are in effect at the time the certification is given.

6. A statement that the building owner has received an explanation of the energy efficiency features of the building and its projected annual energy costs.

7. A statement that "qualified computer software" was used to calculate energy and power consumption and costs and identification of the qualified computer software used.

A taxpayer is not required to attach the certification to its tax return, but must retain it in the taxpayer's records.

I. IRS Issues Guidance on Credit for New Qualified Alternative Motor Vehicles

In *Notice 2006-54*,[19] the IRS issued interim guidance, pending the issuance of regulations, on procedures a car manufacturer may use to qualify for the new qualified motor vehicle credit under Section 30B, including the reduced credit for mixed-fuel vehicles.

The Section 30B credit allowed for a qualified alternative fuel motor vehicle placed in service by the taxpayer during the tax year equals the "applicable percentage" of the "incremental cost" of that vehicle. The "applicable percentage" for a qualified alternative fuel motor vehicle is 50% plus an additional 30% in certain circumstances. Notice 2006-54 set forth that the "incremental cost" of any qualified alternative fuel motor vehicle equals the excess of the manufacturer's suggested retail price ("MSRP") for the vehicle over the MSRP for a gasoline or diesel fuel motor vehicle of the same model, but the incremental cost cannot exceed:

- $5,000, if the vehicle has a gross vehicle weight rating ("GVWR") of not more than 8,500 pounds;
- $10,000, if the vehicle has a GVWR of more than 8,500 pounds but not more than 14,000 pounds;
- $25,000, if the vehicle has a GVWR of more than 14,000 pounds but not more than 26,000 pounds; or
- $40,000, if the vehicle has a GVWR of more than 26,000 pounds.

In addition, Section 30B permits a reduced alternative fuel motor vehicle credit for "mixed-fuel vehicles" placed in service by the taxpayer during the tax year. This reduced credit is determined as follows: for a "75/25 mixed-fuel vehicle," 70% of the credit that would have been allowed if the vehicle were a qualified alternative fuel motor vehicle, and for a "90/10 mixed-fuel vehicle," 90% of the credit that would have been allowed if the vehicle were a qualified alternative fuel motor vehicle.

A "75/25 mixed-fuel vehicle" is a mixed-fuel vehicle that operates using at least 75% alternative fuel and not more than 25% petroleum-based fuel. Notice 2006-54 provides that the vehicle must be unable to perform efficiently in normal operation unless its fuel contains at least 75% alternative fuel and not more than 25% petroleum-based fuel. A "90/10 mixed-fuel vehicle" is a mixed-fuel vehicle that operates using at least 90% alternative fuel and not more than 10% petroleum-based fuel. Notice 2006-54 requires that the vehicle must be unable to perform efficiently in normal operation unless its fuel contains at least 90% alternative fuel and not more than 10% petroleum-based fuel. The percentages of alternative and petroleum-based fuel in a mixed fuel are determined on the basis of the Btu content of the respective fuels. Under Notice 2006-54, if the alternative fuel is a liquid at least 85% of the volume of which consists of methanol, the Btu content of any petroleum-based fuel included in the liquid is treated as part of the Btu content of the alternative fuel and not part of the petroleum-based fuel.

ENDNOTES

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TAX RESIDENCY FOR ENTITIES UNDER MEXICAN LAW

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Until very recently, the Mexican tax provisions contained two clear parameters that were to be used in order to determine if an entity was to be considered as a Mexican resident for tax purposes or not. These parameters were:

a) Incorporation of the entity under Mexican law; and

b) Location of the entity's main administration or place of effective management within Mexican territory.

During the final days of June, the Official Gazette of the Mexican Government published different amendments passed by the Mexican Congress. Among these amendments, several changes were made to the Federal Fiscal Code, including a modification of the abovementioned parameters.

In accordance with this modification, the only parameter for attributing Mexican tax residency to entities is for them to have their "main administration" or "place of effective management" within Mexican territory.

This change, although consistent with international standards, and at first sight irrelevant, could lead to different unwanted consequences, because of an apparent lack of analysis by the Mexican lawmaker while discussing this amendment.

The purpose of this article is to expand on the legal consequences this change could have from a Mexican tax point of view.

Concept of "main administration" and/or "place of effective management"

First, it is crucial to understand the meaning of *"main administration"* and/or *"place of effective management"*.

Although such concepts are not defined within the Mexican tax law, the Mexican tax authorities have established, within general tax rules, that an entity will be deemed to have established its main administration or its place of effective management in Mexico when the place where the person or persons that make or execute, day by day, the decisions of control, management, operation, and administration of such entity is located within Mexican territory.

This interpretation intends to be consistent with the one set forth on the Commentaries by the Organisation for Economic Co–operation and Development (OECD) to the Model Tax Convention on Income and Capital when deeming the "place of effective management" as (i) the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made; (ii) the place where the most senior person or group of persons makes its decisions; and (iii) the place where the actions to be taken by the entity as a whole are determined. However, the wording of such rule is not accurate, as it does not refer to where the decisions are taken, but rather to the place where the person or persons who make or execute such decisions are located. Consequently, according to the Mexican tax authorities, if the decision makers and/or the executors, if any, are regularly based outside of Mexico, the main administration or place of effective management of the relative entity shall be deemed located outside of Mexican territory, regardless of the fact where the actual decisions for such entity are taken or executed.

Therefore, whenever the decision makers and/or the executors, if any, are not physically located in Mexico on a regular basis, according to the criterion of the tax authorities, such entity would not have its main administration or its place of effective management in Mexico.

Legal consequences

Some legal consequences which could derive from the abovementioned amendment are detailed as follows:

(a) **Migration of Mexican entities**

As previously discussed, because of the amendment, the only parameter for determining Mexican tax residency of entities is if they have within Mexican territory their *"main administration"* or *"place of effective management"*, regardless of whether they were incorporated under Mexican law or not.

An entity incorporated under Mexican law, which has its *"main administration"* or *"place of effective management"* located outside of Mexican territory, may no longer be deemed as a Mexican tax resident. If this is the case, in accordance with Mexican Income Tax Law, such an entity shall be considered to have migrated, having to apply the tax effects of a liquidation, that is, being obliged to calculate and pay the relative taxes as if its total assets were alienated.

Although the compatibility of this provision with the Mexican Constitution may be questionable, proper actions should be taken to avoid any risk of having the Mexican tax authorities consider that the entity has migrated, and consequently attribute the referred unwanted consequences.

In this regard, Mexican corporate law refers to two corporate bodies that are allowed to make management or control decisions: (i) shareholders or partners; and (ii) the administrative body that is either a Board of Directors or sole administrator. Consequently, a solution would be that, regardless of where the shareholders or partners are located, the Board of Directors or the sole administrator, as the case may be, are/is in fact based within Mexican territory, and record is kept of every decision made and/or executed by such administrative body.

(b) **Permanent establishment**

If an entity incorporated under Mexican law is no longer deemed as a Mexican tax resident, in most cases it will continue to have physical presence in Mexico, and, therefore, it may be deemed to have a permanent establishment.

As a consequence thereof, the effect of such migration would be, besides the negative tax implication referred to above, an obligation to pay taxes by having a permanent establishment.

(c) **Dual residency**

Entities that have not been incorporated under Mexican law must also take proper measures in order to avoid any risk of having the Mexican tax authorities consider that their *"main administration"* or *"place of effective management"* is located within Mexican territory, and, consequently, that they are deemed as Mexican tax residents.

The foregoing because, even though the parameter of *"main administration"* and/or *"place of effective management"* for the attribution of Mexican tax residency was already foreseen before the amendment, the main criterion followed for such purposes used to be the fact of whether the entity was incorporated under Mexican law or not.

Therefore, because of the amendment, it could be expected that Mexican tax authorities will focus with special heed on the parameter in force for the purpose of detecting entities where decision makers are located within Mexican territory, and, therefore, deem such entities as Mexican tax residents with the unwanted tax consequences that such situation would imply (dual residency).

In this regard, it would be advisable that decision makers of entities not incorporated under Mexican law are not physically located within Mexican territory, and to have this situation properly documented if regular business is to be carried out in Mexico.

Additional comments

It is rather evident that the criterion set forth by the Mexican tax authorities is incorrect. As a consequence thereof, we seriously doubt that this mistake will lead the tax authorities to take any course of action for the purpose of pursuing any type of economic benefit. However, it is always advisable not to incur in unnecessary risks and take some preventive action.

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The comments contained herein express a general view of its authors and shall not be considered as legal opinion.

