THE TEXAS TAX LAWYER

February 2009
Vol. 36, No.2
www.texastaxsection.org

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CHAIR'S MESSAGE

February 13, 2009

Dear Tax Section Member,

Thank you again for your membership in and support of the Tax Section of the State Bar of Texas.

As you may recall, we have published this newsletter in both electronic and magazine formats for the past year. This edition is the first edition of ***The Texas Tax Lawyer*** that will be published in electronic form only.

As you know, ***The Texas Tax Lawyer*** is published three times a year, in February, May, and October. An email with a link to the electronic version of ***The Texas Tax Lawyer*** will be sent to everyone on the Tax Section's mailing list when a new edition is published. In addition, new editions (as well as past issues) of ***The Texas Tax Lawyer*** will always be available on our Section website (www.texastaxsection.org) by the end of the month of publication.

The change to the electronic-only format will save our Section approximately $12,000 per year in printing and postage costs, and this change is part of an overall plan to greatly increase and expand Section Member benefits. The cost savings will be used to help cover the cost of upgrading our website and creating an on-line audio/ video CLE library for Section Members. I will send a message to you in the next few weeks describing these exciting new benefits for Section Members.

While we have the email addresses of the overwhelming majority of our Section Members, we do not have the current email addresses of some of our members. We are sending letters to those members, advising them of the changes, and asking them to go to the State Bar website (i.e., the "Big Bar" website: www.texasbar.com) and provide their current email addresses. We know that we do have some members who are not computer savvy. Accordingly, the letter will also state that if anyone prefers to receive a hard copy of the newsletter, we will print one (on a regular office printer) and mail it to them whenever a new edition is published.

Finally, I cannot thank our Newsletter Editor, Alyson Outenreath, enough for the outstanding work she does year in and year out in editing and publishing a first-rate tax newsletter and for leading us in the transition of ***The Texas Tax Lawyer*** to the electronic-only format. The role of Newsletter Editor is an extraordinarily difficult and time intensive job, and Alyson always delivers an excellent product.

Please contact me if you have any questions or comments or if you would like to become more involved in our Tax Section activities.

Warmest regards,

Daniel J. Micciche, Chair
Section of Taxation
State Bar of Texas

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State Bar of Texas
Tax Section

February 5, 2009

MESSAGE FROM THE CHAIR

It is with great sadness that I announce the death of a true legend in the tax bar, Don Alexander. Don died Monday night after a hard-fought battle with cancer. He was 87.

Don was a great friend of the Texas tax bar. His mind was razor sharp to the end, and he was actively engaged in the practice of tax law as of a few weeks ago. Many of you will remember that Don, though in his 80s and barely able to walk with a cane, came to Texas to speak to us several times in recent years.

An honors graduate of both Yale and Harvard Law and a devoted alumnus of both institutions, Don is perhaps best known for his many years of public service. He served as Commissioner of the Internal Revenue Service during the 1970s. The integrity he demonstrated during his tenure as Commissioner was a great service not only to tax administration but to the country at large. He also served on the Commission on Federal Paperwork, on the Interior Department's Coal Leasing Commission, as director of the U.S. Chamber of Commerce, as chairman of the Internal Revenue Service Exempt Organizations Advisory Group and as a commissioner of the Martin Luther King Jr. Federal Holiday Commission. He served during World War II with the 14th Armored Division and was awarded the Silver Star and the Bronze Star for his valor and bravery.

Don was a partner at Akin Gump, and I had the privilege to work with him for many years. Decades after he served as Commissioner, it was evident that Don still had the respect and admiration of the Service. I can recall one time when I was handling an audit matter for one of Don's client's, the audit manager, after seeing Don's name on the protest letter, asked, "is that our Don Alexander?" But Don was always a forceful advocate for his clients. In another case, when the Service cited a recently decided Tax Court case for support, Don sent away for the Tax Court file. To undercut the precedential value of the case, Don wrote that "neither the Service, with its battery of three lawyers, nor the two Mexican nationals, who did not have a lawyer and could not speak English, cited the relevant authority to the court." And nothing stopped Don. In one case, we had a filing deadline of September 12, 2001. We finished it on September 11.

Don was also known for his kindness and respect towards all of his colleagues. He will be terribly missed.

- Dan Micciche

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SAN ANTONIO LAWYER ELIZABETH COPELAND

RECEIVES NATIONAL PRO BONO AWARD

FROM AMERICAN BAR ASSOCIATION TAX SECTION

WASHINGTON, D.C., Jan. 6, 2009 -- The American Bar Association Section of Taxation will present its annual Janet Spragens Pro Bono Award to San Antonio lawyer Elizabeth Copeland during a luncheon Jan 10 at the section's 2009 Midyear Meeting in New Orleans. Copeland is a shareholder in the San Antonio firm Oppenheimer Blend Harrison & Tate, Inc.

The Janet Spragens Pro Bono Award, named after the late American University Law professor who greatly contributed to ensuring representation for low-income taxpayers, is presented each year to an individual lawyer or law firm that has demonstrated outstanding and sustained commitment to *pro bono* (free) legal services, particularly with respect to federal and state tax law.

"Elizabeth Copeland sets the standard for *pro bono* work in the tax area," said William J. Wilkins, section chair. "She saw a need to assist unrepresented taxpayers in U.S. Tax Court, and single-handedly set up a program to do just that," he said. "Her work in Texas is a model for other states to replicate, and is a testament to her commitment and dedication to helping taxpayers," said Wilkins.

Copeland established the first state-wide Tax Court Pro Bono Program in Texas. The program encourages lawyers to offer *pro bono* consultation services to unrepresented, or *pro se*, taxpayers at calendar calls. Working with the U.S. Tax Court, Copeland set up programs in each of the Texas cities in which the court sits, and oversees the volunteer participation at each location. Lawyer volunteers mediate disputes between the IRS and Tax Court petitioners.

Copeland has been active in the ABA Tax Section's Pro Bono Committee, and has chaired the Low Income Taxpayer Committee's Tax Court Subcommittee. She is vice chair to the Committee on Appointments to the Tax Court and a member of the section's Court Procedure and Practice Committee. Copeland is a council member of the State Bar of Texas and chairs its Tax Section Pro Bono Committee. She is also active in the San Antonio Bar Association and the Bexar County Women's Bar Association.

Copeland was recognized in *The Best Lawyers in America 2009*, and named a "Texas Super Lawyer" in the area of tax law by *Texas Monthly* and *Law & Politics* magazines. She also received mention as one of San Antonio's Best Tax Law Attorneys in *Scene in SA* magazine.

"Many *pro se* petitioners in the Tax Court are unfamiliar with Court procedures," said Chief Judge John Colvin of the U.S. Tax Court. The Tax Court through its recognition provisions has actively encouraged clinical and *pro bono* programs to assist *pro se* petitioners. "The Texas program that Elizabeth developed is a wonderful success story," he said. "Petitioners who have few if any alternatives get useful advice and support in navigating the process, and lawyers who participate are able to provide meaningful *pro bono* assistance," said Chief Judge Colvin. The ABA Tax Section is assisting interested state and local bar associations in setting up programs similar to the one in Texas.

The ABA Section of Taxation Pro Bono Award was initiated in 2002 at the recommendation of the section's Special Pro Bono Task Force. Its name was changed to the Janet Spragens Pro Bono Award in 2007. For more information about the Midyear Meeting, visit the ABA Section of Taxation Web site, http://meetings.abanet.org/meeting/tax/MID09/.

The American Bar Association Section of Taxation is the largest professional association of tax lawyers, with approximately 21,000 members nationwide. Its goals include helping taxpayers better understand their rights and obligations under the tax laws and working to achieve a simplified tax system that is equitable and efficient.

With more than 400,000 members, the American Bar Association is the largest voluntary professional membership organization in the world. As the national voice of the legal profession, the ABA works to improve the administration of justice, promotes programs that assist lawyers and judges in their work, accredits law schools, provides continuing legal education, and works to build public understanding around the world of the importance of the rule of law.

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State Bar of Texas
Tax Section

Annual Law Student Tax Paper Competition

Eligibility: J.D. and LL.M. law students attending Texas law schools

Awards: First Place - $1,000 and plaque

Additional Awards for Second Place and Third Place at Judges' Discretion

Subject: Any federal or state tax topic

Entry Deadline: ***June 15th***

Competition Rules:

Eligible Students: All J.D. and LL.M. degree candidates attending accredited Texas law schools either on a part-time or a full-time basis at the time the paper was written

Awards: *First Place - $1,000 cash prize and plaque*

Additional cash prize of $750 for Second Place and $500 for Third Place may be made in the sole discretion of the Judges if the number of entries and the quality of the papers merit additional awards

Paper Topic: Any federal or state tax topic (including topics relating to tax practice ethical and professional standards)

Eligible Papers:

a. Paper must be sponsored by a law school faculty member (limit of 6 papers per sponsor per competition)

b. Only one paper per student

c. Paper may be submitted for publication in law reviews or law journals; provided the version submitted to the competition does not reflect any changes made to the paper after submission of the manuscript for publication. Paper may not be the work product of employment or an internship (e.g. briefs, legal memoranda, opinion letters, etc.).

d. Paper must be written after May 15th of the year prior to the year of submission

e. Paper may not be longer than fifty pages (on 8 ½ by 11 inch paper, double spaced, twelve point font, and one inch margins on all sides) including footnotes, endnotes and exhibits. Footnotes and endnotes may be single spaced. Footnotes (rather than endnotes) are preferred, but not required.

f. Title of paper (or abbreviated title) and page number must appear on each page of the paper

Submission:

a. All entries must be received ***after*** January 15th and ***before*** June 16th

b. All entries must be submitted electronically as attachments to an e-mail message sent to dmicciche@akingump.com with the subject line "LAW STUDENT TAX PAPER COMPETITION" (in all caps).

c. The e-mail must attach the following documents:

   i. Information Sheet prepared by the entrant in Adobe Acrobat pdf format with the following Information:

      A. Title of the paper

      B. Name of Student, Law School and Class, Address, Phone Number, and E-Mail Address (please include current and summer contact information)

      C. Name of Faculty Sponsor, Address, Phone Number, and E-Mail Address

   ii Paper in Microsoft Word or other word processing format

   iii. Paper in Adobe Acrobat pdf format

d. Paper must contain a title but should not contain any information which identifies the author, law school, or faculty sponsor

e. Within 5 days of receipt of the submission a confirmation of receipt of the entry will be sent to the entrant and faculty sponsor by e-mail with the information sheet as an attachment

Judging: Papers will be evaluated, and prizes awarded, at the sole discretion of a panel of Tax Section members who will have no knowledge of the author, law school, or sponsor of the papers

Evaluation Criteria without specific weighting:

a. legal analysis
b. legal research
c. organization and writing style
d. originality and relevance of topic to current tax matters

Notification: Winners will be notified no sooner than July 15th and an e-mail will be sent to all entrants shortly after the winners are notified

Publication in *The Texas Tax Lawyer*: The author retains all ownership rights with respect to their work submitted to the competition; however, all top entries will be considered for publication in *The Texas Tax Lawyer* and for posting on the Tax Section website.

Publicity: The names of the winning entrants and their sponsors will be listed on the Tax Section website and may be included in e-mails sent by the Tax Section to Section Members.

Questions: Any questions regarding the competition should be sent by e-mail to dmicciche@akingump.com with the subject line "LAW STUDENT TAX PAPER COMPETITION" (in all caps).

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THE TEXAS TAX LAWYER WILL BE PUBLISHED IN ELECTRONIC FORM ONLY BEGINNING WITH THE FEBRUARY 2009 ISSUE

- **DISTRIBUTION WILL BE MADE VIA EMAIL TO THE EMAIL ADDRESS WE HAVE ON FILE FOR YOU**
- **TO UPDATE YOUR EMAIL ADDRESS, PLEASE GO TO: (www.texasbar.com) and click first on "my profile" and then on "update my profile"**
- **THE TEXAS TAX LAWYER WILL ALSO ALWAYS BE AVAILABLE ON OUR WEBSITE (www.texastaxsection.org)**

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If any Member desires to receive a hard copy format of the Texas Tax Lawyer, such request can be made to the Publications Editor

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SHOULD TEXAS PROPERTY TAX INCENTIVES BE PILOT-LESS?

Renn Neilson, Matt Larsen, and Matt Hunsaker[1]

Texas has adopted a variety of property tax incentive programs allowing local taxing jurisdictions to attract capital investment by reducing property tax burdens on investment. In certain of these incentive programs, it has become standard practice for investors to agree to pay taxing jurisdictions a percentage of their tax savings under the programs as a "payment in lieu of taxation" (hereinafter, a "**PILOT**"). This article reviews PILOTs' role in the development of one of Texas' most important property tax incentive programs - the limitation of a large-scale project's appraised value for school district property tax purposes under Texas Tax Code Chapter 313 ("**Chapter 313**").[2] As applied to Chapter 313, the article discusses the legal basis for PILOTs, policy concerns that have been raised regarding PILOTs, and potential remedies for these policy concerns.

Importantly, this article attempts to separate the evaluation of PILOTs under Chapter 313 from an evaluation of the merits of Chapter 313 itself. Disagreements with the objectives and application of Chapter 313 as a whole can manifest themselves as concerns with PILOTs. In other words, opponents of the incentive program authorized by Chapter 313 might argue that PILOTs are bad policy because they make undesirable incentive agreements more attractive for local taxing authorities. If Chapter 313 itself is bad policy, the appropriate response should be to repeal Chapter 313 rather than to prohibit the use of PILOTs under Chapter 313. In order for the impact of PILOTs on Chapter 313 to be properly isolated and evaluated, it is necessary to assume that Chapter 313 carries out the Texas Legislature's objectives and that the use of Chapter 313 will continue to be promoted as good public policy. Given the objectives expressed by the Legislature in Chapter 313, this article attempts to determine whether Texas law allows PILOTs as a means to achieve those objectives and, if so, whether there is a compelling policy reason to prohibit them.

I. Overview of Chapter 313

Chapter 313 was enacted in 2001 in response to a legislative determination that Texas' high property taxes, the majority of which are imposed by school districts, hamper its ability to attract capital-intensive business. Chapter 313's implementing language reflects the Legislature's concern that "the current property tax system of this state does not favor capital-intensive businesses such as manufacturers."[3] Capital-intensive businesses are particularly sensitive to property taxes because (1) property taxes are imposed regardless of start-up losses, and (2) property values, upon which the taxes are based, are usually highest during start-up periods when assets are newly-acquired and have not been significantly depreciated. The Legislature enacted Chapter 313 to encourage large-scale capital investment, to create high-paying jobs, and to provide "school districts with an effective local economic development option."[4]

Chapter 313 allows school districts to attract new investment by limiting the appraised value of an investor's qualified property used for an eligible purpose (*e.g.*, manufacturing, alternative energy) for a ten-year period.[5] Chapter 313 requires investors and school districts to detail terms of their arrangements in written agreements (a "**313 Agreement**").[6] To be eligible for a cap on appraised value, investors must take several steps. First, they must file an application with a school district.[7] The Comptroller reviews the application and makes a nonbinding recommendation to the school district.[8] If the school district approves the application, the investor must make a minimum qualified investment within the first two years of the 313 agreement.[9] Qualified investment includes certain types of statutorily enumerated property.[10] The amount of the minimum qualified investment is tied to total property values in the district.[11] Investors locating in high-value school districts must make greater qualified investments than investors locating in low-value school districts. In addition, Chapter 313 significantly lowers the required minimum qualified investment for investors locating in rural districts.[12] Minimum qualified investments range from $100 million to $1 million.[13]

In addition, to the minimum qualified investment requirement, investors must also agree to create 25 new jobs.[14] Eighty percent of all new jobs created must meet certain qualifying standards (*e.g.*, pay rate, benefits, etc.)[15] Investors locating in rural school districts only have to create 10 new jobs; however, 80 percent of all new jobs must still meet qualifying standards.[16] School districts have some discretion to waive the jobs requirement in limited situations.[17]

If an investor meets these requirements, it is entitled to receive a limitation on the appraised value of its qualified property located in the reinvestment zone.[18] Qualified property is defined expansively and includes most land, improvements, and related tangible personal property.[19]

Chapter 313 has been widely used over the last five years. As of June 2008, school districts have entered into 90 313 Agreements.[20] Total investment under these 313 Agreements is estimated to be $41 billion.[21] Investors receiving 313 Agreements estimate creating 5,590 new jobs.[22]

II. Use of PILOTs in 313 Agreements

It has become standard practice for a 313 Agreement to include provisions requiring the investor to share a portion of its tax savings with the school district, generally in the form of a PILOT. Of the 90 313 Agreements executed to date, 71 require investors to make PILOTs equal to a percentage of their tax savings resulting from the agreement.[23] Fifty-four of these 71 agreements require 40-percent of the tax savings to be shared with the local school district.[24] Share percentages range from 15 percent to 50 percent, and average approximately 40 percent.[25] Of the remaining 19 agreements, thirteen require either fixed cash payments, or fixed cash payments and a share of tax savings; three do not require PILOTs, and three are unknown.[26]

These statistics indicate that, with few exceptions, school districts are unwilling to enter into 313 Agreements unless investors agree to make PILOTs. School districts have executed only three 313 Agreements without some form of PILOT.