ENDNOTES

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TEXAS PROPERTY TAX LAW DEVELOPMENTS

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A TAXING UNIT MAY NOT EFFECTUATE A TAX FORECLOSURE IF IT IS AWARE THAT ITS NOTICE OF FORECLOSURE WAS NOT DELIVERED TO THE TAXPAYER, PROVIDED THAT AN ALTERNATE REASONABLE METHOD OF NOTIFICATION IS AVAILABLE.

Jones v. Flowers, 2006 U.S. LEXIS 3451 (April 26, 2006)

Taxpayer owned a residence. He separated from his wife and moved into an apartment, but he continued making all mortgage payments. The mortgage company paid all property taxes until the mortgage was paid off. Thereafter, no property tax payments were made. A notice of tax delinquency, with a right to redeem, was mailed to the taxpayer at the property by the taxing unit by certified mail. It was returned to the taxing unit unclaimed. The taxing unit later published in the local newspaper a notice of public sale, and subsequently sold the property to a third party. (These procedures fully complied with state law.) When the third party attempted to evict the residents of the house, the taxpayer filed suit contending that his constitutional right to due process was violated by the government's failure to provide adequate notice to him of its intent to foreclose. The United States Supreme Court agreed and held "that when mailed notice of a tax sale is returned unclaimed, the State must take additional reasonable steps to attempt to provide notice to the property owner before selling his property, if it is practicable to do so."

A CLASS ACTION LAWSUIT AGAINST AN APPRAISAL DISTRICT CANNOT INCLUDE TAXPAYERS WHO DID NOT EXHAUST THEIR ADMINISTRATIVE REMEDIES.

Cameron Appraisal District v. Rourk, 194 S.W.3d 501 (Tex. 2006).

A class action lawsuit was filed against an appraisal district seeking a declaration that taxing travel trailers is unconstitutional and seeking a judgment setting aside all individual tax assessments on trailers. The class included taxpayers who had exhausted administrative remedies and others who had not done so. The Texas Supreme Court held that exhaustion of administrative remedies is jurisdictional and that those persons who had not exhausted administrative remedies were not entitled to participate in the class action suit.

PROPERTY TAX LAWSUITS INVOLVING MANY, VARIED PROPERTIES IN MULTIPLE COUNTIES MAY NOT BE CONSOLIDATED FOR PRETRIAL PURPOSES UNLESS IT CAN BE DEMONSTRATED THAT THEY INVOLVE COMMON QUESTIONS OF FACT; A PRETRIAL TRANSFER SOUGHT FOR PURPOSES OF CONVENIENCE AND EFFICIENCY MUST TAKE INTO ACCOUNT THE INTERESTS OF THE MULTIPLE DEFENDANTS.

In re: Ad Valorem Tax Litigation, No. 06-0095 (Tex. Jud. Pan. Mult. Lit. 2006, no pet.) (to be published.)

Taxpayer filed 150 lawsuits against 42 appraisal districts challenging the valuations of a variety of properties including pipelines, terminals, convenience stores and refineries. Taxpayer sought consolidation of the cases for purposes of pretrial procedure claiming that the cases involved common questions of fact and law and that consolidation would eliminate redundant, multiple hearings on common issues (with the potential for inconsistent rulings) and possible multiple depositions of employee witnesses. The Texas Judicial Panel on Multidistrict Litigation denied the consolidation finding that the valuation of these varied properties, in their varied locations, involved distinctly local factual issues. As a result, the cases did not meet the requirement of commonality of fact. The use, or potential misuse, of mass appraisal techniques and the potential for inconsistent legal determinations did not provide the commonality necessary to authorize consolidation. Consolidation was also not authorized for purposes of convenience because the defendants' attorneys and witnesses would have been substantially more inconvenienced by the consolidation, than the taxpayer's attorneys and witness would have been convenienced by the consolidation.

IMPROVEMENTS PERMANENTLY AFFIXED TO LAND BECOME PART OF THE REAL ESTATE AND MAY NOT BE SEIZED BY A TAX WARRANT; USE OF THE COMPTROLLER'S MANUAL AT TRIAL WITHOUT ADDITIONAL SUPPORTING MATERIAL OR TESTIMONY DOES NOT CONSTITUTE EVIDENCE.

Citizens National Bank v. City of Rhome, No. 2-05-337-CV (Tex. App. –Fort Worth, Aug. 10, 2006, no pet. h.) (to be published).

Taxing unit executed a tax warrant against a gas station seeking to collect delinquent taxes. Among the items seized were the station's fuel pumps. A bank, which had loaned money on the real estate, sought an injunction preventing the seizure of the pumps. At trial, the taxing units produced as its evidence an excerpt from the Texas Comptroller's Manual, which defined fuel pumps as commercial personal property. The bank presented extensive testimony as to the manner in which the fuel pumps were permanently attached to the property. The court held that personal property that is permanently attached to real estate becomes part of the real estate and may not be seized by a tax warrant. It further held that the use of the Texas Comptroller's manual without any additional supporting application or authority did not constitute any form of evidence.

UTILIZING A COMMUNITY HOUSING DEVELOPMENT ORGANIZATION ENTITY AS A GENERAL PARTNER IN A LIMITED PARTNERSHIP TO QUALIFY THE ENTITY FOR

EXEMPTION APPLIES ONLY TO PROJECTS CONSTRUCTED AFTER DECEMBER 31, 2001.

American Housing Foundation v. Calhoun County Appraisal District, No. 13-05-00496-CV (Tex. App. –Corpus Christi, July 27, 2006, no pet. h.). (to be published).

A limited partnership composed of a community housing development general partner and a “for profit” limited partner constructed an apartment complex in 1996. It sought a Community Housing Development exemption for the project in 2003. The court held that the provision qualifying limited partnerships for exemption through the use of a qualifying nonprofit general partner was expressly limited to projects constructed after December 31, 2001, and did not apply to projects constructed prior to that date.

A LIEN NEED NOT BE RECORDED TO QUALIFY AS A FIRST LIEN FOR PURPOSES OF A RIGHT OF REDEMPTION SUBSEQUENT TO A TAX LIEN LOAN FORECLOSURE; THE RECORDATION OF THE TAX LIEN LOAN PRIOR TO THE RECORDATION OF A DEED OF TRUST DOES NOT QUALIFY THE TAX LIEN LOAN AS A “FIRST LIEN.”

ABN AMRO Mortgage Group v. TCB Farm and Ranch Land Investments, No. 2-05-292-CV (Tex. App. –Fort Worth, July 27, 2006, no pet. h.). (to be published).

Taxpayers refinanced mortgages and entered into a new deed of trust. Subsequently, the taxpayers borrowed money to pay their property taxes and the property tax lien was transferred from the tax office to the lender. The lien transfer was recorded. Thereafter, the deed of trust was recorded. (The recordation of the deed of trust occurred more than a year after the mortgage was executed.) The taxpayers defaulted on their payments on the tax lien loan, and the property was foreclosed and was sold to a third party. The mortgage company attempted to redeem the property by tendering the correct redemption amount to the third party. The third party rejected the tender, contending that the mortgage company did not have the right to redeem the property because it was not a first lienholder, and that the right of redemption was limited to the taxpayers and first lienholders. The court held that the mortgage company qualified as a first lienholder because the statute did not require liens to be recorded to qualify as first liens. It also held that the tax lien loan recordation did not make it a first lien because the tax lien is a statutory lien that is given automatic priority. The recordation of the tax lien loan is merely a procedural condition precedent to the foreclosure of the tax lien.

THE $1,000 STATUTORY LIMIT ON FEES FOR AIDING IN THE RECOVERY OF DELINQUENT TAX SALE EXCESS PROCEEDS IS A “PER OWNER” LIMITATION.

Davis v. Kaufman County, No. 05-05-01412-CV (Tex. App.–Dallas, June 29, 2006, no pet. h.) (to be published).

Property owner died intestate leaving thirteen heirs. Taxes were not paid on the property and the property was foreclosed. The foreclosure sale yielded excess proceeds of $28,024.91. An attorney filed a motion to disburse excess proceeds on behalf of four of the heirs. The court awarded the attorney $3,500 in attorney’s fees for the attorney work. These funds were to be paid from the excess proceeds. Another heir, not represented by the attorney contested the award arguing that the statutory limit on such fees was the lesser of 25% of the excess proceeds ($7,006.23 in this case) or $1,000. The court of appeals upheld the award noting that the $1,000 limit was a “per owner” limitation. Since the attorney represented four of the co-owners, the award was within the permissible boundaries of the statute.