The following discussion explains why PILOT payments are so prevalent among parties participating in Chapter 313 incentives. Even if a new investment provides a clear benefit for the community at large, the beneficial revenue impact to the participating school district of this new investment is typically blunted both by the appraised value cap imposed by Chapter 313 and by Texas' school finance system. Accordingly, as described below, there is a strong economic incentive for a school district to require a PILOT payment before participating in a 313 Agreement.

The limitation on appraised value of a Chapter 313 investment for district property tax purposes limits the amount of maintenance and operations ("**M&O**") tax revenue a school district can collect during the term of a 313 Agreement. In large urban school districts, this appraised value limit can be as high as $100 million, but the cap is as low as $1 million for some small rural school districts. In most cases, projects will have a market value that significantly exceeds the Chapter 313 value limit. Accordingly, without a PILOT, it is unlikely that a district's incentive to enter into a 313 Agreement will be proportionate to the actual value of the project to the school district.

Although under 313 Agreements, school districts are limited to collecting M&O tax on the capped value of investors' qualified property, 313 Agreements do not prevent school districts from collecting interest and sinking fund tax on the full value of investors' property. In other words, school districts that attract new investment with 313 Agreements can use the increased tax base - at full value - to collect taxes used to pay down debt.

The impact of Texas school finance law is even greater than that of the Chapter 313 value cap in reducing a district's incentive to attract a large capital project under Chapter 313. Since the enactment of Chapter 313, Texas school finance law has, in most cases, operated to reduce State school finance aid to school districts experiencing increased district property values. This reduction in school finance aid has, in many cases, offset a significant portion of the benefit school districts could have received from increased tax collections on increased property values.[27]

This reduction of what would otherwise be a benefit from increased property values has been particularly significant since 2006, when Texas enacted new "target revenue provisions" in its school finance law.[28] In general, these provisions entitle school districts to receive a target amount of revenue based on the school districts' weighted average daily attendance, regardless of district property value or tax collections. If a school district does not generate sufficient tax revenue to meet its target, Texas will make up the difference with a "hold harmless" payment.[29] Conversely, if a school district generates revenue in excess of its target, Texas will recapture, or "claw back" the excess.[30] As a result, adding additional taxable property to a district will not generally increase the district's revenue.[31]

If additional property value from a major capital investment does not materially benefit a district's revenue, the district may be inclined to pass on entering into a 313 Agreement that would otherwise significantly benefit the locality in general. A district may see disincentives to attracting new investment and/or entering into 313 Agreements. For example, school districts may hesitate to attract new investment when it would lead to an influx of students. Increased attendance, particularly in small rural school districts, may necessitate infrastructure improvements and operational changes that marginal increases in target revenue do not offset, as well as creating uncompensated logistical problems.

Negotiating and approving a 313 Agreement may be another disincentive to a district. 313 Agreements can be complicated - they require hiring outside advisors and investing internal administrative time. Public hearings must be held, reinvestment zones designated, and the Comptroller must be involved to approve the application.

Finally, for reasons beyond the scope of this article, the interaction of a 313 Agreement with school finance law may cause a district to experience revenue shortfalls during certain years over the life of the agreement. 313 Agreements will typically require investors to agree to indemnify school districts against such shortfalls, but school districts must take on some risk in predicting when these shortfalls will occur and relying upon investors' indemnities.

In the absence of PILOTs, Chapter 313 projects are likely to benefit local communities, other local taxing jurisdictions, and Texas as a whole, but leave the local school board with little direct benefit to show for its efforts. School districts, however, operate as gatekeepers to Chapter 313.[32] Accordingly, eliminating PILOTs for school districts may eliminate the viability of Chapter 313 in all but rare cases.

III. Legal Basis for PILOTs in 313 Agreements

Nothing in Chapter 313 prohibits PILOTs. On the other hand, Chapter 313 does not explicitly require investors to make PILOTs. Certain language in Chapter 313, however, provides a statutory basis for investors and school districts to agree to PILOTs. Section 313.027(f)(1) provides that 313 Agreements must "to the extent necessary, include provisions for the protection of future school district revenues through the adjustment of the minimum valuations, the payment of revenue offsets, and other mechanisms agreed to by the property owner and the school district."

General statutory construction principles argue in favor of interpreting § 313.027(f)(1), and Chapter 313 in general, to allow PILOTs. Texas' Code Construction Act provides that in construing a statute, whether or not the statute is considered ambiguous on its face, a court may consider, among other matters, the following:

(1) object sought to be attained;

(2) circumstances under which the statute was enacted;

(3) legislative history;

(4) common law or former statutory provisions, including laws on the same or similar subjects;

(5) consequences of a particular construction;

(6) administrative construction of the statute; and

(7 title (caption), preamble, and emergency provision.[33]

With respect to the object to be attained, the Legislature enacted Chapter 313 to attract investment in Texas.[34] As explained above, without PILOTs, school districts probably would not use Chapter 313, frustrating the Legislature's object in enacting these incentive provisions.

Section 313.027(f)'s direction to "protect future school district revenues through . . . the payment of revenue offsets, and other mechanisms agreed to by the property owner and the school district" appears to afford investors and school districts significant flexibility in structuring mutually agreeable financial arrangements. The phrase "payment of revenue offsets" is commonly viewed as requiring investors to indemnify school districts against revenue shortfalls discussed in Section II, above, but the phrase "and other mechanisms" contemplates that the parties to a 313 Agreement may agree to more than an indemnification against shortfalls. This flexibility is consistent with the Legislature's intent that "economic development decisions should occur at the local level . . ."[35]

Perhaps most importantly, PILOTs provide a direct mechanism for transferring revenue from a capital investment to the district. The ultimate legislative objective behind attracting capital investment is the revenue that such investment brings to the locality that attracts it. Having enacted Chapter 313 to spur local economic development, it seems reasonable to assume that the Legislature would view any element of the program that returns revenue to the locality as directly furthering its objectives. Said another way, having decided to provide tax benefits to entice an investor to locate in Texas, the Legislature would almost certainly view the return of a portion of those tax benefits to the Texas locality that successfully attracted the investment in the form of a PILOT as a good result.

With respect to laws on the same or similar subjects, fourteen years before enacting Chapter 313, the Legislature enacted a similar tax incentive program for municipalities and counties - the Property Redevelopment and Tax Abatement Act, codified as Texas Tax Code Chapter 312 ("**Chapter 312**").[36] Chapter 312 allows Texas counties and municipalities to attract investment by abating investors' property taxes for up to ten years.[37] Although Chapter 312 does not explicitly authorize PILOTs, during the fourteen years in which Chapter 312 was in effect before the Legislature enacted Chapter 313, taxing jurisdictions routinely required investors to make PILOTs under their Chapter 312 agreements. When the Legislature enacted Chapter 313, it was aware that taxing jurisdictions required PILOTs under Chapter 312. If the Legislature disapproved of this practice, it would have explicitly prohibited PILOTs in Chapter 313.

With respect to the consequences of a particular construction, as discussed above, interpreting Chapter 313 to prohibit PILOTs would probably prevent Chapter 313 from being used on all but rare occasions. A statutory construction should not be adopted that would render a statute meaningless.[38] Interpreting Chapter 313 in a way that precludes school districts from using it would make Chapter 313 meaningless.

With respect to the administrative construction of the statute, the Comptroller, in her statutorily-required biennial report on Chapter 313, includes significant information about PILOTs and indicates that prospectively school districts and businesses should be required to report PILOTs. By recommending PILOT reporting rules, the Comptroller appears to have concluded that Chapter 313 authorizes PILOTs, or at least that there is no statutory basis for precluding them.

IV. Policy Concerns and Solutions

Three primary policy concerns have been raised regarding the use of PILOTs in 313 Agreements: (a) transparency; (b) reduced investment incentive and (c) occasional inequities in school district revenues.

A. Transparency

Some have expressed concern that PILOTs are secret "side deals." Such concerns appear to reflect the perception that because PILOTs are not regulated in detail by Chapter 313, the terms and conditions of PILOTs are covered outside of 313 Agreements and are not subject to the same public disclosure and regulatory oversight to which other elements of a 313 Agreement are subject.

The perception that PILOTs are shadowy side deals to 313 Agreements does not appear to be supported by the facts. The terms and conditions of PILOTs have consistently been included in 313 Agreements. In fact, investors and school districts have commonly dedicated the bulk of 313 Agreements to addressing PILOTs, revenue shortfall make-ups, and other § 313.027(f)(1) provisions related to the investor's compensation of the district. Many 313 Agreements are entitled "Texas Economic Development Act Participation Agreement" - the title itself advertising that the school district will share in tax benefits.

Because the terms of a PILOT are included in the 313 Agreement, a PILOT is subject to the same public disclosure and regulatory oversight as are other 313 Agreement provisions. School districts conduct public hearings to decide whether to accept Chapter 313 applications and to seek public input on proposed 313 Agreement provisions, including PILOTs.[39] To memorialize this, 313 Agreements commonly include the following recital:

> Whereas, on [ ], the Board of Trustees has conducted a public hearing on the application, at which it has solicited input into its deliberations on the application from all interested parties within the District.

Once adopted, 313 Agreements are public information - interested parties can and regularly do obtain copies from school districts. In addition, Chapter 313 requires the Texas Comptroller of Public Accounts to prepare a biennial report for the Legislature regarding the progress of 313 Agreements.[40] Recipients of 313 Agreements must promptly submit to the Comptroller information required to complete this report.[41] On January 12, 2009, the Comptroller submitted her *Report of the Texas Economic Development Act* to the Legislature. Among other information, the Report provides a table summarizing PILOT computation provisions in each 313 Agreement, and estimating each agreement's PILOT amounts.[42] The Report both (i) illustrates that information about individual PILOTs is readily obtainable by the public and (ii) promotes additional transparency by collecting and summarizing PILOT data for those interested in an aggregate view of Chapter 313 PILOTs.

The Report also makes several recommendations that could further increase transparency. It recommends that the Legislature adopt noncompliance penalties for failure to provide information to the Comptroller as required by statute. In addition, the Report recommends that the Legislature consider requiring investors and school districts to report all transactions associated with their 313 Agreements, including amendments, assignments and PILOTs. Previously, the Legislature did not require school districts and businesses to provide this information to the Comptroller. If implemented, these recommendations should further reduce concerns about the transparency of 313 Agreements.

B. Reduction in Benefits to Investors

PILOTs reduce investors' benefits from 313 Agreements. Therefore, if school districts become too aggressive in their PILOT demands, investors may not receive sufficient benefits from 313 Agreements to justify investing in Texas. Discouraging investment by dampening Chapter 313 benefits would thwart the Legislature's purpose in enacting Chapter 313.

Although excessive PILOTs might well have a chilling effect on 313 Agreements, the fact that Chapter 313 has been so widely used suggests that market forces have largely addressed this concern. The statistics cited in Section II suggest that most 313 Agreement PILOTs fall within a certain fairly narrow benefit percentage range. In many cases, where a project is capable of location in one of multiple Texas localities, school districts effectively compete with each other to attract investment and related PILOT revenue. School districts that demand exorbitant PILOTs thereby risk not receiving any PILOTs at all. A PILOT is not the only element of Chapter 313 about which a district must make an economic decision and which is potentially subject to market forces - districts have discretion in adjusting value limit amounts above the minimum amounts, and have the ability to adjust certain minimum jobs requirements.[43] In any event, if the proposed solution to excessive PILOTs is the prohibition of PILOTs, Chapter 313's purposes would seem better served by occasionally losing investors due to excessive PILOTs than by rendering most 313 Agreements unappealing to districts by prohibiting PILOTs.

Although market forces seem to have generally resolved concerns over excessive PILOTs, the Legislature might address any lingering concern by adopting a cap on PILOTs. This cap could be a percentage of the tax savings realized by the investor (which is how most current Chapter 313 PILOTs are calculated).

C. School Finance Inequities

The third primary concern with PILOTs is that they can give rise to revenue disparities between similarly situated school districts. A school district with access to a PILOT will often have greater revenue per student than a district with similar demographics but no PILOT. This situation can be exacerbated for small districts - a large PILOT spread across small student enrollment increases revenue per student more significantly than it would if spread across a larger school district's enrollment. Critics may argue that any revenues in excess of the target revenue amounts established under school finance law should be redistributed.

Given the importance placed on equality in Texas school finance, concern over any program that increases inequality is understandable. However, it is important to recognize that PILOTs are not the only mechanism by which certain school districts can retain revenues that exceed the target revenue limit. Districts whose tax rate exceeds a certain rate may retain a portion of collections without recapture.[44] Districts may also issue debt to raise additional revenue. Entering into a 313 Agreement might be viewed in a similar manner - an extraordinary action taken by the district to generate additional revenue. As explained above, school districts take on additional financial risk and administrative burdens by entering into 313 Agreements.

It is also important to remember that inequities produced by PILOTs (if any) are temporary. School districts do not receive PILOTs after their 313 Agreements expire. After 313 Agreements expire, and PILOT revenue dries up, increased statewide revenue resulting from an increased tax base could be viewed as offsetting inequities in earlier years. Allowing the implementing district to receive temporary compensation for efforts that benefit the school finance system as a whole in later years might be viewed as equitable.

If the Legislature decides that the equity concern must be addressed, it might mitigate the concern by imposing a cap on PILOTs that bears some relation to a district's weighted average daily attendance, so that any per-student distortions created by a PILOT would be limited. The alternative of prohibiting PILOTs in the name of equity - which, given Chapter 313's reliance on PILOTs as a matter of practice, would render Chapter 313 unworkable - would seem to be a drastic solution.

III. Conclusion

PILOTs play a necessary role in ensuring that Chapter 313 performs its intended purpose of attracting capital investment to Texas. In particular, PILOTs encourage school districts to participate in incentive agreements even though the agreements would otherwise not benefit them. Assuming that Chapter 313 effectively advances desirable policy objectives, concerns about PILOTs generally appear to be outweighed by their benefits, and some concerns could be reduced by legislative or administrative action.

ENDNOTES

1 Renn Neilson and Matt Larsen are partners, and Matt Hunsaker is an associate, in Baker Botts' State and Local Tax Section. They each practice in the firm's Dallas office.
2 Hereinafter, unless otherwise indicated, all chapter and section references are to the Texas Tax Code.
3 § 313.002(5).
4 § 313.003.
5 Technically, Chapter 313 only provides for value limitation in years three through ten of the agreements. However, investors receive property tax credits equal to tax that would have been saved in years one and two had the value limitation been in place. See Subchapter D, Chapter 313.
6 § 313.027(d)
7 § 313.025(a)
8 §313.025(b)
9 § 313.021(2)(A)(iv)(a); § 313.021(4)
10 § 313.021(1)
11 §§ 313.022; 313.023
12 § 313.053
13 §§ 313.023, 313.053
14 § 313.021(2)(A)(iv)(b)
15 § 313.024(d)
16 § 313.051(b)
17 § 313.025(f-1)
18 § 313.027(a), (b)
19 § 313.021(2)
20 *Report of the Texas Economic Development Act*, January 13, 2009, p.1.
21 *Id.*
22 *Id.*
23 *Report of the Texas Economic Development Act*, January 13, 2009, table 5.
24 *Id.*
25 *Id.*
26 *Id.*
27 The mechanics of these state aid reductions for property value increases have been complicated and, with the exception of the basic description of the post-2006 "target revenue" provisions herein, are outside the scope of this article. As a general matter, during the period that Chapter 313 has been in existence, a district whose property values have increased materially from one tax year to the next has been required to make increased "recapture" payments to the state under Texas Education Code Chapter 41 and/or has seen a reduction in state aid payments under Texas Education Code Chapter 42.
28 L. 2006, c. 5, 3rd Called Session, § 1.08

29 Education Code § 42.2516(b)
30 Education Code § 42.2516(h)
31 School districts are generally allowed to retain collections on the first 4 to 6 cents above the first $1 per $100 of tax rate, and some districts may receive additional state aid based on these collections. However, this unrecaptured revenue and aid is likely to be a small percentage of a district's total collections.
32 § 313.025.
33 Texas Gov't Code § 311.023
34 § 313.003
35 § 313.004(1)
36 Acts 1987, c. 191, § 1
37 Texas Tax Code § 312.204.
38 *Stringer v. Cendant Mortgage Corp.*, 23 S.W.3d 353, 355 (Tex. 2000).
39 Chapter 313 does not explicitly require a hearing. School districts, however, may act only after conducting a meeting complying with the Texas Open Meetings Act (Texas Gov't Code Chapter 551). Texas Education Code § 11.051(a-1). The Open Meetings Act, allows school districts to conduct closed meetings for the following purposes:

(1) to discuss or deliberate regarding commercial or financial information that the governmental body has received from a business prospect that the governmental body seeks to have locate, stay, or expand in or near the territory of the governmental body and with which the governmental body is conducting economic development negotiations; or

(2) to deliberate the offer of a financial or other incentive to a business prospect described in the previous paragraph. Texas Gov't Code § 551.087.

Although certain Chapter 313 application deliberations may be conducted by closed meeting, in practice most school districts conduct an open hearing of some sort before entering into a 313 Agreement, including designating a reinvestment zone under § 312.0025.

40 §§ 313.008, 313.032.
41 Tex. Admin. Code 9.1057(a).
42 The Comptroller obtained information used in preparing the table through public information requests made to school districts and information included in initial applications.
43 313.027(c); 313.025(f-1)
44 See note 31.

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AN INTRODUCTION TO THE RESIDUAL PROFIT SPLIT METHOD

Mark Horowitz[1]

I. Introduction

International transfer pricing disputes are increasingly becoming a common fact of life for large and even mid-size companies that operate multinationally. For those unfamiliar with the concept of transfer pricing, it involves the pricing of goods, services, and intangibles charged by one company to a related company.

Using intercompany pricing, multinational enterprises could artificially shift or distort the true taxable income of commonly controlled companies to minimize their worldwide effective tax rate. In order to prevent such a scenario, the United States and the majority of countries around the world have implemented rules and regulations designed to prevent such income-shifting. The fundamental basis of these anti-abuse rules is the "arm's length principle," which states that all related companies should charge the same amount for tangible and intangible goods and/or services that they would charge an unrelated third party.

In the United States, I.R.C. § 482 and the associated regulations are the IRS' principal weapons for policing transfer pricing, and these authorities authorize the IRS to adjust income and force a taxpayer to comply with the arm's length principle. Regulations under I.R.C. § 482 provide various methods which allow taxpayers to calculate the proper transfer price. One of the most flexible methods is the profit split method.

The profit split method is important because it is one of the least understood and most misapplied methods, and also because its flexibility often allows for compromise resolutions of transfer pricing disputes. This is especially important as more and more countries have gained interest in establishing and enforcing their own transfer pricing regimes, and are aggressively pursuing perceived lost tax revenues. The profit split method is used in a variety of circumstances, including the resolution of complex transfer pricing cases in Advance Pricing Agreement or Competent Authority contexts, permanent establishment allocation models, and global trading.

This is especially true with respect to the residual profit split method, which is one of two profit split methods sanctioned by the Treasury Regulations. The other method, the comparable profit split, often requires external market benchmarks and is also less frequently applied. This article serves as an introduction to profit split methods generally, and the residual profit split method specifically.

II. Profit Split Method

A. Generally

In 1994, the U.S. Treasury for the first time passed final regulations with respect to the profit split methodology.[2] The preamble to these regulations recites that:

> [t]he basic approach of a profit split method is to estimate an arm's length return by comparing the relative economic contributions that the parties make to the success of a venture, and dividing the returns from that venture between them on the basis of the relative value of such contributions[3]

The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss.[4] The combined operating profit or loss should be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).[5]

The regulations provide further that:

> The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the

> relevant business activity, consistent with the [general] comparability provisions of [this section]. Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity.[6]

The regulations implicitly reference a fact that many transfer pricing practitioners would do well to remember: all applicable methods which accurately reflect the relative functions performed, risks assumed, and resources employed by the parties should be roughly confirmatory of each other, and should approximate an arm's length result.

Just as the application of other transfer pricing methods may result in a loss for one party with respect to a specific channel of commerce, so a profit split method may also reach such a result. That is, a "profit" split can also split losses. In this regard, Treas. Reg. § 1.482-6(b) states that "The profit allocated to any particular member of a controlled group is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given year, one member of the group may earn a profit while another member incurs a loss."

As a theoretical matter, this is true. However, for taxpayers applying a profit split method, while short-term losses or a division of losses in a combined loss situation are possible, outside of such situations, reallocation of a loss to one party and a profit to another under either of the profit split methods may be difficult to sustain in both a domestic context and in a Competent Authority case or a bilateral Advance Pricing Agreement context, absent confirmation through another method. Of course, foreign tax authorities may (and have) applied profit split methodologies in such combined loss situations, resulting in reallocation of income resulting in a loss to a previously profitable entity.

Note that a loss with respect to the channel of commerce which is addressed by the profit split should be contrasted with a loss by an enterprise with respect to their overall business. Because the combined profit which is to be split is restricted to the profit which relates to the particular related party transactions in question, even a reallocation based on a relatively equal income split could result in an overall loss with respect to an enterprise's entire business (or dramatically reduced profitability), if the original transfer pricing result was a split overwhelming in favor of one party or another.

The IRS also states, as a preliminary matter, that "In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion."[7] While this statement appears obvious, it may be an admonition to taxpayers not to apply the concepts used in early judicial precedent on profit splits (or a taxpayer's idea of a "rough justice" result), in which a Solomon-like 50-50 split approach was often applied.

B. Non-routine Intangibles

Practitioners sometimes state that profit split methods should not be applied if both parties to a transaction or set of transactions do not possess valuable non-routine intangibles. Note that generally under U.S. law, non-routine intangibles are considered to be intangibles that are either extremely difficult or impossible to value using external market benchmarks. A practitioner stating the proposition that all parties to a transaction must possess valuable non-routine intangibles to apply the profit split method would be simultaneously correct and incorrect.

Incorrect, because the final U.S. regulations on the profit split method eliminated the proposed requirement that in order to use the profit split method each controlled taxpayer must own valuable non-routine intangibles, as had been the case under the proposed and temporary regulations.[8] The same practitioner would be correct as a practical matter, as noted below.

The explanation provided by Treasury in the preamble to the final regulations for the deletion of the proposed requirement was that commentators had objected to this requirement on the ground that it could prevent taxpayers from using the profit split method in situations where such methodology "would be likely to provide the most accurate measure of an arm's length result."[9]

In announcing the elimination of the requirement that both parties have valuable non-routine intangibles for application of the profit-split methods, the IRS stated that:

> By removing these restrictions, the final regulations are intended to maximize the extent to which relevant information may be taken into account in evaluating taxpayers' results under the arm's length standard. As a consequence, however, the emphasis on comparability and the importance of the best method rule are increased; because ex ante restrictions will no longer prohibit the use of potentially less reliable information or methodologies, it is critically important that the best method rule be properly applied to select the most reliable measure of an arm's length result from the available evidence.[10]

Essentially, the IRS wanted to allow taxpayers the flexibility to apply the profit split method in the rare circumstance in which it was the best method, but one or both taxpayers did not possess valuable non-routine intangibles. However, taxpayers must use the best and most reliable method. Given that methods other than the profit split methods are usually more reliable in all situations except when there are valuable non-routine intangibles on both sides, those are the only situations where a profit split would likely be the best method. This is especially true with respect to the residual profit split.

III. Residual Profit Split Method

The specific profit split methods provided for in Treas. Reg. § 1.482-6(c)(1) are: (1) the comparable profit-split or (2) the residual profit-split. Under the residual profit split method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following a two-step process, which initially allocates routine profits in accordance with general pricing criteria (e.g., the comparable profits method) and then splits the remainder or "residual."[11]

A. Routine Return

The first step allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity.[12] Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services, and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayers.[13] Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with other pricing methods.[14]

B. Allocation of Residual Profit

The allocation of income to the controlled taxpayers' routine contributions will not reflect profits attributable to the controlled group's valuable intangible property where similar property is not owned by the uncontrolled taxpayers from which the market returns are derived.[15] Thus, in cases where such intangibles are present there normally will be an unallocated residual profit after the allocation of routine income formation. The residual profit generally should be divided among the controlled taxpayers based on the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution.

C. Valuing Contributions

In this regard, the I.R.C § 482 regulations provide that the relative value of the intangible property contributed by each taxpayer may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, such relative value may be estimated by the capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible.[16]

While in many cases all capitalized expenses related to intangible development must be taken into account, often current expenses will yield the most accurate measure of relative contributions. For example, the regulations provide that "If the intangible development expenditures of the parties are relatively constant over time, and the useful life of the intangible property of all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of non-routine intangible property contributions."[17] If the intangible property contributed by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the intangibles must be made among all the business activities in which it is used.[18]

However, Treas. Reg. § 1.482-6(c)(3)(ii)(C)(3) provides that:

> If capitalized costs of development are used to estimate the value of intangible property, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate, for the following reasons. First, in any given case, the costs of developing the intangible may not be related to its market value. Second, the calculation of the capitalized costs of development may require the allocation of indirect costs between the relevant business activity and the controlled taxpayer's other activities, which may affect the reliability of the analysis. Finally, the calculation of costs may require assumptions regarding the useful life of the intangible property.

Therefore it is clear that, while the regulations endorse the use of capitalized costs absent any other information, there is a clear preference for external market benchmarks and an objective valuation of the value of the non-routine intangibles and the relative contributions thereto.

D. Comparability and Reliability

The comparability considerations that are relevant for the first step of the residual profit-split (profit to routine functions) are those that are relevant for the methods that are used to determine market returns for the routine contributions.[19] The second step of the residual profit-split, however, may not rely so directly on market benchmarks. Thus, the reliability of the results under this method is reduced to the extent that the allocation of profits in the second step does not rely on market benchmarks (as noted in the discussion of the valuation of intangibles above).[20] In addition, the reliability of the allocation of costs, income, and assets and accounting consistency can affect the reliability of results from the residual profit split method.[21]

ENDNOTES

1 Gardere Wynne Sewell LLP, 1000 Louisiana Street, Suite 3400, Houston, Texas 77002-5011, 713-276-5467, mhorowitz@gardere.com.
2 T.D. 8552, 59 Fed. Reg. 34971, 34986, effective July 8, 1994 and currently in effect (except §§1.482-OT through 1.482-6T were removed effective October 6, 1994).
3 *Id.*
4 Treas. Reg. § 1.482-6(a).
5 *Id.*
6 Treas. Reg. § 1.482-6(b).
7 *Id.*
8 T.D. 8470, 58 Fed. Reg. 5263 (Jan. 21, 1993), effective April 21, 1993 through July 7, 1994.
9 T.D. 8552, 59 Fed. Reg. 34971 (effective July 8, 1994).
10 *Id.*
11 *See* Treas. Reg. § 1.482-6(c)(3)(i).
12 Temp. Treas. Reg. § 1.482-6T(c)(3)(i)(A) (2006).
13 Temp. Treas. Reg. § 1.482-6T(c)(3)(i)(A) (2006).
14 The other methods would be the comparable uncontrolled price method, resale price method, cost-plus method, and comparable profits method, and/or the corresponding materially similar methods with respect to intangible and service transactions.
15 Temp. Treas. Reg. § 1.482-6T(c)(3)(i)(B) (2006).
16 *Id.* While neither the regulations nor any other authority appears to explicitly address whether costs that have been reimbursed can be or should be used to calculate the contribution to intangible property, the answer appears obvious. Even by merely using the term "costs" or "expenses," the implication is that the costs have actually been incurred or borne by the party in question. If such costs are reimbursed, they cease to be costs in the strict sense of the term. However, the fact that the regulations refer to "capitalized" costs is an even stronger indication that only unreimbursed costs should be included in assessing the relative contributions to intangible property. Specifically, in order for costs to be capitalized under Sections 263 or 263A, such costs cannot have been reimbursed. Consequently, the U.S. regulations have clearly taken the logical position that only unreimbursed costs should be used in assessing the relative contributions to intangible property.
17 Temp. Treas. Reg. § 1.482-6T(c)(3)(i)(B)(2) (2006).
18 Temp. Treas. Reg. § 1.482-6T(c)(3)(i)(B) (2006).
19 Treas. Reg. § 1.482-6(c)(3)(ii)(B).
20 Treas. Reg. § 1.482-6(c)(3)(ii)(C).
21 *Id.*

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CHARITABLE FUNDRAISING POKER TOURNAMENTS

By Kallie S. Myers[1]

Typical charitable fundraising poker tournaments constitute illegal gambling under Section 47 of the Texas Penal Code. However, there are certain ways in which a charity may modify such tournaments to ensure their conduct is lawful.

I. Chapter 47 of the Texas Penal Code

In addition to various collateral offenses, Chapter 47 describes the general offense of "gambling" as "mak[ing] a bet on the partial or final result of a game or contest or on the performance of a participant of a game or contest" or "play[ing] and bets for money or other thing of value at any game played with cards, dice, balls or any other gambling device."[2] As used in Section 47.02, the term "bet" means "an agreement to win or lose something of value solely or partially by chance."[3]

In a 1992 opinion, Texas Attorney General Dan Morales addressed the legality of a "charitable fundraising event," which the petitioning party described generally as a "casino night."[4] Specifically, the event involved admission that was paid for on a table by table basis and a large room full of casino games at which patrons were given a specified amount of chips to play (more of which could be purchased during the night).[5] At the close of play, patrons would then enter a room where they could "purchase" prizes. These prizes would be donated by local merchants.[6] A.G. Morales examined the casino night's legality under Chapter 47 of the Texas Penal Code and explained that the "three basic elements compris[ing] the offense of gambling" are: 1) consideration; 2) chance; and 3) prize.[7] Based on those elements, A.G. Morales determined that the casino night at issue violated Section 47's prohibition on gambling, since the admission fee and any other sums paid for chips by participants would constitute consideration, the casino games would presumably involve chance, and the chips retained by participants at the close of play as well as the items donated by local merchants which the chips could be used to purchase would constitute prizes.[8] Notably, neither the casino night's purpose of raising funds for charity nor the fact that the prizes were donated affected A.G Morales' analysis. The casino night described in A.G. Morales' opinion was simply a multi-game version of a typical charitable fundraising poker tournament: that is, a tournament in which 1) the participants must pay to play poker; 2) the participants' payments are used to fund charitable activities; and 3) the participants may acquire things of value by winning.

A. Eliminating the "Prize"

With a typical tournament's illegality in mind, how might a charity legally conduct a fundraising poker tournament? One option is to remove the tournament's "prize" element. Of course, to do so requires knowledge of the definition of "prize." Section 47.02(a)(3) of the Texas Penal Code begins to offer such, prohibiting "play[ing] and bet[ting] for money or other thing of value." "Thing of value" means any benefit, but does not include "an unrecorded and immediate right of replay not exchangeable for value."[9] That definition suggests that virtually any poker game - even one played for the sole benefit of entertainment or amusement - is illegal. However, a substantive limit is found in the Texas Penal Code's "General Provisions," which define "benefit" as "anything reasonably regarded as economic gain or advantage, including benefit to any other person in whose welfare the beneficiary is interested."[10] Accordingly, a charity may legally conduct a fundraising poker tournament if that tournament does not allow participants to "play and bet" for any "economic gain or advantage."[11] Of course, that is a significant restriction, since the opportunity to win economically valuable prizes is presumably an important draw for tournament participants.

The question remains whether charities may award an inexpensive trophy, plaque or other similar recognition prize to the winner of a fundraising poker tournament. A personal inscription on such an award, while presumably increasing the award's sentimental value to its winner, essentially eviscerates the award's already limited economic value as a fungible commodity.