TO QUALIFY FOR A COMMUNITY HOUSING DEVELOPMENT ORGANIZATION EXEMPTION, AT LEAST ONE-THIRD OF THE MEMBERS OF THE ORGANIZATION’S BOARD OF DIRECTORS MUST BE COMPRISED OF LOW INCOME INDIVIDUALS; ADDITIONALLY, THE ORGANIZATION MUST HAVE A FORMAL PROCESS FOR LOW INCOME BENEFICIARIES TO ADVISE IT ON VARIOUS MATTERS; THE EXCLUSIVE PURPOSE OF THE ORGANIZATION MUST BE TO MAKE HOUSING AVAILABLE TO LOW OR MODERATE INCOME INDIVIDUALS; BUT THE ORGANIZATION IS NOT REQUIRED TO RENT 100% OF ITS UNITS TO LOW OR MODERATE INCOME INDIVIDUALS.

American Heritage Apartments, Inc. v. Bowie County Appraisal District, No. 06-05-00112-CV (Tex. App. –Texarkana, June 27, 2006, no pet. h.) (to be published).

Taxpayer sought a Community Housing Development Organization exemption for its apartment complex. The evidence showed that none of the members of the organization’s board of directors lived in low income areas. It further demonstrated that the organization did not have a formal process by which beneficiaries of the low income housing program could advise the organization regarding the design, siting, development and management of the complex. (It did have a comment and complaint process available to the tenants.) Additionally, the complex rented units to individuals who were not of either low income or moderate income status. The court held that the failure to have low income individuals filling at least one-third of the seats of the organization’s board of directors and the failure to have a formal advisory process, as required by federal law, was fatal to the qualification for exemption. The court also ruled that the organization was not required to rent 100% of its units to low or moderate income individuals so long as the organization’s exclusive purpose was to provide housing for such persons.

A CHIEF APPRAISER’S FAILURE TO DELIVER NOTICE OF CANCELLATION OF AN EXEMPTION TO A TAXPAYER RENDERS THAT DECISION VOIDABLE; A TAXPAYER WAIVES A CLAIM OF LACK OF NOTICE BY VOLUNTARILY PROTESTING THAT DETERMINATION AND APPEARING BEFORE AN APPRAISAL REVIEW BOARD TO CHALLENGE THE DENIAL OF THE EXEMPTION.

Harris County Appraisal District v. Pasadena Property, LP., No. 11-05-00013-CV (Tex. App. –Eastland, June 15, 2006, no pet. h.) (to be published).

A chief appraiser cancelled a taxpayer’s existing pollution control exemption, but failed to deliver notice of the cancellation to the taxpayer. The taxpayer learned of the cancellation when the taxpayer received its tax bill. The taxpayer filed a notice of protest with the appraisal review board under the provisions which allows challenges of “any other action of the chief appraiser ...that applies to or adversely affects the property owner.” (The taxpayer did not protest the failure of the chief appraiser to deliver the notice.) The appraisal review board conducted a hearing and denied the taxpayer’s request for reinstatement of the exemption.

Taxpayer filed suit claiming that the failure to deliver the notice of cancellation rendered the chief appraiser's decision void. The court of appeals disagreed, ruling that the failure to deliver the notice rendered the determination voidable, but not void. The taxpayer was afforded an opportunity to complain of the cancellation prior to the tax bill becoming final. This opportunity satisfied the requirements of due process. Additionally, the taxpayer waived its right to complain about the chief appraiser's failure to deliver the notice of cancellation by voluntarily protesting the cancellation of the exemption and appearing at the appraisal review board hearing.

STATEMENT AUTHENTICATED BY DEPUTY TAX ASSESSOR AND CONTAINING SEAL OF COUNTY CONSTITUTES ADMISSIBLE EVIDENCE IN DELINQUENT TAX TRIAL; COPY OF DELINQUENT TAX STATEMENT ATTACHED TO PETITION SATISFIES SUBSEQUENT DISCOVERY DEMAND EVEN IF ADDITIONAL SUMS ARE INCLUDED IN STATEMENT AT TRIAL; FAILURE TO PLEAD NONOWNERSHIP AND TO OBJECT AT TRIAL ON THAT GROUND WAIVES THE ISSUE.

Williams v. County of Dallas , 194 S.W.3d 29 (Tex. App.–Dallas 2006, no pet. h.).

Taxing unit sued to collect delinquent taxes. At trial, it presented as its sole evidence a photocopy of the delinquent tax roll, attested to by the deputy tax assessor and sealed by the official seal of the county. The taxpayer objected to its admissibility. On appeal, the court found that the evidence met the criteria for certified, self authenticating governmental evidence as required by the Texas Rules of Evidence. Additionally, the document satisfied Section 33.47 of the Texas Tax Code, which authorized the use of such evidence. As a result, the court upheld the judgment against the taxpayer finding that government had produced *prima facie* evidence of the tax delinquency. The taxpayer also objected to the document because it had not been produced by the government in response to a request for disclosure. The court held that an earlier copy of the document that had been attached to the Original Petition notifying the taxpayer that the government would be seeking all subsequent unpaid taxes was sufficient to satisfy the discovery demand notwithstanding the inclusion of additional tax amounts in the document introduced at trial. Finally, the court ruled that the taxpayer's complaint that judgment against her was inappropriate because the evidence demonstrated that the property was owned by the estate of another person was waived because the taxpayer failed to object on that ground at trial and because the taxpayer did not raise the affirmative defense of nonownership in her pleadings.

A TAX LIEN ON A MANUFACTURED HOME ATTACHES ON JANUARY 1 OF EACH TAX YEAR AND IS PERFECTED BY FILING NOTICE OF THE LIEN WITHIN SIX MONTHS OF THE END OF THE TAX YEAR; A TAX LIEN IS NOT REQUIRED TO BE FILED WITH THE DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS IF THE HOME HAS BEEN DESIGNATED AS REAL PROPERTY.

Op. Tex. Att'y Gen. No. GA-0443 (2006).

A tax lien on a manufactured home attaches on January 1 of each tax year. If the property is designated as personal property, the tax lien is not perfected until a statement of the lien is filed by the Manufactured Housing Division of the Texas Department of Housing and Community Affairs. Such filing must be made within six months after the end of the tax year. No filing is required to perfect a lien on a manufactured home which has been designated as real property by the taxpayer.

NEW PROPERTY TAX LEGISLATION

House Bill 1.

Effective: May 31, 2006.

- For the 2006 tax year, the maintenance and operations portion of the school district tax rate is reduced from $1.50 per $100 of value to $1.33 per $100 of value. (School districts whose rates were lower than $1.50 per $100 of value are reduced to 88.67% of their 2005 rate.) School district boards of directors may add up to an additional 4¢ per $100 of value to this rate and retain those additional funds for exclusive use by the district. The voters of a school district, in an election, may further add up to an additional 13¢ per $100 of value to the maintenance and operations tax rate. The school district may retain those additional funds for exclusive use by the district. (If all of these options were to be exercised, a maximum tax rate of $1.50 per $100 of value for the 2006 tax year would result.)

- For the 2007 tax year, the maintenance and operations portion of the school district tax rate is further reduced from $1.33 per $100 of value to $1.00 per $100 of value, provided that sufficient funds are available from the state from the new and increased state taxes to fund this decrease. If sufficient funds are not available, the rate will be lowered in proportion to the additional funding which is available. (School districts whose rates were lower than $1.33 per $100 of value are reduced to 66.67% of their 2005 tax rate.) School district boards of directors may add up to an additional 4¢ per $100 of value and retain those funds for exclusive use by the district. The voters of a school district, in an election, may further add up to an additional 13¢ per $100 of value to the maintenance and operations tax rate. The school district may retain those additional funds for exclusive use by the district. (If all of those options were to be exercised, and if full state funding is available, this would result in a maximum tax rate of $1.17 per $100 of value for the 2007 tax year.)

- The requirement that tax bills reflect comparisons of appraised values and taxes for a property from the current year to the fifth previous year are repealed.

- School district tax bills shall separately identify the maintenance and operations tax rate for the current and prior tax year, the debt rate for the current and prior tax year, and the total tax rate for the current and prior tax year.

- The provision authorizing tax offices to state that they do not have available comparative tax data for prior tax years to place on tax bills is repealed.