Neither the Texas Penal Code nor Texas courts have explicitly addressed whether recognition awards are prohibited prizes under the gambling statute. An obvious consideration when determining if something qualifies as "economic gain or advantage" is that item's status for taxation purposes. But since Texas does not impose a tax on personal income, no provision of the Texas Tax Code addresses the reporting requirements for trophies, plaques and similar prizes. Though certainly not controlling, federal tax rules and regulations offer some limited guidance. Section 170(f)(8)(ii)-(iii) of the Internal Revenue Code explains that a charity is required to provide a donor with a "good faith estimate of the value of any goods or services" provided by the charity to the donor. Clarifying that requirement, the preamble to Section 170 refutes a commenter's suggestion that "recognition items, such as plaques or trophies with an honoree's name inscribed, should be considered to have little, if any, fair market value;" rather, the preamble explains, "such items may have some value, even though the value may be less than cost."[12] That conclusion, if borrowed and applied to Texas' gambling prohibition, would suggest that a plaque or other recognition award may indeed constitute some economic gain or advantage—however insubstantial—to its poker-winning recipient. Still, a charity that awards only inscribed plaques or trophies to poker tournament winners is unlikely, as a practical matter, to encounter official resistance.

Notably, even if a trophy or plaque constitutes "economic gain or advantage" to its recipient, the same would not be true where a tournament-sponsoring charity, instead of transferring ownership of a plaque or trophy to a tournament winner, inscribes that plaque or trophy with the winner's name and displays it publicly. Of course, one might argue that even such a public display, because of its recognition and reputation benefits, constitutes indirect economic gain or advantage to the tournament winner. But reading the gambling statute to prohibit such oblique and unquantifiable benefits would leave it without any identifiable limits.

B. Eliminating the "Consideration"

Another option for lawfully conducting a charitable fundraising poker tournament is to remove the tournament's "consideration" element. In a 1985 opinion, Texas Attorney General Jim Mattox addressed the legality of a high school graduation "casino nite," in which each graduating student would be given a set amount of play money to use at various tables where cards or "other games of chance" would be played.[13] The students would be able to use the play money to bid in an auction for donated prizes or to enter lotteries for donated prizes.[14] Importantly, no charge would be made to any student, as an admission fee or otherwise, for taking part in the casino nite.[15] Conducting an analysis nearly identical to that in A.G. Morales' casino night opinion, Op. Tex. Att'y. Gen. No. DM-112 (1992) (described above), A.G. Mattox concluded that a casino nite format in which no person gives or promises to give anything of value in order to participate lacks the element of consideration that is essential to the offense of gambling under section 47.02 of the Texas Penal Code.[16] Accordingly, a charity may lawfully conduct a fundraising poker tournament if it does not require that participants pay to play. However, that defeats the purpose of the event as the fundraising ability of the typical charitable fundraising poker tournament is the collection of admission and participation fees. A charity might still lawfully conduct awareness raising poker tournaments in which participants are not required to pay to play, but are instead informed during play of the charity's initiatives and encouraged to make optional donations. While such tournaments would surely produce different results than those in which funds are raised through entry fees, they would still capitalize on the popularity of poker and could lawfully offer valuable prizes as participation incentives.

Short of eliminating the consideration element altogether, a charity might simply attempt to detach the consideration from the poker tournament. For example, a charity might charge patrons a fee equal to the fair market value of a donated dinner, and allow paying diners to collaterally participate in a "free" poker tournament. Yet, such a design would be unlikely to garner judicial support. As the charity would have no economic incentive to accompany the dinner with a poker tournament if the dinner alone would achieve the same fundraising results, it could be difficult to prove that the participants did not pay for the right to play poker.

C. Statutory Exceptions

Charities interested in conducting lawful fundraising poker tournaments might explore Section 47's exceptions and defenses to gambling offenses. Section 47.02(b) of the Texas Penal Code provides that it is a defense to prosecution under that section if: (i) the actor engaged in gambling in a private place; (ii) no person received any economic benefit other than personal winnings; and (iii) except for the advantage of skill or luck, the risks of losing and the chances of winning were the same for all participants. "Private place" broadly excludes, among other places, "restaurants, taverns, nightclubs, schools, hospitals, and the common areas of apartment houses, hotels, motels, office buildings, transportation facilities and shops."[17] Additionally, a place does not simply become "private" when not being used for its normal public purpose.[18] Regardless of whether the typical charitable fundraising poker tournament might meet the "private place" requirement, it would inevitably fail the requirement that "no person receive[] any economic benefit other than personal winnings."[19] The Texas Penal Code defines "person" as "an individual, corporation, or association," and "corporation" as including nonprofit corporations.[20] Since the very purpose of the typical charitable fundraising poker tournament is to create "economic benefit other than personal winnings" for the charity, such tournaments do not qualify for the defense described in Section 47.02(b) of the Texas Penal Code.

Section 47's definition of "bet" offers another gambling exception. Section 47.01 explains:

> A bet does not include . . . an offer of merchandise, with a value not greater than $25, made by the proprietor of a bona fide carnival contest conducted at a carnival sponsored by a nonprofit religious, fraternal, school, law enforcement, youth, agricultural, or civic group . . . if the person to receive the merchandise from the proprietor is the person who performs the carnival contest.[21]

To invoke this exception, a charity conducting a fundraising poker tournament must assert that the tournament qualifies as a "bona fide carnival contest" conducted at a "carnival."[22] Although the statute does not define those terms, the ordinary meanings of "carnival" and "carnival contest" seem to exclude the typical charitable fundraising poker tournament. The American Heritage Dictionary defines "carnival" as "[a] traveling amusement show usually including rides, games, and sideshows."[23] Perhaps if a charity offered poker as one game among multiple traditional carnival contests, it could invoke the carnival exception in good faith. But a poker tournament standing alone would be unlikely to qualify. Even if it did, the exception only allows the sponsoring organization to award merchandise valued at $25 or less—an underwhelming enticement for prospective poker tournament participants (unless inexpensive trophies or plaques are the sole award to tournament winners).

II. Unrelated Business Income Tax (UBIT)

Section 511 of the Internal Revenue Code imposes a tax on tax-exempt organizations' "unrelated business taxable income," which is the gross income derived by any organization from any unrelated trade or business regularly carried on by it.[24] An "unrelated trade or business" is "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational or other [tax-exempt] purpose or function."[25] Accordingly, an exempt organization's gross income is taxable under Section 511 if (1) it is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.[26]

A. The Three-Part Test

1. "Trade or Business"

Section 513(c) of the Internal Revenue Code provides that the term "trade or business" includes any activity that is carried on for the production of income from the sale of goods or services. The regulations further clarify that the term "trade or business" has the same meaning it has in Section 162.[27] In *United States v. Am. Bar Endowment*, the United States Supreme Court explained that the standard test for the existence of a trade or business for purposes of Section 162 is whether the activity is "entered into with the dominant hope and intent of realizing a profit."[28] The Fifth Circuit has held that the key inquiry in determining whether a tax-exempt organization is carrying on a trade or business is whether there is a "profit motive."[29]

Under the "profit motive" test, a charitable fundraising poker tournament clearly qualifies as a "trade or business" for purposes of the unrelated business income tax. The fundamental purpose of a charitable poker tournament is to generate income for the sponsoring organization. Indeed, charitable poker tournaments are precisely the type of activities that would not be conducted if they did not produce income.

Despite its profit motive, a charity conducting a poker tournament might argue that such event does not qualify as a trade or business for purposes of UBIT because the tournament does not present a risk of unfair competition with any nonexempt organization. The primary objective of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.[30] However, the relevant regulations refute the notion that courts should determine whether a specific activity conducted by an exempt organization is actually "competitive," explaining that generally any activity that falls within the meaning of Section 162 "presents sufficient likelihood of unfair competition to be within the policy of the tax."[31] Accordingly, the presence or absence of competition between a tax-exempt organization and taxable entities engaged in similar activities is not controlling in determining whether a tax-exempt organization's business income should be taxed.[32]

A charity desperate to avoid trade or business status might attempt to artfully characterize its relationship with poker participants as a two-way gift exchange. For example, a charity running a poker tournament might argue that the tournament is a "gift" to the participants, and any income generated is simply the result of the participants' voluntary "contributions." Although truly voluntary contributions do not constitute income for UBIT purposes (since they are not generated by a trade or business), the Supreme Court held in *Am. Bar Endowment* that where a charity in fact offers goods or services and receives value in return, a characterization of that transaction as a gift exchange "cannot be determinative, or any exempt organization could engage in a tax-free business by 'giving away' its product in return for a 'contribution' equal to the market value of the product."[33] The incidence of taxation depends upon the *substance* of a transaction rather than its mere *form*.[34] Accordingly, a charity is unlikely to avoid "trade or business" status merely by recasting its transactions as voluntary "gifting."

For these reasons, and specifically because charitable poker tournaments are conducted with a "profit motive," such tournaments qualify as a trade or business for purposes of the unrelated business income tax.

2. "Regularly Carried On"

Having concluded that charitable fundraising poker tournaments meet UBIT's "trade or business" requirement, we must next determine whether such trade or business is "regularly carried on" by the charitable organization.[35] The regulations provide that specific business activities of an exempt organization will ordinarily be deemed to be regularly carried on if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.[36] Applying that general principle, the regulations explain that where income producing activities are of a kind normally conducted on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business.[37] On the other hand, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business.[38] That distinction accords with the Fifth Circuit's position that an exempt organization is subject to UBIT if it "is engaged in extensive activity over a substantial period of time."[39] The regulations also provide a special rule in certain cases of "infrequent conduct," under which income producing or fundraising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they occur only "occasionally or sporadically."[40] Moreover, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis.[41] As an example, the regulations explain that income derived from the conduct of an annual fundraising event for charity would not be income from a trade or business regularly carried on.[42]

An exempt organization's annual charitable fundraising poker tournament would likely qualify as the type of fundraising activity "lasting only a short period of time" that Treas. Reg. § 1.513-1(c)(2)(iii) exempts from UBIT. In *Suffolk County Patrolman's Benevolent Assoc. v. Commissioner*, the court held that the petitioning organization's presentation of annual vaudeville shows did not constitute a trade or business which was regularly carried on.[43] In reaching its conclusion, the *Suffolk* court emphasized that in the regulations and the legislative history of Sections 511 through 513, "every example of an activity not considered regularly carried on concerns an event of some sort."[44] An annual poker tournament is a similar type of "event." An annual charitable poker tournament is unlikely to "manifest a frequency and continuity, [or be] pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations," since nonexempt organizations that run poker tournaments likely do so year round. Of course, a different conclusion might apply to an exempt organization that conducts poker tournaments on a more than annual basis, depending on the tournaments' frequency and continuity.[45]

3. "Substantially Related"

The final step in the UBIT three-part test is to determine whether the conduct of an exempt organization's trade or business is "substantially related (other than through the production of funds) to the organization's performance of its exempt functions."[46] If it is not, the income generated by that trade or business is subject to UBIT.[47] In *Texas Farm Bureau*, the Fifth Circuit described the appropriate considerations included in a "substantially related" analysis:

> For the conduct of a trade or business to be substantially related to the tax exempt purpose, the business activity must 'contribute importantly' to the accomplishment of the tax exempt purpose. A trade or business is 'related' to an organization's tax exempt purpose 'only where the conduct of the business activities has a causal relationship to the achievement of the exempt purposes', and it is 'substantially' related 'only if the causal relationship is a substantial one. To determine whether the business activity contributes importantly to the exempt purpose, 'the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve.' This is a fact-sensitive inquiry and must be made on a case-by-case basis.[48]

Applying those principles, Section 1.513(d)(4)(i) of the Treasury Regulations offers the example of an exempt organization that operates a school for training children in the performing arts, and that derives income from fees charged for admittance to performances by the school's students. The regulation explains that if the students' participation in performances before audiences is an essential part of their training, then the income realized from the performances is derived from activities that contribute importantly to the accomplishment of the organization's purposes and does not constitute income from unrelated trade or business.[49] In Revenue Ruling 76-94, 1976-1 C.B. 171, the IRS provided another example of an activity that is substantially related to an organization's exempt purpose. The IRS held that an exempt organization's operation of a retail grocery store as part of its therapeutic program for emotionally disturbed adolescents, which store is almost fully staffed by the adolescents, and is operated on a scale that is not larger than is reasonably necessary for the performance of the organization's exempt functions, is not unrelated business within the meaning of Section 513 of the Internal Revenue Code.[50] The IRS warned, however, that where an exempt organization's activities are conducted on a scale larger than that necessary for the performance of the organization's exempt functions, the gross income attributable to that portion of the activities in excess of the needs of the exempt functions constitutes gross income from the conduct of unrelated trade or business.[51]

It is hard to imagine a charitable poker tournament that would be substantially related to a sponsoring charity's exempt functions. A charity committed to helping underprivileged youths develop marketable talents might follow the grocery store example described above by having those youths organize and operate a poker tournament, but even then, the organization would only avoid UBIT to the extent the event's profit-making motive is secondary to the goal of developing the youths' talents.[52] A charity conducting a poker tournament is unlikely to have as its principal goal anything other than income generation. Accordingly, exempt organizations conducting poker tournaments are unlikely to find relief from UBIT by demonstrating their activities' are substantially related to the organizations' exempt functions.

B. Exceptions

Even if an exempt organization's poker tournament is regularly carried on and otherwise eligible for UBIT, it may be exempt from UBIT if it qualifies under either of two relevant statutory exceptions. Section 513 provides that the term "unrelated trade or business" does not include any trade or business (i) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation, or (ii) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.[53]

1. Uncompensated Workers

The Fifth Circuit offered some guidance in *Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner*, 696 F.2d 372 (5th Cir. 1983) (per curiam) by refuting the notion that "any monetary or non-monetary 'payment,' no matter how small, equals 'compensation' under the code," and by holding that "whether non-monetary 'payment' qualifies as 'compensation' must be decided on the facts of each case."[54] But the court also held that where the services of compensated workers added up to approximately 21 percent of the work performed, that was a sufficiently "substantial figure" to preclude the uncompensated work exception.[55] Contrastingly, in *St. Joseph's Farms v. Commissioner*, 85 T.C. 9 (1985), the Tax Court held that the exception applied where 94 percent of the total hours worked and 91 percent of the labor was supplied by an exempt organization's volunteers and the balance was provided by paid outside workers.[56]

Waco Lodge and *St. Joseph* thus provide no precise definition of what constitutes "substantially all the work" for purposes of the uncompensated workers exception. However, the term "substantially all" has usually been interpreted to mean 85 percent or more.[57] Of course, if an organization conducting a charitable poker tournament chooses to compensate some workers, it is likely that such workers will be those that are crucial to the activity (*e.g.*, professional dealers). In Revenue Ruling 78-144, the IRS stated that the uncompensated workers exception only applies if the performance of the uncompensated services is "a material income-producing factor in carrying on business."[58] That ruling suggests that even if numerous collateral service-providers (*e.g.*, caterers, musicians, janitors, etc.) at a charitable poker tournament are uncompensated, the sponsoring organization's provision of compensation to crucial "income-producing" service providers (*e.g.*, dealers) could preclude the exception.

2. Donated Merchandise

There is a dearth of material interpreting the UBIT exception for businesses that sell donated merchandise. Section 1.513-1(e) of the Treasury Regulations explains that the exception "applies to so-called 'thrift shops' operated by a tax exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, et cetera, to be sold to the general public with the proceeds going to the exempt organization." This raises the question of whether the exception applies only to thrift shops per se, or if it applies to any business that involves the selling of donated merchandise. The plain language of the statute suggests the latter interpretation, since its only explicit requirement is that the trade or business involve the "selling of merchandise, substantially all of which has been received by the organization as gifts or contributions."[59] A more difficult question is whether the exception would apply to charitable poker tournaments that offer donated merchandise as prizes. Although the regulations and subsequent interpretative material provide no explicit answer, the plain language of the statute – requiring the "selling" of merchandise – suggests the exception would not apply where the donated merchandise is neither bought nor sold, but instead won by tournament participants. An exempt organization might argue that the participants' admission fees constitute a "purchase" of the prize merchandise.[60] But that argument is likely to fail, since the admission fees represent consideration not for the donated merchandise, but for the chance to play poker and the opportunity to acquire the donated merchandise.

Even if a poker tournament is deemed to involve the sale of merchandise, the exception is limited to donated merchandise (defined by Black's Law Dictionary (8th ed. 2004) as "a movable object involved in trade or traffic; that which is passed from hand to hand by purchase and sale"). Therefore, such exception seems unavailable to donated services (*e.g.*, a hotel stay, a spa treatment, tax preparation, etc.).

III. Deductions under I.R.C. § 170

Under Section 170(a)(1) of the Internal Revenue Code, a taxpayer may deduct from taxable income "any charitable contribution." A "charitable contribution" is defined as "a contribution or gift to or for the use of" a qualifying entity.[61]

Section 1.170A-1(h) of the Treasury Regulations describes the rules governing charitable deductions of payments made in exchange for consideration. Specifically, the regulation provides that no part of a payment that a taxpayer makes to or for the use of an exempt organization that is consideration for goods or services is a contributions within the meaning of Section 170(c) unless the taxpayer intends to make (and does indeed make) a payment in an amount that exceeds the fair market value of the goods and services.[62] The payment is deductible only if and to the extent it exceeds the market value of the benefit received and the excess payment is made with the intention of making a gift.[63] Accordingly, where a taxpayer intentionally makes a payment to an exempt organization in an amount which exceeds the fair market value of the goods or services received in return, the taxpayer may deduct the amount of the excess payment.[64] The regulations further provide that to determine the fair market value of goods or services received from a donee organization, a taxpayer may rely on the donee organization's properly made estimate of the fair market value of the goods or services provided, unless the taxpayer knows that estimate to be unreasonable.[65]

Where participation in a fundraising poker tournament includes the opportunity to win a valuable prize, any payment made for entry into that tournament is presumptively not a charitable contribution, but merely "the price paid for the chance to obtain a valuable prize."[66] Accordingly, a taxpayer who intends to deduct any portion of an amount paid to enter a fundraising poker tournament bears the burden of establishing the value of the chance to win and demonstrating that any payment in excess of that value was made with the intention of making a gift.[67]

Even if a fundraising poker tournament does not offer players the opportunity to win a valuable prize, a participating taxpayer may deduct only the portion of the participation fee that exceeds the fair market value of the entertainment received.[68] In Revenue Ruling 67-246, the IRS explained that where a charity conducts an entertainment event for which there are established charges for admission, such as theatrical or athletic performances, the established charges should be treated as fixing the fair market value of the admission or privilege.[69] Where the for-profit market yields no such counterpart (as it is unlikely to do for "entertainment only" fundraising poker tournaments), only the portion of the participation payment that exceeds a reasonable estimate of the fair market value of the admission or other privileges may be designated as a charitable contribution.[70] Fundraising poker tournaments that do not offer valuable prizes are thus like any other fundraising entertainment event, such as a dinner, dance or show, and as with such events, a charity conducting a fundraising poker tournament should determine in advance the tournament's fair market entertainment value and advise participants that only the portion of their payment which exceeds that value is deductible.[71]

IV. Conclusion

In summary:

1. The typical charitable fundraising poker tournament is arguably illegal in Texas, but may be made lawful by removing either the participants' payment of consideration or their opportunity to win a valuable prize.

2. Charitable fundraising poker tournaments may in some instances be unrelated business activities, but in most cases are not, either because they are not regularly carried on or because they involve uncompensated workers.

3. Participants in fundraising poker tournaments may deduct only the portion of their payment that they intentionally make in excess of the fair market value of the goods or services received from the donee organization.

ENDNOTES

1 Kallie S. Myers is an associate attorney in the Dallas office of the law firm of Thompson & Knight L.L.P. specializing in estate planning and representation of nonprofit organizations. The author gratefully acknowledges the contributions of Alex Bailey, a 2008 summer associate at Thompson & Knight, for his contributions to this article. Mr. Bailey will join Thompson & Knight on a full-time basis in the fall of 2009 as an associate attorney in the trial section.
2 Tex. Penal Code Ann. § 47.02 (Vernon 2008).
3 Tex. Penal Code Ann. § 47.01(1) (Vernon 2008).
4 Op. Tex. Att'y. Gen. No. DM-112 at 1 (1992).
5 *Id.*
6 *Id.*
7 *Id.*
8 Op. Tex. Att'y. Gen. No. DM-112 at 1.
9 Tex. Penal Code § 47.01(9).
10 Tex. Penal Code 1.07(a)(7); *see also State v. Fry*, 867 S.W.2d 398, 402 (Tex. App.—Houston [14th Dist.] 1993 (no writ)).
11 Tex. Penal Code. 47.02(a)(3); Tex. Penal Code 1.07(a)(7).
12 Preamble to TD 8690, 12/13/96.
13 Op. Tex. Att'y. Gen. No. JM-412 at 1 (1985).
14 *Id.*
15 *Id.*
16 *Id.*
17 Tex. Penal Code 47.01(8).
18 *See* Op. Tex. Att'y. Gen. No. DM-112 at 1 (1992) (citing *Cole v. State*, 28 Tex. Ct. App. 536, 537; 13 S.W. 859, 859 (1890) (holding that the temporary occupation of a school house for other than school purposes does not make it any less a public place).
19 *Id.*
20 Tex. Penal Code §§ 1.07(13), 1.07(38).
21 Tex. Penal Code §47.01(1).
22 *Id.*
23 The American Heritage Dictionary of the English Language (4th ed. 2006).
24 I.R.C. § 511(a)(1), 512(a)(1).
25 I.R.C. § 513(a).
26 Treas. Reg. § 1.513-1(a).
27 Treas. Reg. § 1.513-1(b).
28 477 U.S. 105 (1986).
29 *Texas Farm Bureau v. United States*, 53 F.3d 120, 125 (5th Cir. 1995); *accord Louisiana Credit Union League v. United States*, 693 F.2d 525, 532 (5th Cir. 1982); *Veterans of Foreign Wars v. Commissioner*, 89 T.C. 7, 20 (1987).
30 Treas. Reg. § 1.513-1(b); *see also Am. Bar Endowment*, 477 U.S. at 114.
31 Treas. Reg. § 1.513-1(b).
32 *Louisiana Credit Union*, 693 F.2d at 541; *accord Educ. Athletic Assoc., Inc. v. Commissioner*, T.C. Memo. 1999-75 at 3.
33 477 U.S. at 115.
34 *Veterans of Foreign Wars*, 89 T.C. at 21.
35 Treas. Reg. § 1.513-1(b).
36 Treas. Reg. § 1.513-1(c)(1).
37 Treas. Reg. § 1.513-1(c)(2)(i).
38 *Id.*
39 *Louisiana Credit Union*, 693 F.2d at 532.
40 Treas. Reg. § 1.513-1(c)(2)(iii).
41 *Id.*
42 *Id.*
43 77 T.C. 1314, 1325 (1981).
44 *Id.*
45 Treas. Reg. § 1.513-1(c)(1).
46 Treas. Reg. §1.513-1(a).
47 I.R.C. §513(a).
48 53 F.3d at 125 (quoting Treas. Reg. § 1.513(d)).
49 *Id.*
50 *Id.* at 171.

51 *Id.*
52 *Id.*
53 I.R.C § 513(a).
54 *Id.* at 375.
55 *Id.*
56 *Id.*
57 See Treas. Reg. §§ 53.4942(b)-(c), 1.514(b)-1(b)(1)(ii); see also Rev. Rul. 73-248, 1973-1 C.B. 295.
58 Rev. Rul. 78-144, 1978-1 C.B. 168.
59 I.R.C. § 513(a).
60 I.R.C. §513(a).
61 I.R.C. § 170(c).
62 Treas. Reg. § 1.170A-1(h)(1).
63 *See Am. Bar Endowment*, 477 U.S. at 117.
64 Treas. Reg. § 1.170A-1(h)(2).
65 Treas. Reg. §1.170A-1(h)(4).
66 *Patterson v. Commissioner*, T.C. Memo. 1987-252; *see also Goldman v. Commissioner*, 388 F.2d 476, 480 (6th Cir. 1967) (disallowing deduction of taxpayer's payment for fundraising raffle ticket based on lower court's finding that the taxpayer was merely purchasing that which the charitable organization had to sell, namely, chances for a valuable prize); Rev. Rul. 67-246, 1967-2 C.B 104, 108 (ruling that amounts paid for chances to participate in raffles, lotteries, or similar drawings or to participate in puzzles or other contests for valuable prizes are not gifts in such circumstances, and therefore, do not qualify as deductible charitable contributions).
67 *See* Rev. Rul. 67-246, 1967-2 C.B 104, 105; *Goldman*, 388 F.2d at 480.
68 Treas. Reg. §1.170A-1(h)(2).
69 1967-2 C.B at 106.
70 *Id.*
71 *Id.* at 105-06.

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TEXAS PROPERTY TAX LAW DEVELOPMENTS

John Brusniak, Jr.[1]

TEXAS COURTS OF APPEALS

TAX PAYMENT SENT BY PRIVATE DELIVERY SERVICE DOES NOT SATISFY MAILBOX RULE; TAX PAYMENT SENT WITH INSUFFICIENT POSTAGE DOES NOT SATISFY MAILBOX RULE.

Tenaska Frontier Partners, Ltd. v. Sullivan, No. 14-07-01042-CV (Tex. App.–Houston [14th Dist.] November 13, 2008, no pet.). (to be published).

Taxpayer mailed a check for $2,273,695.59 on January 30 to the tax collector. The envelope was properly addressed and had a 39¢ first-class, postage stamp affixed. The post office returned the envelope on February 4 because the proper postage for the delivery was 63¢. The taxpayer placed the check in a new envelope and transmitted it to the tax collector by United Parcel Service. The tax collector posted the payment as delinquent and assessed penalties and interest in the amount of $159,158.66. Taxpayer paid that amount and sought a refund of the penalties and interest contending that its payment satisfied the mailbox rule contained in §1.08 of the Texas Tax Code. That section provides that a payment is timely if "it is sent by regular first-class mail, properly addressed with postage prepaid." The court disagreed and ruled that the first delivery failed because "postage prepaid" requires full payment of the proper postal charges. It further ruled that the second delivery attempt also failed because it was made by a private delivery service and not by the United States Postal Service.

STATUTE OF LIMITATIONS FOR CHALLENGING TAX SALE DOES NOT VIOLATE OPEN COURTS PROVISION OF TEXAS CONSTITUTION; DISCOVERY RULE EXCEPTION TO STATUTES OF LIMITATIONS DOES NOT APPLY TO TAX SALES; ISSUES OF VALIDITY OF TAX SALE MUST BE RAISED WITHIN THE LIMITATIONS PERIOD.

W. L. Pickens Grandchildren's Joint Venture v. DOH Oil Co., No. 08-06-00314-CV (Tex. App. –El Paso, August 7, 2008, pet. denied). (to be published).

Person acquired property in 1963. In 1976, the person transferred the property to a joint venture for the benefit of his grandchildren. The joint venture failed to pay property taxes on it in 1994 and 1995. Taxing unit sued to collect the delinquency but failed to include the joint venture in the suit. Due to an addressing error, the joint venture never received notice of the suit. Defendants were cited by publication and an attorney *ad litem* was appointed for the defendants. The property was foreclosed and sold at a sheriff's sale to a third party. Three years after the deed was recorded, the purchaser at the sheriff's sale filed a trespass to try title suit and obtained a summary judgment against the joint venture based on the tax sale statute of limitations. The joint venture claimed that the statute of limitations violated the Texas Constitution's Open Courts Provision. The court disagreed finding that no violation had occurred because there had been a trial in court prior to the foreclosure of the joint venture's interest. It further held that the statute was adequate because it gives parties the right to extend the statute of limitations indefinitely by paying the taxes accruing between the date of tax sale and the date of suit to contest title. The court further held that the "discovery rule" which allows for statutes of limitations to be extended when an underlying injury "is inherently undiscoverable" does not apply to tax sales because the legislature clearly intended to limit these challenges to one year from the date on which a tax deed is recorded. Finally, the court held that all challenges, including those attacking the omission of a party from the underlying court proceeding, must be brought within the statutory limitations period.

DISTRICT COURTS DO NOT HAVE DIRECT JURISDICTION TO REVIEW COMPLAINTS REGARDING FAILURES OF APPRAISAL REVIEW BOARDS TO COMPLY WITH PROVISIONS OF THE TEXAS TAX CODE.

Appraisal Review Board of Harris County v. O'Connor & Associates, 267 S.W.3d 413 (Tex. App.–Houston [14th Dist.] 2008, no pet.).

Tax consulting firm and its clients sued an appraisal review board and sought mandamus and injunctive relief alleging various violations of the Texas Tax Code by the board including improper postponements of hearings, improper refusals to consider taxpayers' evidence, improper admission of governmental evidence which had not been previously produced to taxpayers and improper entry of orders in favor of the government when the government produced either no evidence or insufficient evidence. The appraisal review board filed a plea to the jurisdiction. In response, the consulting firm argued that the court had jurisdiction to hear the case based on three alternative exceptions to the exhaustion of administrative remedies doctrine. The court disagreed. The court found that Section 41.45(f), which allows taxpayers to compel hearings, does not provide an alternative means for reviewing appraisal review board improprieties "under the facts presented in this case." It held that construing Section 41.45(f), in the manner presented by the consulting firm would allow taxpayers to avoid the judicial appeals process contained in the Tax Code and render those provisions meaningless. It further ruled that the court did not have the power to review the case under its general jurisdictional powers because mandamus remedies are inappropriate when parties are entitled to *de novo* review of administrative determinations. Finally, it held that direct judicial review of administrative violations is only appropriate when an agency acts wholly outside its statutory authority and not when mere allegations of statutory violations are raised.

SHERIFF'S DEED TRANSFERRING TITLE TO PROPERTY FORECLOSED IN DELINQUENT TAX SUIT WHICH FAILED TO JOIN MORTGAGE LIEN HOLDER WAS VOID; PURCHASER AT VOID SHERIFF'S SALE WAS ENTITLED TO RECOVER EXCESS PROCEEDS FROM REGISTRY OF COURT.

Memorial Park Medical Center, Inc. v. River Bend Development Group, L. P., 264 S.W.3d 810 (Tex. App. –Eastland 2008, no pet.).

Taxing unit sued to foreclose delinquent tax lien but failed to include mortgage lien holder in the suit. Judgment was entered, and the property was sold at a sheriff's sale. When the purchaser at the sheriff's sale discovered that the lien existed, he sought to recover the excess funds from the sale from the registry of the court. The trial court authorized the withdrawal. Thereafter, the purchaser at the sheriff's sale transferred his interest in the property by quitclaim deed to a third party. In the interim, the mortgage company also foreclosed its interest in the property and transferred title to another party. A trespass to try title suit ensued. The claimant through the purchaser at the sheriff's sale claimed that the purchaser through the mortgage company could not contest the sheriff's sale because the limitations period provided by the Tax Code for contesting tax sales had expired and because the purchaser had failed to follow the Tax Code's contest provisions. The court disagreed ruling that the challenge provisions were inapplicable because the underlying sheriff's sale was void due to the taxing unit's failure to join the mortgage company as a defendant to the original delinquent tax suit. As a result, the withdrawal of the funds from the registry of the court was valid and compliance with the delinquent tax challenge provisions of the Tax Code was not required.

JURISDICTION TO TAX AN AIRCRAFT MOVING IN THE STREAM OF INTERSTATE COMMERCE IS DETERMINED BY THE AMOUNT OF CONTACT AN AIRCRAFT HAS WITH THE STATE IN THE CALENDAR YEAR PRECEDING JANUARY 1, NOT CONTACT OCCURRING SUBSEQUENT TO JANUARY 1; AN AIRCRAFT IS USED "CONTINUALLY" WITHIN THE STATE WHEN 23% OR MORE OF ITS TAKE-OFFS OCCUR WITHIN TEXAS AND OTHER EVIDENCE OF EXTENDED PRESENCE IS SHOWN.

Alaska Flight Services, LLC v. Dallas Central Appraisal District, 261 S.W.3d 884 (Tex. App.–Dallas 2008, no pet.).

A Texas company with its principal place of business in Dallas acquired an aircraft in August 2001. The aircraft was operated and based in Colorado but had 9 of its 42 take-offs in Texas and the aircraft was in Dallas from November 11, 2001 through January 11, 2002 for repairs and modifications in connection with a lease to an Alaskan company. Its only Texas take-off in 2002 was its departure on January 11. Its remaining 253 takeoffs occurred out of state. Taxpayer claimed that Texas did not have jurisdiction to tax the aircraft for tax year 2002. The court disagreed, ruling that jurisdiction to tax (as opposed to tax situs) is determined by looking at the contact which an aircraft has with the state in the year preceding January 1 of the tax year in question. Events occurring after that date are irrelevant to the determination of jurisdiction. The court further held that the 9 Texas take-offs, which constituted 23% of the total takeoffs, and its extended presence for purposes of repair were sufficient to conclude that the aircraft had been located "continually" in Texas as required by the jurisdiction provisions contained in Section 11.01(c)(3) of the Texas Tax Code.