- Persons over the age of 65 qualifying their homesteads for a "freeze" of school district taxes in 2006 or 2007 shall be entitled to a proportionate reduction in the taxes to reflect the reductions in tax rates mandated by this bill.

House Bill 2.

Effective: May 24, 2006.

All revenue resulting from (a) the new margins tax, (b) the increased tobacco taxes and (c) the increased "liar's affidavit" motor vehicle taxes shall be placed in a special fund in the state treasury. These monies shall be utilized to reduce the average school district maintenance and operations tax rate to $1.00 per $100 of value. Once this goal is achieved, all additional revenue from those sources shall be divided as follows: 2/3 of those funds shall be utilized to further reduce the maintenance and operations tax rate below $1.00 per $100 of value, and 1/3 of those funds shall be utilized to increase the level of school district enrichment tax efforts.

House Bill 3.

Effective: May 15, 2006.

Portable drilling rigs are deemed sitused at their owner's principal place of business unless the rig has been located in another county for the entire preceding calendar year.

ENDNOTES

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CURRENT DEVELOPMENTS IN FEDERAL TAX COLLECTION, LIENS & LEVIES

January through June 30, 2006

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Section 6511(b): Remittance Accompanying Form 4868 Extension As a Payment

Deaton v. Comm'r., 440 F.3d 223 (5th Cir. 2006). This was a case of first impression in the Fifth Circuit. It involved taxpayers' remittance that accompanied their Form 4868 application for an extension of time to file their 1993 tax return. The court held it was a "payment," not a "deposit," and that as such, it could not be credited against the taxpayers' 1994 1996 tax liabilities because it fell outside the "look back period" of Section 6511(b)(2)(A).[2]

Section 6331: Progress Payments under Texas Law Not Subject to Levy

Capital Indemnity Corporation v. United States,---F.3d---, 2006 WL 1609417 (5th Cir. 2006). This case involved a surety that brought a wrongful levy action to determine whether a general contractor (MEB) had "property or rights to property" in contract payments following default in a public works contract for which the surety was obligated under a performance bond. The Service was attempting to levy on the general contractor's rights to a progress payment from the city. The contractor had defaulted under the city construction contract and the surety had to takeover the contract under its performance bond contract. The contract contained a provision authorizing the city to withhold from the contract proceeds any amounts that the contractor had not paid suppliers and subcontractors. The Fifth Circuit held that, under state (Texas) law, that the general contractor had not earned rights to progress payments under the public works contract because the project owner (*i.e.*, city) has a contractual right to withhold from a contractor amounts necessary to satisfy the subcontractors' and suppliers' claims. The retained funds were held not to be the contractor's property, and the government could not acquire the right to the funds via a tax lien against the contractor's property.

Section 6321: Nominee Liens – Role of State Law

The role of state law in influencing the use of nominee liens was at issue in *Spotts v. United States*, 429 F.3d 248 (6th Cir. 2005). The result was that the Sixth Circuit vacated and remanded a district court summary for the Service in a quiet title action brought by a divorce action seeking to remove a nominee lien filed against the wife's property on account of delinquent taxes owed by the wife's ex husband. The interesting part of the decision was that the vacating of the district court summary judgment for the Service was grounded on the failure of the district court to rely sufficiently on state law. Interestingly, the wife was pro-se before the Sixth Circuit and was successful in vacating the district court summary judgment for the Service.

The Internal Revenue Manual describes an alter-ego lien situation as follows:

The obligation of a corporation will be recognized as those of another person, and vice versa, where it appears that the corporation is not only influenced and governed by that person, but there is such a unity of interest and ownership that the individuality or separateness, of the person and the corporation has ceased. Also the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote an injustice.[3]

Sections 6320 and 6330: Collection Due Process Hearings

The National Taxpayer Advocate has reviewed and cited weaknesses in the collection due process ("CDP") procedure in the 2005 Annual Report released in January 2006. Among the many issues raised, the National Taxpayer Advocate's 2005 Annual Report cites the following issues as particularly worthy of consideration:

1. Taxpayers can only use the CDP process following the issuance of the first Notice of Federal Tax Lien for a particular tax period and once the first Notice of Intent to Levy is issued with respect to that tax.[4] While a taxpayer's situation is fluid, the CDP process captures the taxpayer at only a moment in time.

2. Taxpayers may have self-assessed the tax liability, while allowing taxpayers to contest the underlying tax liability before Appeals and in de novo judicial review proceedings on appeal from Appeals' determination.

3. Some taxpayers raised frivolous issues or solely for purposes of delay of the collection function.[5]

4. CDP hearing process does not protect taxpayers who have failed to request a CDP hearing, and thus prevents judicial oversight of proposed IRS levy actions for a particular tax debt.[6]

The Service is planning to reduce the number of notices sent to taxpayers.[7] As a consequence, the CDP notice will be issued much earlier in the notice process, with the potential risk that taxpayers will be notified so early in the notice process that the taxpayer may not actually receive the CDP notice. Receipt of the CDP notice earlier in the notice cycle means that the Service may not check last notice addresses against commercial databases and verify whether it has a more current address for the taxpayer.

Business taxpayers receive two collection notices prior to the Notice of Intent to Levy and Right to Due Process Hearing.[8] As proposed, business taxpayers will receive the CDP notice in the second collection notice. Individual taxpayers receive four collection notices prior to the Notice of Intent to Levy and Right to Due Process Hearing.[9] As proposed, individual taxpayers will receive the CDP notice in the fourth collection notice. The Service's goal is to reduce collection cycle time. The National Taxpayer Advocates points out that the harm to taxpayers in this proposed streamlines notice process is great.

Moreover, in the 2005 Annual Report, the low utilization of the CDP process by affected taxpayers continued to be a highlight. In 2004, only 1.24% of taxpayers receiving CDP notices requested CDP hearings.[10]

***Cox v. Comm'r*, 126 T.C. No. 13 (2006).** The term "prior involvement" as used in Section 6330 context does not arise when Appeals Officer's consideration of later years is peripheral to a hearing involving an earlier year.

***Bell v. Comm'r.*, 126 T.C. No. 18 (2006).** In this Tax Court case, the taxpayer was erroneously informed that he could not challenge his underlying tax liability in a collection due process hearing. But the Service was in error in making this statement and the taxpayer did not seek judicial review of the notice of determination. In a subsequent collection due process hearing involving the same year, the taxpayer was precluded from challenging the underlying tax liability because of his failure to have sought judicial review of the first determination. The second preclusion from challenging the underlying tax liability was held not to be an abuse of discretion.

Collection Due Process Hearings Judicial Review

- *Robinette v. Commissioner*, 439 F.3d 455 (8th Cir. 2006). In this case, the Eighth Circuit, reversing the Tax Court, limited a judicial collection due process hearing review to reviewing the evidence presented in the administrative record and found no abuse of discretion when the Service decided to proceed with collecting on an individual's liabilities.

- *United States v. Thornton*, 859 F.2d 151 (4th Cir. 1988) (unpublished) (reversing and remanding District Court judgment). In this case, the Fourth Circuit held that the district court erred by not indicating either (i) what the delinquent taxpayer's interest was in the property sought to be foreclosed or (ii) how the court valued the interest. It was also held that the district court erred in failing to conduct the kind of the contemplated inquiry in deciding to exercise its discretion to order a sale as required by *United States v. Rodgers*.

- *Colson v. United States*, 446 F.3d 836 (8th Cir. 2006), *aff'g* 322 BR 118 (8th Cir. BAP 2005). The Eighth Circuit affirmed the holding of the district court that, for a taxpayer's document to be returned unfiled, "does not require inquiry to the circumstances under which a document was filed."[11] Rather, "the honesty and genuiness of the filer's attempt to satisfy the tax laws should be determined from the face of the form itself, not from the filer's delinquency or the reasons for it. The filer's subjective intent is irrelevant."[12]

In 2005, Congress added a provision to Section 523(a) of the Bankruptcy Code, which states that "the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)."[13]

Consideration of Offer-in-Compromise by IRS Appeals

- *Sampson v. Comm'r*, 2006 WL 1228593, T.C. Summ. Op. 2006 75 (2006). The Service was held to have abused its discretion in rejecting an offer-in compromise. The case involved an Appeals officer who determined that the taxpayer's status as a student was "not really relevant." But the Appeals officer simultaneously determined that the taxpayer's future income included the wages he could have earned, but chose to forgo, in order to pursue his studies (forgone earnings).

- *In re Uzialko*, 339 BR 579 (Bankr. E.D. Pa. 2006). Case held that the Service cannot be compelled to process a debtors' offer in compromise.