EVIDENCE OF ITEMS IN CATEGORIES OF PROPERTY WHICH HAD NOT BEEN PREVIOUSLY VALUED BY APPRAISAL DISTRICT, BUT WHICH WERE INCLUDED IN BELATED RENDITION, AND POTENTIAL VARIANCES BETWEEN BELATEDLY RENDERED ITEMS AND PRIOR APPRAISAL DISTRICT VISUAL INSPECTION ARE SUFFICIENT TO SUPPORT THE CREATION OF AN OMITTED BUSINESS PERSONAL PROPERTY ACCOUNT.

Cenveo Corp. v. Dallas Central Appraisal District, 260 S.W.3d 713 (Tex. App.–Dallas 2008, no pet.).

In 2003, taxpayer failed to render its business personal property. Appraisal district, based on a visual inspection and "best available information existing at the time" valued the property at $5,013,000. Taxpayer did not protest the valuation. Pursuant to special legislation, taxpayer filed an amnesty rendition which identified property in categories which the appraisal district had not included in its earlier appraisal. Additionally, the rendition contained information as to yearly-itemized purchases of which the appraisal district had no previous knowledge. The appraisal district calculated the total, undepreciated cost of the property as $12,602,821 and issued an omitted property assessment of $2,824,820. The taxpayer sued claiming the total market value of the property could not have exceeded $4,500,000 and, as a result, no property was omitted from the appraisal roll. The court disagreed finding that the inclusion, in the rendition, of categories of property which were not previously reported and the additional data provided by the taxpayer could have reasonably lead the appraisal district to believe that items of property were excluded in the initial appraisal.

JURISDICTION OVER AN APPRAISAL DISTRICT APPEAL MAY NOT BE CONFERRED BY JUDICIAL ADMISSIONS; INTERVENTION OF PARTY INTO APPRAISAL DISTRICT LAWSUIT MUST BE FILED WITHIN THE 45 DAY STATUTORY JURISDICTIONAL PERIOD; STATUTORY FILING PERIOD DOES NOT VIOLATE EITHER THE DUE PROCESS CLAUSE OF THE UNITED STATES CONSTITUTION OR THE OPEN COURTS PROVISION OF THE TEXAS CONSTITUTION.

Dolenz v. Dallas Central Appraisal District, 259 S.W.3d 331 (Tex. App. - Dallas 2008, pet. denied).

Taxpayer, a disbarred attorney, sought a religious exemption on behalf of a trust in which he held a life estate. After his claims had been rejected by the appraisal district and appraisal review board, he filed an appeal to district court on behalf of the trust. The appraisal district objected to his representation of the trust based on his disbarment and the trial court ordered him to find separate counsel for the trust. Instead, in response, well after the 45 day statutory period for filing suit had expired, he filed an intervention into the suit on his own behalf. The trial court dismissed the suit. On appeal, taxpayer contended that the dismissal was improper because the appraisal district had admitted in requests for admission that the trial court had jurisdiction over the suit, that the court could not dismiss the portion of the appeal pertaining to him because he could lawfully represent himself before the court and because the statutory appeals period violated the due process clause of the United States Constitution and the Open Courts Clause of the Texas Constitution. The appellate court disagreed. It held that subject matter jurisdiction can never be conferred by answers to requests for admission. It further ruled that although the taxpayer could lawfully represent himself before the trial court (but not the trust) his intervention into the suit was after the 45 day jurisdictional deadline for filing suit and as a result the trial court had no jurisdiction to consider his claims, and finally the court ruled that his constitutional objections had been previously rejected in prior case law.

PURCHASER OF FORECLOSED PROPERTY AT A PROPERTY TAX RESALE IS RESPONSIBLE FOR TAXES, PENALTIES AND INTEREST WHICH ACCRUE BETWEEN THE DATE OF JUDGMENT AND THE DATE OF ACQUISITION OF TITLE BY A TAXING UNIT AT THE ORIGINAL TAX FORECLOSURE SALE.

Irannezhad v. Aldine Independent School Dist., 257 S.W.3d 260 (Tex. App.–Houston [1st Dist.] 2008, no pet.).

Taxing unit sued for foreclosure of nonpayment of $145,000 in ad valorem taxes. Judgment was entered and when no one bid on the property at the sheriff's foreclosure sale, the property was "struck off" to the taxing unit. A purchaser bought the property at a public resale from the taxing unit for $25,000. Thereafter, the taxing unit sued the taxpayer for taxes which had accrued on the property between the date of judgment and the date on which the property had been "struck off" to the taxing entity. (The parties stipulated that no taxes accrued on the property while title was held by the taxing unit.) The purchaser claimed that the post-judgment taxes merged into the title at the time of the resale, and that he owed nothing to the taxing unit. The court of appeals disagreed and held that both the judgment and the specific provisions of the Texas Tax Code authorized collection of these taxes. Specifically, Sections 33.52 (d) and 34.01(l) state that liability for post-judgment taxes, interest and penalties continue to accrue post-judgment.

SECTION 41.45(F) OF THE TAX CODE MAY NOT BE USED TO CHALLENGE ALLEGED PROCEDURAL DEFICIENCIES AT AN APPRAISAL REVIEW BOARD HEARING.

Appraisal Review Board of Harris County Appraisal District v. Spencer Square, Ltd., 252 S.W.3d 842 (Tex. App. –Houston [14th Dist.] 2008, no pet.).

Appraisal review board conducted an evidentiary hearing on July 8, 2005 and issued its order determining protest on July 27, 2005. Taxpayer did not appeal the order to district court but instead eleven months later filed suit pursuant to Section 41.45(f) of the Tax Code seeking to compel a new appraisal review board hearing, alleging that the appraisal review board had failed to comply with procedural guidelines contained in the Tax Code. The court disagreed and held that Section 41.45(f) of the Tax Code only authorizes suits to compel an appraisal review board hearing where no hearing has taken place. It does not create an alternate avenue for challenging procedural errors committed by an review board. The only remedy for such errors is a *de novo* appeal to district court within the 45 day appeal period authorized by the Tax Code.

PROPOSAL OF THE SAME VALUE BY AN APPRAISAL DISTRICT AND A TAXPAYER AT AN APPRAISAL REVIEW BOARD HEARING CREATES AN AGREEMENT BETWEEN THE PARTIES AND RENDERS AN APPRAISAL REVIEW BOARD DETERMINATION UNAPPEALABLE TO DISTRICT COURT; DUE PROCESS RIGHTS ARE NOT VIOLATED BY RECOGNITION OF SUCH AN AGREEMENT.

Hartman v. Harris County Appraisal Dist., 251 S.W.3d 595 (Tex. App.–Houston [1st Dist.] 2007 pet. denied).

Appraisal district appraised a property at a higher value than the price a taxpayer had recently paid for it. At an appraisal review board hearing, the taxpayer's agent argued that the value of the property should be the purchase price. Thereafter, the appraisal district's agent also recommended the purchase price to the review board The appraisal review board issued an Order Determining Protest at the purchase price, and the taxpayer appealed the decision to district court. On appeal, the court held that the recommendation of the same value by both parties constituted an agreement as to value pursuant to Section 1.111(e) of the Tax Code and as such was not appealable. The court held that the taxpayer's rights to due process were not violated because the taxpayer had been given an opportunity to appear before the appraisal review board.

TO ESTABLISH BAD FAITH IN FILING OF DELINQUENT TAX LAWSUIT AND RECOVER ATTORNEY'S FEES, A PARTY MUST SHOW MORE THAN NEGLIGENCE ON THE PART OF THE DELINQUENT TAX ATTORNEYS.

Shaw v. County of Dallas, 251 S.W.3d 165 (Tex. App. –Dallas 2008, pet. denied).

Shaw sued taxpayer and obtained a personal judgment. Shaw filed an abstract of judgment lien and subsequently released the lien when the taxpayer paid off the judgment. A year later, taxing unit sued the taxpayer for delinquent taxes and included Shaw as a defendant to the suit. The suit had the words "IN REM" next to Shaw's name but the prayer in the suit asked for a personal judgment. Rather than inform the tax office of the release of lien, Shaw filed a counterclaim for declaratory judgment and later raised a Rule 13 claim for attorney's fees based on a bad faith filing by the taxing entity. The taxpayer paid the delinquent taxes, and the case went to trial on Shaw's claims. The court refused to award attorney's fees to Shaw based on the bad faith filing claim ruling that there was no showing of intentional misconduct on the part of the delinquent tax attorney, only negligence. Negligence cannot serve as the basis for a bad faith filing claim. In doing so, the court pointed out that Shaw failed to inform the delinquent tax attorney that his claim had been released, but instead chose to wait until trial to mention this important fact. The court further found that the taxing entity had clearly plead that it was not seeking personal liability by placing "IN REM" by Shaw's name on the pleading and that the prayer for personal relief did not counter the initial claim for relief against Shaw's interest in the property.

FOR PURPOSES OF CALCULATING TAX REVENUE LOSS ON AN AFFORDABLE HOUSING PROJECT, THE MEASURE

IS THE DIFFERENTIAL IN TAX ON THE COMPLETED PROJECT WITH, AND WITHOUT, THE EXEMPTION.

Dallas Independent School Dist. v. Outreach Housing Corp., 251 S.W.3d 152 (Tex. App.–Dallas 2008, pet. denied).

Taxpayer constructed an affordable housing project and sought a 50% exemption from the school district in which the property was located. The school district denied the exemption pursuant to Section 11.1825(x)(3)(A) of the Texas Tax Code on the grounds that it could not "afford the loss of ad valorem tax revenue that would result from approving the exemption." Taxpayer filed suit claiming that the denial was in appropriate because no revenue loss would result. It demonstrated that the property, prior to the construction of the project, was paying $2,500 in ad valorem taxes and that thereafter, even with a 50% exemption, it would be paying $50,000 in taxes. The court of appeals disagreed with the taxpayer's analysis and held that the correct measure of the school district's loss was the differential between the taxes on the full value after construction (i.e., $100,000) and the taxes on the property that would be incurred as a result of the granting of the exemption (i.e., $50,000).

THE FILING OF A MOTION TO COMPEL A CASE INTO NON-BINDING ARBITRATION DOES NOT SUPERSEDE A TRIAL COURT'S INHERENT POWER TO DISMISS A CASE FOR WANT OF PROSECUTION.

National Golf Operating, P.S., L.P. v. Williamson County Appraisal Dist., 251 S.W.3d 149 (Tex. App.–Austin 2008, no pet.).

Taxpayer filed suit challenging the value of a property in 2000. Thereafter, the taxpayer amended the suit to add tax years to 2001 through 2003 to it. In late 2003, the court placed the case on its dismissal docket, but at the taxpayer's request retained the case and set it for trial in June 2004. The case was not reached at that setting. In August 2006, the court again placed the case on the dismissal docket. On the morning of the dismissal hearing, the taxpayer filed a motion to compel the case to non-binding arbitration. The district court disregarded the motion and dismissed the suit. On appeal, the taxpayer contended that the court abused its discretion because Section 42.225 of the Texas Tax Code provides that upon the filing of a motion to compel a case to non-binding arbitration, the court "shall submit the appeal to non-binding arbitration." They claimed that the mandatory language of the statute did not afford the trial court any discretion. The court of appeals disagreed, ruling that the trial court's inherent power to dismiss cases which are not timely prosecuted is not "trumped" by this statutory provision.

TEXAS ATTORNEY GENERAL OPINIONS

WITH RARE EXCEPTIONS, APPRAISAL DISTRICTS MUST MAINTAIN THEIR OFFICES WITHIN THE COUNTY THEY SERVE.

Tex. Op. Att'y. Gen. No. GA-0681. (2008).

With the exception of branch offices or appraisal offices established under interlocal governmental agreements, an appraisal district may not maintain an office outside the boundaries of the county for which it is established.

CONSTITUTIONAL AMENDMENT INCREASING HOMESTEAD EXEMPTION AMOUNTS FOR DISABLED VETERANS WAS SELF EXECUTING; APPRAISAL DISTRICTS MUST GRANT THE EXEMPTION AMOUNTS LISTED IN THE CONSTITUTION, NOT THE LOWER AMOUNTS LISTED IN THE TEXAS TAX CODE..

Tex. Op. Att'y. Gen. No. GA-0676. (2008).

The Texas Constitution was amended in November 2007 to increase the amounts of homestead exemptions granted to disabled veterans. The legislature did not pass enabling legislation to accompany the constitutional amendment, but left the prior statute in place reflecting lower amounts. The Attorney General ruled that the constitutional revision was self-executing, and that appraisal districts are required to grant the higher exemption amounts contained in the constitution and to disregard the lower amounts contained in the Texas Tax Code.

A PERSON WHO OWNS LAND, IMPROVEMENTS OR PERSONAL PROPERTY AND IS OTHERWISE QUALIFIED IS ENTITLED TO SEEK TAX LIMITATION UNDER THE PROVISIONS OF THE TEXAS ECONOMIC DEVELOPMENT ACT; LESSEES OF LAND MAY APPLY FOR SUCH BENEFITS.

Op. Tex. Att'y Gen. No. GA-0665 (2008).

Notwithstanding the wording of the Texas Economic Development Act providing that owners of "land, improvements *and* personal property" may seek tax limitation relief under the provisions of the Texas Economic Development Act, considering the structure of the various sections and legislative intent, it is clear that a person need not own all three classes of property, but may qualify for relief if the person owns any one of the three categories of property. Accordingly, lessees of land qualify for relief under the Act.

APPRAISAL DISTRICTS AND APPRAISAL REVIEW BOARDS WHICH LOST JURISDICTION OVER PROPERTY AS A RESULT OF HOUSE BILL 1010 MUST CONTINUE HANDLING MOTIONS, PROTESTS AND OMITTED PROPERTY ISSUES WHICH AROSE PRIOR TO JANUARY 1, 2008.

Op. Tex. Att'y Gen. No. GA-0631 (2008).

House Bill 1010 made appraisal districts' jurisdictional boundaries contiguous with county lines and eliminated all extraterritorial jurisdiction effective January 1, 2008. The Attorney General ruled that, notwithstanding the provisions of House Bill 1010, appraisal districts and appraisal review boards are required to handle all protests, motions, lawsuits and omitted property issues within their prior extraterritorial jurisdiction pertaining to matters arising prior to January 1, 2008. Appraisal districts are required to continue cooperating with each other regarding valuation matters in areas which were within formerly overlapping territories during these prior periods.

TAX ABATEMENTS MAY NOT BE GRANTED ON IMPROVEMENTS LOCATED ON LEASED LAND; A MEMBER OF A COUNTY COMMISSIONERS COURT MUST ABSTAIN FROM VOTING ON AN ABATEMENT AGREEMENT IF THE MEMBER WILL BENEFIT ECONOMICALLY FROM THE AGREEMENT.

Op. Tex. Att'y Gen. No. GA-0600 (2008).

Section 312.402(a) of the Tax Code authorizes a county to execute tax abatement agreements with the owners of taxable property located in a reinvestment zone. A county commissioners court may execute tax abatement agreements with real property owners, as well as with owners of leasehold interests or improvements on tax-exempt, governmentally-owned, real property. Under the provisions of the "Property Redevelopment and Tax Abatement Act," a tax abatement may not be granted on improvements which are located on privately leased land. A commissioners court may not authorize a tax abatement agreement with a leaseholder for improvements located on taxable real property. A member of a commissioners court may not participate in a vote on a matter involving the commissioner's real property "if it s reasonably foreseeable that an action on the matter will have a special economic effect."

APPRAISAL DISTRICTS MUST CONTINUE TO DEFEND LITIGATION ON PROPERTIES PREVIOUSLY WITHIN AN APPRAISAL DISTRICT'S BOUNDARIES.

Op. Tex. Att'y Gen. No. GA-0590 (2007).

Although House Bill 1010 limited an appraisal district's jurisdiction to properties located within its county's boundaries, the appraisal district is required to continue to handle all challenges pre-dating the effective date of House Bill 1010. The appraisal district has a right to be reimbursed for the cost of handling the challenges by the taxing unit on whose behalf it is acting.

A PROPERTY TAX CONSULTANT WHO IS A "PERSON AUTHORIZED TO ACT ON BEHALF OF THE OWNER" MAY SIGN AND COMPLETE THE DESIGNATION OF AGENT FORM FOR THE PROPERTY OWNER.

Op. Tex. Att'y Gen. No. GA-0589 (2007).

A property tax consultant may be authorized to sign a fiduciary form under Section 1.111 of the Texas Tax Code by a taxpayer. If a consultant signs a form under such circumstances, it is valid.

ENDNOTE

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WHAT BENEFIT PLAN OFFICIALS NEED TO KNOW ABOUT THE ERISA BOND REQUIREMENT

Quinn D. Baker[1]

I. INTRODUCTION

One of the stated goals of the Employee Retirement Income Security Act of 1974 ("ERISA") is to establish "standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans."[2] One way ERISA seeks to accomplish this goal is by requiring plan fiduciaries and certain other individuals to be bonded in order to protect the plan against losses due to fraud or dishonesty. Recently, the Department of Labor ("DOL") has in its investigations of employee benefit plans been scrutinizing plans' bonds. Perhaps not coincidentally, on November 25, 2008, the DOL's Director of Regulations and Interpretations issued a Field Assistance Bulletin ("Bulletin") to all Regional Offices providing guidance as to the bond requirements under ERISA.[3] With what may be stepped-up enforcement from the DOL, the Bulletin is a useful tool for plan fiduciaries in ensuring that the bond requirements are met. This article summarizes the Bulletin and draws special attention to specific requirements plan fiduciaries and officials should watch out for and correct before the DOL comes knocking on the door.

II. THE BASICS OF THE ERISA BONDING REQUIREMENT

ERISA requires that "every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan ... shall be bonded."[4] The statute refers to persons who handle funds or other property as "plan officials." The bond must "protect the plan against loss by reason of acts of fraud or dishonesty on the part of the persons required to be bonded, whether the person acts directly or through connivance with others."[5] The Bulletin distinguishes this bonding requirement from fiduciary liability insurance, which insures the plan against losses due to breaches of fiduciary duties.[6] Fiduciary liability insurance is outside the scope of Section 412 of ERISA and this article.

The amount of the bond must be fixed at the beginning of each fiscal year of the plan. Each fiduciary or plan official must be bonded for at least 10% of the amount of funds he or she handles, with a minimum of $1,000 and a maximum of $500,000. Beginning in 2008, the maximum bond requirement is increased to $1,000,000 in the case of any plan that holds employer securities.[7]

ERISA defines an "employee benefit plan" as a plan providing either retirement income to employees or medical, disability, or similar benefits to employees.[8]

Only sureties or reinsurers named on the Department of the Treasury's Listing of Approved Sureties, Circular 570, and in some cases, the Underwriters at Lloyds of London, may issue ERISA bonds.[9]

III. EXEMPTIONS TO BONDING REQUIREMENT

Not all employee benefit plans are subject to the bond requirement under Section 412 of ERISA. Additionally, certain plan officials are exempt from the requirement.

A. Plan Exemptions

There are two broad categories of employee benefit plans to which the bonding requirement of ERISA Section 412 does not apply: unfunded plans, and plans not subject to Title I of ERISA.[10]

<u>1. Unfunded Employee Benefit Plans</u>

A plan is considered "unfunded" if the plan pays benefits only from the general assets of a union or employer. Notably, fully insured plans (i.e., plans in which benefits are paid by an insurance company) do not meet this requirement.[11] Merely maintaining special ledger accounts or accounting entries for plan funds as a part of the general books and records of the union or employer is usually not enough to exempt a plan from the bonding requirement, but may be taken into account in determining whether the exemption applies. Labor regulations set forth four types of plans which are not subject to this exception:

- If any benefits under the plan are provided or underwritten by an insurance carrier or service or other organization;
- If there is a trust or other separate entity to which contributions are made or out of which benefits are paid;
- If contributions are made by employees (through withholding or otherwise) or by any source other than the union or employer; or
- If there is a separately maintained bank account or separately maintained books and records for the plan or other evidence of the existence of a segregated or separately maintained or administered fund out of which plan benefits are to be provided.[12]

Even though employee benefit plans that receive employee contributions are not generally considered to be unfunded, employee welfare benefit plans associated with a fringe benefit plan under Section 125 of the Internal Revenue Code that are treated as unfunded for annual reporting purposes are, as an enforcement policy, treated as unfunded for bonding purposes.[13]

2. Plans Not Subject to ERISA

Any plan not subject to Title I of ERISA is not subject to the bonding requirement of Section 412. Title I of ERISA does not apply to:

- "governmental plans" (which includes, *inter alia*, plans maintained by the federal government, any state or political subdivision, an Indian tribal government, or a plan to which the Railroad Retirement Act of 1925 or 1037 applies;[14]
- plans maintained by a church or convention or association of churches, unless an election under Section 410(d) of the Internal Revenue Code has been made;
- plans maintained solely to comply with workers' compensation laws, unemployment compensation or disability insurance laws;
- plans maintained outside the U.S. that primarily benefit nonresident aliens; or
- unfunded excess benefit plans[15]

Fiduciaries and plan officials of such plans need not concern themselves with Section 412 of ERISA.

B. Exempted Plan Officials

Some plan officials are not subject to the bonding requirement, even though they handle funds of a plan to which Section 412 of ERISA applies. Essentially, anyone who is required to be bonded under another federal or state law or is otherwise required to maintain certain capitalization levels need not also be bonded under ERISA.

ERISA exempts from the bonding requirement any entity registered as a broker or a dealer under Section 15(b) of the Securities Exchange Act of 1934, if the broker or dealer is subject to the fidelity bond requirements of Section 3(a)(26) of that Act.[16] Additionally, the broker-dealer's officers, directors and employees are also subject to this exemption.[17] The statute also exempts from the bonding requirement any fiduciary (or any officer, director, or employee of such fiduciary) that is a bank or insurance company subject to state or federal supervision or examination. Such entity must meet minimum capitalization requirements.[18]

In addition to the above two statutory exemptions, the Department of Labor has granted several additional exemptions by regulation. These exemptions include:

- Banking institutions and trust companies (even those that are not fiduciaries) that are subject to regulation and examination by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation.[19] This exemption does not apply if the institution is only subject to state regulation.[20]
- Savings and loan associations subject to regulation and examination by the Federal Home Loan Bank Board are exempt, but only with respect to plans for the benefit of their own employees for which they act as plan administrator.[21]
- Insurance carriers (or other similar organizations) providing or underwriting plans in accordance with state law, but only with respect to plans benefiting persons other than the employees of the insurance carrier.[22]

IV. HANDLING "FUNDS OR OTHER PROPERTY"

Only plan officials who handle "funds or other property" are subject to the ERISA bonding requirement. For these purposes, "funds or other property" is broadly defined to include plan contributions received from any source (e.g. employees, employers, and employee organizations), quick assets such as cash and marketable securities, and any other property with cash value held or acquired for the ultimate purpose of distribution to plan participants and beneficiaries. This includes land, buildings, and securities in closely-held corporations, if such assets are held for investment purposes.[23]

A plan official is deemed to be handling funds or other property whenever his or her "duties or activities with respect to given funds or other property are such that there is a risk that such funds or other property could be lost in the event of fraud or dishonesty on the part of such person, acting either alone or in collusion with others."[24] There is no *de minimis* exemption based on the amount of funds handled.[25] Subject to this basic standard, the Department of Labor has set forth general criteria for determining whether an individual handles funds or other property:

- Physical contact (or power to exercise physical contact) with cash, checks or similar property;
- Power to transfer funds or other property from the plan to the individual or a third party;
- Disbursement authority over funds or other property;
- Authority to sign checks or other negotiable instruments; or
- Supervisory or decision-making authority with respect to any of the above activities.[26]

No handling occurs where risk of loss to the plan through fraud or dishonesty is negligible. Examples of such a situation include where checks cannot be negotiated by the persons performing duties with respect to them, or where an individual physically handles funds but only in a clerical nature.[27]

Employers often appoint an administrative committee to handle plan operations. The Bulletin clarifies when members of such a committee are required to be bonded. If the committee has final authority to direct a corporate trustee (who has custody of plan funds) to pay benefits to plan participants, the committee members are handling funds and must be bonded.[28] If the committee makes investment decisions with respect to plan assets, the committee members are handling funds and must be bonded; however, if the committee merely makes investment recommendations that are subject to another party's final approval, the committee members are not handling funds.[29]

V. SPECIFICS OF THE ERISA BOND

A. Form and Scope

As stated above, recent DOL investigations indicate a focus on the existence and propriety of ERISA bonds. The Labor regulations allow considerable flexibility regarding the form bonds may take, so employers should be able to meet the requirement without too much trouble. In short, the bond may take any form so long as the substantive requirements of ERISA Section 412 are met. Such forms include individual bonds, name schedule bonds (where one bond names several individuals), position schedule bonds (where one bond covers individuals by their occupation or position), and blanket bonds (where the bond covers all of the insured's officers and employees). The plan may be insured on its own bond or may be added as a named insured on an employer's existing bond, such as a commercial crime policy, so long as the provisions meet Section 412 of ERISA.[30] If an employer maintains more than one plan, it may use one bond to cover multiple plans. However, the bond must provide that each plan may recover the covered amount (at least 10% of funds handled) from the individual as if the plan were bonded separately. Put another way, all individuals must be covered for 10% of the funds they handle under each plan, not each bond.[31]

B. Amount of Bond

Each plan official must be bonded in an amount equal to at least 10% of the amount of funds he or she handled in the previous year, subject to a minimum of $1,000 and a maximum of $500,000 (the maximum for plans that hold employer securities was raised to $1,000,000 beginning January 1, 2007). A plan official handling funds of more than one plan must be bonded for the required amount for each plan whose assets he or she handles. If there is no preceding plan year upon which to measure the amount of funds handled (as would be the case for a new plan), the DOL has provided procedures whereby plan officials may estimate the amount of funds handled.[32] A plan may purchase coverage for an amount higher than the $500,000 (or $1,000,000, as applicable) maximum, but will not be required to do so unless the Department of Labor, after notice and a hearing, so requires. The decision to purchase a greater amount of coverage is a fiduciary one and subject to ERISA's fiduciary standards.[33]

The Bulletin clarifies when a plan is considered to hold employer securities. Citing the Joint Committee on Taxation's technical explanation of this additional requirement, the Department of Labor takes the position that a plan that holds employer securities as a part of "a broadly-diversified common or pooled investment vehicle that holds employer securities, but which is independent of the employer and any of its affiliates," shall not be considered to hold employer securities for purposes of Section 412.[34] Thus, a publicly-traded company that sponsors a retirement plan will not be considered to hold employer securities if the only employer securities in the plan are held in a mutual fund in which the plan invests.

A bond meeting the requirements of Section 412 may not have a deductible. ERISA requires that the plan be insured "from the first dollar of loss up to the maximum amount for which the person causing the loss is required to be bonded."[35] This requirement can easily fall through the cracks where the coverage is attached to an existing bond with a deductible. The bond must clearly state that there is no deductible for loss from fraud or dishonesty in accordance with Section 412 of ERISA. It is unclear if blanket language stating such coverage "meets the requirements of ERISA" will satisfy this requirement. The bond may have a deductible for coverage in excess of the maximum amount required.[36]

C. Bond Terms and Provisions

Bonds intended to meet the Section 412 requirements must include specific provisions, and Department of Labor investigators are looking closely at bonds to ensure all such provisions are included.

The amount of the bond must be fixed at the beginning of each plan year. Some insurers may offer reduced premiums or other benefits for terms longer than one year. A bond may have a term of longer than one year and still meet the requirements of Section 412; however, at the beginning of each subsequent year, the bond must be adjusted, if necessary, to reflect the newly revised estimated amount of funds handled.[37] The bond does not need to be updated if the amount of funds handled increases during the year.[38]

The covered plan or plans must be either specifically named or identified in such a way as to enable the plan's representatives to make a claim under the bond.[39] The bond may include an omnibus clause, whereby the bond insures, for example, "all employee benefit plans" of the company, provided each plan has the required amounts of coverage.[40]

One important provision that is often omitted is the one-year "discovery period." A bond must provide that a plan has one year after termination of the bond to discover losses that occurred during that period. A bond may provide that this discovery period terminates upon the effective date of a replacement bond, but only if the replacement bond provides the required one-year discovery period. Thus, any time a bond terminates and a new bond begins, plan fiduciaries should examine both to ensure the one-year discovery period does not fall through the cracks.[41]

VIII. CONCLUSION

An ERISA-covered plan should have a Section 412 bond in place, as the plan is required to report the amount of such bond on its annual Form 5500 return. However, plan fiduciaries should, in consultation with plan counsel and insurance agents, review any and all bonds to ensure they comply with Section 412 of ERISA before the plan may come under DOL examination.

ENDNOTES

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2 ERISA § 2(b) (29 U.S.C. § 1001(b)).
3 F.A.B. 2008-04.
4 ERISA § 412(a) (29 U.S.C. 1112(a)).
5 F.A.B. 2008-4, Q&A-1.
6 F.A.B. 2008-4, Q&A-2.
7 ERISA § 412(a).

8 ERISA § 3(3) (29 U.S.C. 1002(3)).
9 F.A.B. 2008-4, Q&A-4.
10 ERISA § 412(a)(1).
11 F.A.B. 2008-4, Q&A-13.
12 29 C.F.R. 2580.412-2.
13 F.A.B. 2008-4, Q&A-13.
14 ERISA § 3(33)).
15 ERISA § 4(b).
16 ERISA § 412(a)(2).
17 F.A.B. 2008-4, Q&A-15.
18 ERISA § 412(a)(3).
19 29 C.F.R. §§ 2580.412-27, -28.
20 F.A.B. 2008-4, Q&A-15.
21 29 C.F.R. §§ 2580.412-29, -30.
22 29 C.F.R. §§ 2580.412-31, -32.
23 29 C.F.R. § 2580.412-4.
24 29 C.F.R. § 2580.412-5(a)(1).
25 29 C.F.R. § 2580.412-5(a)(2).
26 29 C.F.R. § 2580.412-5(b).
27 F.A.B. 2008-4, Q&A-18.
28 F.A.B. 2008-4, Q&A-19.
29 F.A.B. 2008-4, Q&A-20, Q&A-21.
30 F.A.B. 2008-4, Q&A-22.
31 F.A.B. 2008-4, Q&A-23, Q&A-24.
32 *See* 29 C.F.R. § 2580.412-15.
33 F.A.B. 2008-4, Q&A-36.
34 F.A.B. 2008-4, Q&A-38.
35 F.A.B. 2008-4, Q&A-30.
36 *Id.*
37 F.A.B. 2008-4, Q&A-33.
38 F.A.B. 2008-4, Q&A-41.
39 29 C.F.R. § 2580.412-18.
40 F.A.B. 2008-4, Q&A-32.
41 F.A.B. 2008-4, Q&A-26.

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APPLICATION OF THE STEP TRANSACTION DOCTRINE TO TRANSFERS OF PARTNERSHIP INTERESTS

Daniel H. McCarthy[1]

Taxpayers utilize family limited partnerships as part of a wealth management strategy to provide a variety of tax and non-tax benefits including asset protection, consolidation of assets for investment management, retention of assets within a family, protection from spouses in event of divorce, avoiding out of state probate filings and inheritance tax liabilities, and providing management succession for family assets. As part of this wealth management strategy, senior generation family members will gift and/or sell limited partnership interests to children, grandchildren, or trusts for the benefit of junior generation family member's benefit.

Benefits of Lifetime Transfers of Partnership Interests

Lifetime gifts or sales of partnership interests can provide many benefits. One benefit is that any appreciation in the value of the partnership interest gifted or sold will escape estate taxation at the death of the senior generation family member. Another benefit is that lifetime gifts of partnership interests can provide a defense to even the most successful argument that the IRS has made with respect to denying discounts for valuation of partnership interests at death which is the application of Code Section 2036(a)(1). The cases in which the IRS has been successful in challenging discounts taken by taxpayers for lack of marketability and lack of control in valuing partnership interests for estate tax purposes generally involve an argument that the taxpayer retained the right to the income from the underlying property conveyed to the partnership, thus requiring that the assets contributed to the partnership be includable in the decedent's taxable estate rather than the partnership interests.[2]

The gift tax statutes do not contain a counterpart to Code Section 2036(a)(1) so a taxpayer can gift or sell all of his or her partnership interest during life and avoid the application of Code Section 2036(a)(1) if the taxpayer survives the gift by more than three years to avoid the potential application of Code Section 2035.

Integrated Plan

In two recent Tax Court cases[3] the IRS asserted that gifts of limited partnership interests to children followed closely after the formation of the partnership were part of an "integrated plan" to convey the underlying partnership assets to the taxpayer's children. While the Tax Court ruled favorably on behalf of the taxpayers in each case, the Tax Court stated that it may have reached a different result had the underlying assets of the partnerships consisted of less volatile assets as opposed to the marketable securities held by the subject partnerships. It is likely that the IRS will continue to assert this argument in challenging the discounts taken by taxpayers in conjunction with gifts or sales of partnership interests. Prior to analyzing these cases, it is helpful to review the prior case law.