- *Fargo v. Comm'r*, 447 F.3d 706, 2006 WL 1215379 (9th Cir. 2006). The Ninth Circuit held that because of the long time period of resolving underlying TEFRA tax issues with entities in which the taxpayer had an interest, substantial interest accrued on the taxpayer's deficiency. The taxpayer sought an offer in compromise to reduce interest expense. The Service did not abuse its discretion in rejecting the taxpayers' offer on grounds of exceptional circumstances. Section 7122 is inherently discretionary. Legislative history expressions that contemplate compromise of longstanding cases where large amounts of fines and interest accrue do not meet the threshold for proving the Commissioner's abuse of discretion. The Service owes no duty of negotiation of offers-in-compromise.

Date of Withdrawal of Offer in Compromise

- *United States v. Donovan*, 348 F.3d 509 (6th Cir.2003). The Sixth Circuit held that the date of the effective withdrawal of the offer is a different matter from that of the date when the offer is no longer "pending," and agreed with the government that the IRS form letter sent to the taxpayer "contains the effective withdrawal date merely to indicate that the government can no longer accept the offer in compromise, and that this has nothing to do with when the statute of limitations begins to run again."[14] Rather, "the statute of limitations question turns on when the offer ceases to be "'pending' under ... Form 656. The latter controls when the statute of limitations begins to run again."[15]

ENDNOTES

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

3 I.R.M. 5.12.2.6.5(May 20, 2005).

4 National Taxpayer Advocate 2005 Annual Report, p.447.

5 *Id.*

6 National Taxpayer Advocate 2005 Annual Report, p. 447.

7 National Taxpayer Advocate 2005 Annual Report, p. 460.

8 I.R.M. §5.19.1 (Oct. 1, 2001).

9 I.R.M. §5.19.1 (Oct. 1, 2001).

10 National Taxpayer Advocate 2005 Annual Report, p. 458-459.

11 *Id.* at 840.

12 *Id.*

13 The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. No. 109 8 § 714 (April 20, 2005), 11 U.S.C. § 523(a).

14 *Id.*

15 *Id.* at 513

CORPORATE TAXATION: RECENT DEVELOPMENTS

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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.

Final Regulations Allow §338(h)(10) Elections in Certain Multi-step Transactions

Effective July 5, 2006, the Service issued final regulations[2] adopting the temporary regulations and notice of proposed rulemaking (proposed regulations) issued in 2003, without modification.

Temporary Regulations

The temporary regulations[3] addressed the availability of a section 338(h)(10) election in certain multi-step transactions. Specifically, the temporary regulations allowed a section 338(h)(10) election to be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase, even if after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P). The election is allowed whether or not, under relevant provisions of law, including the step transaction doctrine, the acquisition and the merger or liquidation qualify as a section 368(a) reorganization. If the election is made in a situation where the acquisition of T, followed by the merger or liquidation of T into P, may qualify as a section 368(a) reorganization, the acquisition of T by P is treated as a qualified stock purchase and not as a 368(a) reorganization.

Comments

No public hearing was requested or held but the Service received comments regarding the proposed regulations. Some commentators recommended that the final regulations allow section 338(g) elections (as well as section 338(h)(10) elections) to turn off the step transaction doctrine in a multi-step transaction that constitutes a section 368(a) reorganization. Extending the final regulations to section 338(g) elections would allow the acquiring corporation to unilaterally elect to treat the transaction, for all parties, as other than a section 368(a) reorganization. In light of potentia l whipsaw and other concerns, the final regulations continue to apply only to section 338(h)(10).

Service Withdraws Proposed Regulations on Use of Basis Shifting to Create Artificial Losses

Effective April 19, 2006, the Service and Treasury have withdrawn proposed regulations providing guidance on the treatment of the basis of redeemed stock when a redemption of the stock is treated as a section 301 dividend.[4]

The proposed regulations set forth a general rule that, in any case when the amount received in redemption of stock is treated as a distribution of a dividend, an amount equal to the basis of the redeemed stock is treated as a loss recognized on disposition of the stock on the date of redemption.

In response to comments that the approach of the proposed regulations was an unwarranted departure from current law and would create the potential for two levels of tax in certain transactions, the Service and Treasury have decided to withdraw the proposed regulations.

The Service and Treasury are continuing to study the approach of the proposed regulations and are interested in receiving comments on the following:

- Whether a difference should be drawn between a redemption in which the redeemed shareholder continues to have direct ownership of the stock in the redeemed corporation (whether the same class of stock as that redeemed or a different class) and a redemption in which the redeemed shareholder only constructively owns stock in the redeemed corporation;
- Whether a different approach is warranted for corporations filing consolidated income tax returns;
- Whether a different approach is warranted for section 304(a)(1) transactions;
- Whether, under section 301(c)(2), basis reduction should be limited to the basis of the shares redeemed or whether it is appropriate to reduce the basis of both the retained and redeemed shares before applying section 301(c)(3).

Sixth Circuit Overrules Tax Court Finding Payments are Loans, and not Dividends

In *Indmar Products Co., Inc. v. Commissioner*,[5] the Sixth Circuit reversed the Tax Court and determined that advances made to the company, by its majority shareholders, more closely resemble debt than equity.

Facts
The company claimed deductions for interest payments made on shareholder advances. The Commissioner issued a notice of deficiency asserting that the interest payments were nondeductible dividend distributions. The Tax Court agreed. The Sixth Circuit reviewed the Tax Court's findings for clear error, noting that the debt/equity question is one of fact.[6] In this determination, since the circuit courts have not settled on a single approach to the debt/equity question, the court considered the debt/equity factors in *Roth Steel Tube Co. v. Commissioner*, a Sixth Circuit case.[7]

Analysis
The court considered the eleven *Roth* non-exclusive factors, and noted that no single factor is controlling and that the weight of each factor depends on the facts of each case. The eleven factors include (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, of the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.

Conclusion
The Sixth Circuit reviewed the Tax Court's factual findings for "clear error" and its application of law *de novo*. Under the clear error standard, the Sixth Circuit gives deference to the Tax Court's factual findings and inferences drawn from those findings.[8] However, whether the lower court failed to consider or accord proper weight or significance to relevant evidence are questions of law reviewed *de novo*.[9] The Sixth Circuit found that the Tax Court clearly erred in concluding that the advances were equity contributions rather than bona fide debt.

The Sixth Circuit found that the Tax Court (1) failed to consider several *Roth Steel* factors, and (2) did not address, in its analysis, certain undisputed testimony and evidence stipulated by the parties.[10] Specifically, the court held eight of the eleven *Roth Steel* factors favor debt. The three remaining factors suggest the advances were equity, but the Sixth Circuit found two of the three factors – the absence of a fixed maturity date and schedule of payments and the absence of a sinking fund – deserve little weight under the facts of this case. The only factor weighing in favor of equity with any real significance – the lack of security – does not outweigh all of the other factors in favor of debt.[11]

Service Finalizes Anti-Loss Duplication Consolidated Return Regulations

Effective March 9, 2006, the Service and Treasury issued regulations finalizing Treas. Reg. §1.1502-35T.[12] The preamble indicates the Service and Treasury will publish proposed regulations that address both the circumvention of *General Utilities* repeal and the inappropriate duplication of loss in a single integrated regulation. Until those proposed regulations are published as final or temporary regulations, however, the circumvention of *General Utilities* repeal will continue to be addressed by Treas. Reg. §1.337(d)-2 and the duplication of loss will continue to be addressed by the rules of Treas. Reg. §1.1502-35T. This new regulation adopts the rules of Treas. Reg. §1.1502-35T as final regulation §1.1502-35.

These regulations are intended to prevent a consolidated group from duplicating deductions or losses within its consolidated tax return. The final regulations adopt the rules of the temporary regulations without substantive changes, but modify certain examples in the temporary regulations to reflect the enactment of section 362(e)(2). The Service states that the modifications do not change the operation of the regulations or address the application of section 362(e)(2) to transactions between members of a consolidated group.

Service Rules on an F Reorganization

In PLR 200626037,[13] the Service concluded that the transaction, in which a new corporation was formed resulting from an exchange of foreign entity stock for the new corporation's stock, to achieve foreign tax savings, qualified as a tax free reorganization under section 368(a)(1)(F). None of the participants in the stock exchanges would recognize any gain or loss under section 354(a)(1), and the basis of the assets of the foreign entity in the hands of the new corporation would remain the same. The distribution of excess cash by the foreign entity to its sole shareholder, a subsidiary, was treated as a distribution of property separate from the reorganization.

Facts
Parent, a domestic corporation, owns all of the outstanding stock of Sub 1. Sub 1 owns all of the outstanding stock of Sub 2 and an interest in Sub 3. Sub 2 owns the remaining interest in Sub 3. Sub 2 and Sub 3 are disregarded entities for U.S. federal income tax purposes. Sub 3 owns all of the outstanding stock of Oldco, a foreign entity, located in Country A. Oldco owns all of the outstanding stock of Sub 4 and Sub 5, each of which is a disregarded entity for U.S. federal income tax purposes. Sub 4 and Sub 5 own directly and indirectly the stock of numerous subsidiaries, all of which are also disregarded entities for U.S. federal income tax purposes.

Parent's principle purpose for engaging in the transaction is to change the place of incorporation of Oldco from Country A to Country B to achieve foreign tax savings.

Transaction Steps
Oldco and Management Company transferred property in exchange for Newco stock. Management Company had no rights (economic or otherwise), other than the right to vote; so Newco was considered for federal income tax purposes as having a single economic owner (Oldco) and elected disregarded entity status. On the same day, Oldco contributed the stock of Sub 5 and its subsidiaries (but retained some cash) to Newco in exchange for newly issued Newco stock. Pursuant to the same transfer, Management Company transferred its stock in Newco to Oldco. Pursuant to these transfers, Oldco became the sole owner of all of the outstanding stock of Newco. On a subsequent date, Oldco

transferred Sub 4 and its subsidiaries to Newco in exchange for additional Newco stock. Newco elected to be treated as a corporation for federal income tax purposes, and Oldco elected to be treated as a disregarded entity. Then, Oldco distributed the excess cash (retained in its prior contributions) to its sole shareholder, Sub 1.[14] Taxpayer represented that the assets distributed to Sub 1, assets used to pay expenses, and all redemptions and distributions (except for regular dividends) made by Oldco immediately preceding the transaction constituted less than one percent (1%) of the net assets of Oldco.

Conclusion

Citing Rev. Rul. 96-29; 1996-1 C.B. 50 and Treas. Reg. §1.301-1(e), the Service ruled that the proposed transaction would qualify as a section 368(a)(1)(F) reorganization, and that the distribution of excess cash would not prevent the proposed transaction from so qualifying.

Section 355 Modified

The Tax Increase Prevention and Reconciliation Act of 2005 (the Act), enacted May 17, 2006, modified section 355 by adding sections 355(b)(3) and 355(g).[15]

Active Trade or Business Test

Section 355(b)(3) modifies the active trade or business requirement for distributions made after May 17, 2006 and on or before December 31, 2010. Specifically, it suspends the "substantially all" requirement of section 355(b)(2)(A) and adds an affiliated group rule for determining if a corporation meets the remaining active trade or business requirement. [16] These changes simplify the active trade or business requirement by applying the test on an affiliated group basis, as determined under section 1504(a) if the corporation were the common parent and section 1504(b) did not apply. This simplification eliminates the issue of whether a business is owned directly or indirectly through a holding company, and diminishes the need for restructuring to meet the "substantially all" portion of the active trade or business requirement.

Disqualified Investment Corporation

Section 355(g) disallows section 355 tax-free treatment to "disqualified investment corporations". A disqualified investment corporation is defined in section 355(g)(2) as a distributing or controlled corporation if the fair market value (FMV) of the "investment assets" of the corporation is 2/3 or more the FMV of all assets of the corporation on or after May 18, 2007, and 3/4 or more of the FMV of all assets on or before May 17, 2007. Section 355(g)(2)(B) defines investment assets as cash, stock, securities, debt instruments, hedging and derivative assets, and any similar assets. The provision also discusses several liquid assets not included in the definition, and is aimed at preventing tax-free treatment to cash rich corporations attempting to spin off an entity.

Taxpayer Can Claim Loss on Intercompany Receivables

In PLR 200611032[17], the taxpayer claimed a loss on sales of its accounts receivable at a discount to its controlled, but not consolidated, subsidiary. The Service found that the transaction was within the "factoring exception" in Treas. Reg. §1.267(f)-1(f) and that the anti-avoidance rules in Treas. Reg. §§ 1.267(f)-1(h) and 1.1502-13(h) did not apply. The sale of the receivables was a closed and completed transaction under sections 165(a) and 1001 with respect to the rights that were transferred. Because the taxpayer sold only a portion of the rights in the receivables, it was appropriate and necessary to make an equitable allocation of basis based on the relative fair market value of the rights transferred and the rights retained, an allocation that would reduce the amount of loss on the sale of the receivables under section 165(b).

ENDNOTES

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

2 T.D. 9271, 71 Fed. Reg. 38074 (2006).

3 REG-143679-02, T.D. 9071, 68 Fed. Reg. 40766 (2003).

4 71 Fed. Reg. 20044 (2006), withdrawing REG-150313-01, 67 Fed. Reg. 64331 (2002).

5 444 F.3d 771 (6th Cir. 2006).

6 *Id.* at 776.

7 800 F.2d 625 (6th Cir. 1986).

8 444 F.3d 771, 777 (6th Cir. 2006).

9 *Id.* at 778.

10 *Id.* at 779.

11 *Id.* at 784.

12 T.D. 9254, 71 Fed. Reg. 13008 (2006).

13 March 24, 2006.

14 Sub 1 is considered Oldco's sole shareholder because Sub 2 and Sub 3 are disregarded entities for federal income tax purposes.

15 P.L. 109-222, §§202 and 507(a).

16 For advance ruling purposes, the Service interprets section 355(b)(2)(A)'s reference to "substantially all" of the corporation's assets as meaning at least 90% of the fair market value of a corporation's gross assets (assets undiminished by liabilities). Rev. Proc. 77-37, 1977-2 C.B. 568.

17 November 2, 2005.

STATE BAR OF TEXAS

SECTION OF TAXATION

Report — Regulations Governing Practice Before the Internal Revenue Service

June 6, 2006

I. Introduction

This report[1] provides comments to the Proposed Regulations issued by the Treasury Department and the Internal Revenue Service on February 2, 2006 (REG-122380-02) and December 20, 2004 (REG-159824-04). The report also provides comments with respect to Circular 230, Title 31 Code of Federal Regulations, Subtitle A, Part 10, revised as of June 20, 2005. The comments provided herein represent the views of the persons who have reviewed these comments and do not necessarily represent the position of the State Bar of Texas or its Section of Taxation.

Although many of the persons reviewing these comments have clients that would be affected by the federal tax principles addressed by these comments, none of the persons reviewing these comments (or the firm or organization to which such person belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

Our comments primarily relate to:

1. the revised definition of practice before the Internal Revenue Service;

2. clarifications of and additional safeguards with respect to the disciplinary procedures;

3. changes with respect to covered opinions; and

4. changes with respect to State and local bond opinions.

II. General Comments Concerning the Revised Definition of Practice Before the Internal Revenue Service

The Final Regulations adopted in December 2004 and the two sets of Proposed Regulations concerning Circular 230 use the authority provided by the American Jobs Creation Act of 2004 (the "Jobs Act") for the Internal Revenue Service (the "Service" or "IRS") to impose standards for rendering written advice on arrangements having a potential for tax avoidance or evasion. We acknowledge that certain tax professionals in the past have provided written advice with respect to transactions determined by the Service to be abusive tax shelters. We believe, however, that the proposed regulatory regime has erred on the side of over-inclusiveness — in terms of both the type of advice and the type of advisors that are covered. Thus, we believe that an unintended result of the proposed regime may be to discourage many attorneys from providing any written tax advice to clients (or avoid preferring any federal tax advice at all) — a result that we believe would not be in the best interests of taxpayers or the administration of the federal tax laws.

Section 10.2[2] of the Proposed Regulations would extend Circular 230 coverage to any attorney who renders written advice concerning an arrangement "having a potential for tax avoidance or evasion." The concept of "potential for tax avoidance" is broad, arguably extending to any deduction, credit, deferral, exemption or favorable rate sought by taxpayers under the Internal Revenue Code. Therefore, as a practical matter, a cautious lawyer who has a general practice and who does not consider himself or herself a federal tax "expert" may well shy away from giving any written advice on a federal tax matter, no matter how straightforward, simply because the lawyer does not want to address the complexity of Circular 230. Those lawyers may find the Circular 230 rules a challenge that is more daunting than the interpretation of the tax laws on which they are being asked to render advice.

A non-tax specialist practicing in a law firm without a tax department may be asked for written advice on, for example, the ability to deduct mortgage interest on a second home, the ability to take a charitable contribution for items donated to charity, or the ability to take a depreciation deduction on a rental house held as an investment property. The proposed changes to Circular 230, including the imposition of monetary penalties for violations of Circular 230, provide an incentive for the lawyer to decline to give federal tax advice in writing. The lawyer also may choose not to give oral advice on technical federal tax questions for fear the client will misunderstand the advice. That leaves the client unadvised or looking for a more expensive "tax expert." Faced with that choice, many taxpayers will decide not to obtain any tax advice. This is not a good result for taxpayers or for tax administration.

We question whether the benefits from a broad definition of tax practice are outweighed by the burdens of obtaining written federal tax advice (or perhaps any federal tax advice at all) only from tax experts. We urge Treasury to consider changes to the rules that would permit lawyers to give written advice to taxpayers who seek to avail themselves of straightforward, congressionally-intended tax benefits without requiring the lawyers to comply with complex rules governing that advice.

We recommend that Treasury narrow the proposed definition of practice before the Service to include only rendering written advice with respect to the following:

1) listed transactions or arrangements as defined in Section 10.35(a)(2)(A);

2) principal purpose transactions or arrangements defined in Section 10.35(a)(2)(B), as modified by our comments described below; and

3) significant purpose transactions or arrangements if the written advice: (i) is a marketed opinion as

> defined by Section 10.35(a)(5)(i) (without any exclusion for opt out opinions), (ii) is subject to conditions of confidentiality as defined in Section 10.35(a)(6), (iii) is subject to contractual protection as defined in Section 10.35(a)(7), or (iv) does not contain disclosure that the written advice cannot be used for the purpose of avoiding penalties.

Our proposed definition would satisfy Congressional intent while not discouraging non-tax experts from providing written advice to their clients. Under our definition, tax practitioners involved in writing tax shelters and marketed opinions (without any carve out for opt out opinions) would still be subject to discipline by the IRS. We believe this less expansive definition is in the best interests of taxpayers and the efficient administration of the tax laws.

III. Requests for Clarifications and Additional Safeguards with Respect to the Proposed Changes to the Disciplinary Procedures

The following are comments with respect to specific provisions of the Proposed Regulations.

Section 10.27. **Fees.** We applaud the removal of the provision in Section 10.27 that, while allowing contingent fee charges for amended returns or claims for refund, limited those contingency fees to cases where "the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended return or refund claim will receive substantive review by the Internal Revenue Service." It was very difficult to determine how a practitioner would know that the amended return or refund claim prepared would receive "substantive review."

Revised Section 10.27, however, tends to be overly broad by prohibiting contingent fees except for services in connection with (i) the IRS' examination of or challenge to an original return or (ii) an amended return or claim for refund filed prior to the IRS' examination of or challenge to the original return. This revision would hinder efficient administration of the tax laws. By way of example, the Proposed Regulations would prohibit a practitioner from collecting a contingent fee out of refund monies received for correcting a return of a low income taxpayer who clearly misunderstood the tax laws in preparing his or her original return. That taxpayer would not otherwise be able to afford the services provided. We recommend ameliorating this issue by amending Section 10.27(b)(1) to include a third exception, which new exception would be added and read as follows:

> A practitioner may charge a contingent fee for services rendered in preparing an amended return or claim for refund where substantial authority exists for the change to the return.

The proposed rule allows a practitioner to charge a contingent fee for services rendered in connection with examination of, or challenge to, an amended return or claim for refund, but only if the amended return or claim was filed prior to the taxpayer's receiving a written notice of examination of, or a written challenge to, the original tax return. Since contingent fees can be charged in connection with examination of an original tax return and an amended return or claim for refund, there is no compelling reason to prohibit contingent fees in connection with the examination of an amended return filed after the taxpayer receives a notice of examination of the original return. Where the taxpayer is under examination at the time the amended return or claim is filed, there is no risk that the taxpayer and the practitioner are playing the audit lottery with respect to the amended return or claim. Contingent fees do not inherently undermine a practitioner's legal judgments. It is inconsistent to allow contingent fees for a practitioner representing a taxpayer in an examination of an original return or an amended return, but to prohibit contingent fees for the preparation of an amended return by a practitioner already representing a taxpayer in connection with an ongoing examination, who then files the amended return or claim with an examiner during the course of the examination. Circular 230 should restrict the terms of engagement agreements between taxpayers and practitioners only where those terms directly impact the role of practitioners in the administration of the tax law. Otherwise, practitioners and taxpayers generally should be allowed to negotiate the terms of their relationship without undue restrictions. The prohibition on contingent fees for amended returns filed after commencement of examination of an original return is not supported by any ethical concern or standard of practice. Therefore, it appears to be designed to keep taxpayers from filing amended returns and refund claims in the course of an examination. That goal or purpose does not justify a provision under Circular 230 and ultimately undermines respect for Circular 230, since it makes Circular 230 appear to be a tool for limiting taxpayer's rights rather than a set of standards of practice for practitioners.[3]

Section 10.29. Conflicting Interests. The requirement of a written consent is more stringent than the American Bar Association model rules and the rules of a number of State bar organizations. This proposed rule is a federal pre-emption of existing bar association rules relating to conflicts of interest. We encourage Treasury not to implement a new set of rules addressing issues for which a set of well-established rules is already in place. Instead, we encourage Treasury to enforce the rules that would otherwise apply to the practitioner, if the practitioner were subject to discipline by (legal or accounting) organizations in the state in which the practitioner practices or resides. We recommend that Treasury make clear that it has the authority to discipline persons practicing before the Service using such standards.

If the expanded definition of practice before the IRS is retained, we recommend the addition of a materiality standard. Otherwise, many immaterial issues could create an unknown conflict of interest, subjecting the practitioner to possible discipline. Therefore, we recommend that the term "directly adverse" in Section 10.29(a)(1) be modified to "materially and directly adverse."

If Treasury retains its own conflict of interest rules, we recommend the deletion of the language in Section 10.29(b)(3) "confirmed in writing by the affected client" and Section 10.29(c), which requires the retention of written consents. While written consents may be a best practice, we urge Treasury not to impose a federal pre-emption of the regulation of conflicts in a manner inconsistent with existing state rules governing attorneys or accountants. This comment is particularly important if the broad definition of "practice" included in the Proposed Regulations is retained, since Section 10.29(c) would then apply to all types of written tax advice. A lawyer advising a husband and wife about simple wills, for example, would be required to disclose and obtain written and acknowledged consents to conflicts of interest between the spouses or risk sanctions under Circular 230.

Section 10.65. Charges. We recommend that the ability to file supplemental charges be limited to the examples given in the Proposed Regulation. This limitation would ensure that the supplemental charges relate to the original charges or to the proceeding itself. We are concerned that supplemental charges not be used to circumvent the requirements for instituting a proceeding under Section 10.60 or to broaden the charges without service of the evidence supporting the charges.

Section 10.71 Discovery. We recommend that the Administrative Law Judge be allowed to permit discovery by written interrogatories (limited to 30, as under the current proposal for requests for admission) and requests for documents. These means of discovery are more cost-effective than depositions upon oral examination. In addition, interrogatories and document requests are useful means of acquiring evidence and narrowing the dispute between the parties.

Section 10.71(d)(8) does not authorize discovery if the information is available "to the party seeking the discovery through another source." We recommend a clarification to make clear that the "other source" not include the IRS itself.

Section 10.72.Hearings. We applaud the Treasury Department for confirming the right to cross-examination and the right to submit evidence and for its new procedural safeguards for protecting third party information and trade secrets. We recommend adding a further provision ensuring that third parties are informed that their return information is being disclosed for limited use in a disciplinary proceeding. Third parties should be given an opportunity to protect their information under 10.72(d)(3)(h)(ii). We also recommend clarifying how a request under Internal Revenue Code § 6103(1)(4)(A) for third party information is made by respondent. Is it served on the Director of Practice of the Office of Professional Responsibility, the delegate who signs the complaint or some other person? A provision should also be added to ensure timely response to a request under Internal Revenue Code § 6103(1)(4)(A), requiring the Secretary, or his or her delegate, to disclose objections based on relevance or materiality. If the third party return information is withheld or not timely provided, the respondent should be given an opportunity to resolve such discovery disputes with the Administrative Law Judge.

Further, Section 10.72(d)(1) does not specify when the pleadings, evidence, reports and decisions of the Administrative Law Judge are to be made public. We believe it could harm practitioners and the tax system if public disclosure is made immediately upon filing of the complaint and recommend proceedings not be made public unless there is a ruling by the Administrative Law Judge that sanctions are warranted. In the alternative, publication just prior to a hearing or at time of an agreed sanction or a default may be appropriate. This would allow a practitioner relieved of sanctions to have his or her reputation restored shortly after the proceedings are made public. In addition, avoiding immediate publicity would allow the Administrative Law Judge an opportunity to issue necessary protective orders to ensure the provisions of Internal Revenue Code § 6103(1)(4)(A) and (B) are followed and sensitive third party information is protected from public disclosure.

Finally, we recommend adding a time deadline, such as 10 days before the hearing, for the filing of the Section 10.72(c) prehearing memorandum. Likewise, we recommend that a provision be added to Section 10.72(c) to allow parties an opportunity to respond to the prehearing memoranda.

Section 10.76. Decision of Administrative Law Judge. We recommend that the standard of proof set forth in Section 10.76(b) be the same in all cases, *i.e.*, clear and convincing evidence. A lower standard of proof should not be applied in any case in which any suspension may result, given the seriousness of that penalty. In addition, a lower standard of proof in any case may indirectly encourage the pursuit of borderline cases, which is not in the best interests of the Service or practitioners.

We recommend that Section 10.76(c) be amended to require that a copy of the decision of the Administrative Law Judge be sent to the Secretary or his delegate. The Secretary or his delegate would then obtain the decisions as a matter of course, allowing an informed decision regarding whether to file a petition for review under Section 10.77.

Section 10.77. Petition for Review of Administrative Law Judge. The Proposed Regulations state that a final decision of the agency made by the Secretary is required before judicial review can be obtained. However, the Proposed Regulations are silent as to how to obtain judicial review. We recommend that the regulations state that a practitioner may obtain judicial review of the final decision of the agency — whether a censure, suspension, disbarment, or monetary sanction — under the Administrative Procedures Act (5 U.S.C. §§ 701-706), which requires substantial evidence to support the agency's decision.

IV. <u>Request for Changes with Respect to Covered Opinions</u>

A primary purpose for the rules in Section 10.35 appears to be to regulate the form or content of opinions used by taxpayers to avoid tax penalties. A number of commentators have called for a new approach to the rules contained in Section 10.35.[4] We applaud the Service's efforts to prescribe rules with respect to listed transactions because of the overriding need for taxpayers to understand the risks associated with listed transactions. We recommend, however, that a new standard be substituted for the uncertain "principal purpose" standard in the determination of whether a written opinion is a covered opinion. We propose that the standard be unique to Circular 230 and not be tied to terms of art used in other procedural or substantive tax law provisions. Our recommendation is for the Service to periodically identify transactions or arrangements in lieu of the language in Section 10.35(a)(2)(B) tied to principal purpose transactions. This list of transactions or arrangements would clearly signal to non-tax experts and tax experts that providing written guidance concerning the listed topics constitutes practice before the Service and the necessity of providing an opinion which satisfies the requirements of Section 10.35 of Circular 230. We believe that maintenance of such a list by the Service is an effective means of providing the clarity that tax advisors need in conforming their actions to the requirements of Circular 230.

A taxpayer may be interested in an abbreviated analysis of possible tax issues before deciding to go forward with a proposed transaction. Alternatively, a taxpayer may not want to incur the expense of obtaining a written opinion. We recommend that taxpayers be allowed to opt out of the covered opinion requirements, except for transactions or arrangements identified by the Service as indicated in Section 10.35(a)(2)(A) and our proposed change to Section 10.35(a)(2)(B).

If our proposed definition of practice before the IRS is accepted, any written advice provided by a tax practitioner with respect to marketed opinions would remain subject to the requirements of Section 10.37. Attorneys and accountants rendering reliance opinions with an opt out legend would still be held to the standards of practice of their respective professions. Attorneys and certified public accountants would also remain subject to malpractice claims if they do not properly advise their clients of the risks involved with a particular transaction. We believe these safeguards will adequately protect the tax system.

The current opt out mechanism in Section 10.35 appears to work well in the marketplace for legal services. Clients decide if they want to incur the time and expense of obtaining a written opinion that meets the requirements for a covered opinion. We recommend, however, that Circular 230 provide specific safe harbor language for opting out of the Section 10.35 requirements for covered opinions.

V. Requests for Changes with Respect to State and Local Bond Opinions

The Proposed Regulations issued in December 2004 require that a practitioner who provides a State or local bond opinion comply with the requirements of Proposed Section 10.39 as opposed to the requirements of Section 10.35 of Circular 230. Section 10.39 of the Proposed Regulations requires separate written advice that essentially meets the requirements for covered opinions in Section 10.35.

We applaud Treasury's efforts to accommodate the concerns of the market place by creating a special rule (Section 10.39) for State or local bond opinions. However, as under the general rules that apply to covered opinions, we believe that an opt out provision should be added to Section 10.39. The issuers of State and local bonds and the purchasers of the bonds should use the market place to determine whether to deliver an opinion that complies with the requirements of Section 10.39 or whether to place a disclosure legend on the tax opinion. The same safe harbor disclosure legend should apply for purposes of both Sections 10.35 and 10.39. Again, the taxpayer should be the one to decide whether to incur the time and expense of complying with the additional writing requirements of Section 10.39.

An opt out provision would also resolve many ancillary issues surrounding State and local bond opinions. Issuers and conduit borrowers frequently ask compliance questions after the State and local bonds are issued. An opt out provision will allow these entities to continue to receive tax advice on an affordable basis and thus enhance tax compliance. Such post-issuance advice typically is not considered a reliance opinion or a marketed opinion under Section 10.35. We have been unable to identify any reason to impose a greater burden upon such advice for State and local bond opinions than for other significant purpose transactions.

Section 10.39 requires that the separate written advice be included in the transcript of proceedings. That raises a number of attorney-client privilege concerns under applicable State rules. Written advice is frequently provided to entities other than the bondholder. For example, written tax advice is routinely provided to bond issuers, conduit borrowers, bond trustees, and managers of bond financed property. An opt out provision will permit written tax advice to be provided at the least possible cost and will result in the nondisclosure of confidential information that would otherwise be disclosed under Section 10.39.

VI. Conclusion

We applaud Treasury's effort to revise Circular 230 to address the standard of tax practice. However, we urge the Treasury not to prescribe standards that discourage affordable written tax advice. Voluntary tax compliance is the cornerstone of the efficient administration of our federal tax laws and the ability of the practitioner to communicate effectively with his or her client is an important part of voluntary tax compliance.

We recommend that Treasury not implement a new set of conflict of interest rules for which a set of well-established rules is already in place. Instead, we encourage Treasury to enforce those rules. We also recommend that the current proposals be revised to provide additional safeguards with respect to disciplinary procedures.

The standards of practice should be a model of clarity in order to promote compliance and avoid unintentional violations. Therefore, we recommend that the Service periodically publish a list of transactions that are considered "principal purpose" transactions for which a taxpayer may not opt out of the covered opinion requirements of Section

Lastly, we recommend that an opt out provision be added to the special rule (Section 10.39) for State or local bond opinions. That would provide consistent treatment for all marketed opinions and allow taxpayers to determine the type and cost of written advice they seek.

ENDNOTES

1 This report was prepared by members of the Section of Taxation of the State Bar of Texas. The principal drafters were Bob Griffo, Charles Almond, Elizabeth Copeland, H. James Howard, and Mary McNulty. Helpful comments were received from a task force selected by the Section of Taxation to advise on this project, comprised of Gregg Jones and Emily Parker. The Committee on Government Submissions of the Section of Taxation of the State Bar of Texas, which consists of Emily Parker, Vester Hughes, Steve Salch, Stanley Blend, and Patrick O'Daniel, has approved this report.

2 All references to Sections are to current or proposed sections of Circular 230.

3 If the goal is to prevent delays in closing audits, the better course is to simply close the audit and let the refund claim be processed in the normal course. If the refund claim is not processed in six months, then the taxpayer would have the right to sue to recover, and the IRS can generally moot the matter by paying if it finds the claim is meritorious.

4 *See e.g.* Deborah H. Schenk, "The Circular 230 Amendments: Time to Throw Them Out and Start Over," Tax Notes, March 20, 2006.

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