Prior Case Law

Shepherd v. Commissioner

In *Shepherd*[4], the taxpayer owned timberland and stock in three closely-held banks which he planned to convey to a newly formed partnership. On August 1, 1991 Mr. Shepherd executed the Shepherd Family Partnership Agreement, forming an Alabama general partnership.[5] The partnership agreement indicated that he was to own a 50% partnership interest in exchange for a $10 capital contribution and that each of his sons was to own a 25% partnership interest in exchange for a $5 capital contribution.[6] Mr. Shepherd also executed deeds to convey the timberland to the partnership on August 1. On August 2, Mr. Shepherd's sons executed the partnership agreement. On September 9, Mr. Shepherd conveyed a portion of the stock in each of the three closely-held banks to the partnership.[7] Mr. Shepherd filed a gift tax return for 1991 reporting a gift of the timberland and the bank stock (rather than a gift of the partnership interests). The IRS audited the gift tax return and proposed a valuation adjustment to the gifts.[8]

One of the issues addressed by the Tax Court was whether Mr. Shepherd made gifts of partnership interests or gifts of an undivided interest in the timberland and bank stock. Mr. Shepherd argued the former and that such gifts should be valued with discounts for lack of control and lack of marketability. The IRS argued the latter and pointed to the fact that Mr. Shepherd's gift tax return was consistent with this position.[9]

In support of its position the IRS also argued that, under Alabama law, a partnership was not created until August 2 (the day on which the sons executed the partnership agreement). The IRS then concluded that since the deeds conveying the timberland to the partnership were executed on August 1, Mr. Shepherd gave a 25% interest in the timberland property to his sons either directly or indirectly.[10]

The Tax Court found that no direct gifts of timberland or bank stock were made to the sons since any ownership the sons might have possessed was acquired by virtue of their status as partners in the partnership.[11] In analyzing the issue of an indirect gift, the Tax Court cited Treas. Reg. § 25.2511-1(a) which provides that a transfer of property to a corporation by a shareholder generally represents a gift by the transferring shareholder to the other shareholders. The Tax Court analyzed prior case law interpreting this regulation and found that it applies to partnerships; however, the Tax Court also noted that partnerships differ from corporations in that partnerships maintain capital accounts and the a contributing partner's capital account is generally credited with the value of the property contributed. However, in this case the capital accounts of the sons were each credited with 25% of the value of the timberland property and bank stock. As a result, the Tax Court found that Mr. Shepherd made an indirect gift of the timberland and bank stock to his sons.[12]

The case was appealed to the 11th Circuit which affirmed the holdings of the Tax Court.[13] In dicta the court noted that if steps in the funding and gifting of the partnership interests had been properly ordered (if the value of the timberland and bank stock were first credited to Mr. Shepherd's capital account and Mr. Shepherd then made gifts of partnership interests), it would have been possible for Mr. Shepherd to take the discounts for lack of marketability and lack of control in valuing the gifts of the partnership interests.[14]

Jones v. Commissioner

The next case addressing the indirect gift argument was *Jones*.[15] Mr. Jones was a cattle rancher and had a desire to keep his ranches in his family after his death. Mr. Jones had one son and four daughters who each owned an interest in certain real property used for ranching which they inherited from an aunt. Mr. Jones and his son formed a Texas limited partnership on January 1, 1995. Mr. Jones contributed certain assets to the partnership in exchange for a 95.54% limited partnership interest and his son contributed certain assets in exchange for general and limited partnership interests collectively representing a 4.46% interest. The books of the partnership reflect the fact that each partner's capital account was credited with the value of the assets he contributed. Mr. Jones then made a gift to his son of an 83.08% limited partnership interest on the same day.[16]

Mr. Jones formed a second limited partnership with his four daughters on January 1, 1995 whereby he contributed certain real estate to that partnership in exchange for an 82.18% limited partnership interest and his four daughters contributed property for general and limited partnership interests representing a 17.82% partnership interest. Mr. Jones made a gift of 16.92% limited partnership interests to his daughters on the same day.[17]

Mr. Jones filed a gift tax return reporting the gifts of the limited partnership interests which reflect discounts for lack of control and lack of marketability as determined by an appraiser.[18]

One of the arguments raised by the IRS was that Mr. Jones made a taxable gift upon the formation of the partnerships since he contributed property worth $17,615,857 to the partnerships and the limited partnerships he received in consideration were only worth $6,675,156 after taking into account discounts for lack of control and lack of marketability.[19] The court rejected the IRS's argument and distinguished its current holding from that in *Shepherd* on the basis that the property contributions made by Mr. Jones were all credited to his capital account unlike those by Mr. Shepherd. Accordingly, the court rejected the indirect gift argument.[20]

The difference in the results between *Shepherd* and *Jones* indicate the importance of adhering to proper formalities in documenting partnership transactions.

Senda v. Commissioner

In *Senda v. Commissioner*,[21] Mr. Senda, his wife, and Mr. Senda in his capacity as trustee of trusts for his three children, executed the Mark W. Senda Family Limited Partnership Agreement on April 1, 1998, and on June 3, 1998 the Secretary of State of Missouri issued a Certificate of Limited Partnership. No written trust agreements existed for the three trusts and the children reported their share of income or loss from the partnership on their individual returns. On December 28, 1998, Mr. and Mrs. Senda transferred 28,500 shares of MCI stock to the partnership and the children's trusts purportedly contributed accounts receivable to the partnership although no written documentation existed to support the validity of the accounts receivable. Mr. and Mrs. Senda sent a facsimile transmission to their accountant informing him of the capital contributions and requested advice on the percentage partnership interest to gift to the trusts. Mr. and Mrs. Senda together gifted a 29.99% limited partnership interest to each trust although the assignment memorializing the transfer was not executed until several years later.[22]

Mr. and Mrs. Senda decided to make additional gifts in 1999 and were advised to create a new limited partnership. A certificate of limited partnership was issued by the Secretary of State of Missouri on December 2, 1999. Trusts agreements for the children were executed by one of the trustees of December 4, 1999, but Mr. and Mrs. Senda did not execute the trust agreements until May 2000. On December 17, 1999, Mr. and Mrs. Senda and the trustee of the children's trusts executed the partnership agreement. On December 20, 1999, Mr. and Mrs. Senda contributed 18,477 shares of MCI stock to the new partnership and the children's trusts purportedly contributed accounts receivable, although no documentation existed to support the existence of the accounts receivable. On that same day, Mr. and Mrs. Senda made a gift of a 17.9% limited partnership interest to each child's trust, but the assignments memorializing the transfer were not made until several weeks later. On December 22, 1999 Mr. Senda sent a facsimile transmission to his accountant informing him of the capital contribution and asking advice as to how large a gift to make to his children's trusts to maximize the remaining lifetime gift tax exemption. On January 31, 2000, Mr. and Mrs. Senda made a gift of a 4.5% limited partnership interest to each child's trust.[23]

The 1998, 1999, and 2000 gift tax returns filed by Mr. and Mrs. Senda reported the gifts of the limited partnership interests with valuation discounts for lack of control and lack of marketability.[24]

In challenging the value of the reported gifts, the IRS again asserted the indirect gift theory arguing that Mr. and Mrs. Senda actually made gifts of the MCI stock to their children and cited the holding in *Shepherd*. The IRS also argued that even if the contribution of the MCI stock to the partnership was actually credited to the capital accounts of Mr. and Mrs. Senda that such allocation was merely transitory and were all steps in an integrated transaction which attempted to transfer the stock to the children in partnership form. This argument was presumably made as a response to the language in the 11th Circuit's opinion in *Shepherd* which implied that if the capital accounts of Mr. Shepherd been first credited with the capital contribution of the property, rather than 50% to Mr. Shepherd and 50% to his two sons, the result would have been different. Mr. and Mrs. Senda argued that the holding in *Jones* was applicable and that contributions to partnerships and gifts of partnership interests made on the same day should be respected as long as the capital accounts are properly credited.[25]

The Tax Court found in favor of the IRS stating that the facts were was similar to *Shepherd*. The Tax Court stated that the taxpayers were unable to prove that the MCI stock was ever credited to their capital accounts which differentiated the case from *Jones*. The court also pointed to the fact that the Sendas did not maintain any books and records other than the brokerage statements and the tax returns. That Court concluded "[a]t best, the transactions were integrated (as asserted by respondent) and, in effect, simultaneous."[26]

It is interesting to note that the Tax Court's decision only covers the 1998 and 1999 gifts since the IRS conceded prior to trial that the Sendas made gifts of partnership interests on January 31, 2000 which was 42 days after the second partnership was funded.

On appeal, the 8th Circuit affirmed the ruling of the Tax Court that the formation and funding of the partnership was part of an integrated transaction. The 8th Circuit did state that even if the Sendas were able to demonstrate that the MCI stock was first credited to their capital accounts that "this formal extra step does not matter."[27] This language is at odds with the language contained in the 11th Circuit's opinion in *Shepherd* which implies that had Mr. Shepherd first contributed the land to the partnership, and then made gifts to his sons, the result would have been different.[28]

Recent Cases

Holman v. Commissioner

In *Holman*[29] the taxpayer was a former executive of Dell and had accumulated a substantial amount of Dell stock. Mr. Holman and his wife began to transfer Dell stock to their three children through uniform transfer to minors accounts (UTMA) which they established in 1996. In 1997 Mr. Holman and his wife relocated to Minnesota and sometime thereafter met with an estate planning attorney to discuss various estate planning matters. The Holmans recognized that they were wealthy and wanted to transfer their wealth to their children in a manner which would create responsibility in the children in managing the wealth. The attorney discussed the benefits of creating a family limited partnership and transferring interest to the children. The attorney discussed with the Holmans the transfer tax savings which would arise because of the discounts associated with lack of control and lack of marketability. Mr. Holman stated that he had four reasons for creating the partnership: (i) very long-term growth; (ii) asset preservation; (iii) asset protection; and (iv) education.[30]

The partnership agreement was executed on November 2, 1999 by Mr. and Mrs. Holman as both general and limited partners, and Mr. Holman's mother, as trustee of a newly created trust for the Holman's children, and as custodian of the UTMA accounts. Each partner transferred a certain amount of Dell stock to the partnership in exchange for a proportionate interest in the partnership on November 2, 1999 as well. On November 3, 1999 a certificate of limited partnership was filed with the Minnesota Secretary of State.[31] On November 8, 1999, Mr. and Mrs. Holman made gifts of limited partnership interests to the newly created trust as well as to the UTMA account for their youngest child which represented approximately 70% of the limited partnership interests. The Holmans filed gift returns reporting the gifts with the value of the gifts determined by an independent appraiser who took a combined discount of 49.25% for lack of control and lack of marketability.[32]

Mr. and Mrs. Holman made subsequent gifts of limited partnership interests on January 4, 2000 and January 4, 2001. The limited partnership interests were appraised each year and the Holmans filed gift tax returns reporting the gifts and claimed discounts for lack of marketability and lack of control.[33] The IRS audited the gift tax returns for 1999, 2000 and 2001 and asserted two separate indirect gift arguments – (i) the capital contribution to the partnership was an indirect gift of Dell stock to the children's trusts and (ii) that the formation and funding of the partnership should be aggregated under the step transaction doctrine.[34]

The Tax Court addressed the first argument by reviewing Treas. Reg. §25.2511-1(h)(1) which provides that a shareholder who makes a capital contribution to a corporation for less than full and adequate consideration makes and indirect gift of such property to the other shareholders and its holdings in *Shepherd* and *Senda*. The court found that those cases were not applicable because in *Holman* the partnership was funded six days prior to the gifts of the limited partnership. This case can be distinguished from the facts in *Shepherd*, where the taxpayer made gifts of partnership interests prior to the funding of the partnership and the funding was then allocated in proportion to the gifted interest, and *Senda*, where the funding and gifting occurred on the same day.[35]

The Tax Court then addressed the step transaction argument and began its analysis by summarizing the doctrine and the three tests employed by courts: binding commitment, interdependence, and end result. The court assumed that the IRS was basing its argument under the interdependence test which applies when "the steps in a series of transactions are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series" and, thus, the question to address is whether "the individual steps had independent significance or whether they had significance only as part of a larger transaction."[36]

The court then analyzed whether the formation and funding of the partnership were interdependent events. The IRS asserted that the six day delay between funding and gifting was done by the taxpayer to avoid and indirect gift under Treas. Reg. §25.2511-1. While the court acknowledged that one of the purposes in funding the partnership was to make gifts to their children the court stated "we cannot say that the legal relations created by the partnership would have been fruitless had petitioners not also made the 1999 gift."[37]

The court pointed out that the IRS did not assert the same argument made with respect to the 2000 gift or the

2001 gift and stated that "the passage of time may be indicative of a change in circumstances that gives independent significance." The court found that that because the Dell stock held by the partnership changed in value between the date of contribution to the partnership and the date of the gifts, the change in value provided independent significance. The court did state that it was not making a bright line test (i.e. that a six day period between funding and gifting is sufficient to avoid that step transaction doctrine and in a footnote indicated that if the underlying assets consisted of another less volatile asset such as a government bond or preferred stock that it might have reached another conclusion).[38]

Gross v. Commissioner

The opinion in *Gross*[39] was written by Judge Halpern, who wrote the opinion in *Holman*, and reaches the same conclusions as those in *Holman*. Bianca Gross formed a limited partnership by filing the Certificate of Limited Partnership with the New York Secretary of State on July 11, 1998. Ms. Gross made a capital contribution of $100 and each of her two daughters contributed $10. During the next several months Ms. Gross contributed approximately $2 million of marketable securities to the partnership and the funding was complete on December 4, 1998. On December 15, 1998, Ms. Gross and her daughters executed a partnership agreement and Ms. Gross made a gift to each daughter of a 22.5% limited partnership interest. Ms. Gross filed a gift tax return reporting the gifts and claimed a combined 35% discount for lack of control and lack of marketability. The IRS audited the gift tax return and issued a notice of deficiency denying the discounts claimed for lack of control and lack of marketability on the theory that Ms. Gross made an indirect gift of 22.5% of the underlying securities to each of her daughters.[40] As in *Holman*, the IRS asserted two separate theories of how Ms. Gross made an indirect gift. The first theory was based upon Treas. Reg. §25.2511-1 and the holding in *Shepherd*. The second theory was based upon the application of the step transaction doctrine.[41]

The Tax Court first addressed the issue of when the partnership was formed. The IRS argued that the filing of a Certificate of Limited Partnership requires that the parties execute an agreement of limited partnership prior to the filing. The IRS further argued that since the parties executed the partnership agreement on December 15, 1998 that the partnership was not in existence prior to the signing date. The Tax Court disagreed with the IRS and found that a partnership was created on July 15, 1998, at which time the parties "agreed to the essential terms of their partnership arrangement". The Tax Court stated that even if all of the necessary formalities to form a limited partnership did not occur on that date, the parties still formed a general partnership on that date.[42]

The Tax Court reviewed its prior holdings in *Jones* and *Shepherd* in light of the fact of its determination that the partnership was formed on July 15, 1998 and found that the facts in *Gross* were analogous to those in *Jones* and dissimilar to those in *Shepherd*. As in *Jones*, the taxpayer contributed property to a partnership and the taxpayer's capital account was credited with the value of the property contributed. After the contributions were recorded on the books of the partnership, the taxpayer made gifts of partnership interests.[43]

In addressing the step transaction argument, the Tax Court cited its ruling in *Holman* and held that because (i) the partnership at issue held mostly marketable securities and (ii) 11 days elapsed between the funding of the partnership and the gifts, the step transaction doctrine was not applicable. As in *Holman*, the court included a footnote which stated that its conclusions may have differed if the partnership held less volatile assets.[44]

Analysis of Holman and Gross

Both *Holman* and *Gross* implied that if the underlying partnership assets had been less volatile that the Tax Court would have been more receptive to applying the step transaction doctrine in those cases. The volatility of the underlying assets between the date of funding the partnership and the date of the gift as a rationale for granting independent significance to the formation of the partnership as an independent step seems dubious. If, instead of Dell stock, the Holmans owned commercial real estate and contributed it to the partnership and made the same gifts of partnership interests, the Tax Court implied that it might be willing to use the step transaction doctrine to ignore the formation of the partnership as a separate step because, presumably, the commercial real estate would not have the same fluctuation in value as the Dell stock from the date of funding to the date of the gift.

The focus should be on whether the partnership would have been formed absent the transfer tax savings from the valuation discounts since the partnership interests were gifted and not the underlying assets. In *Holman*, the Tax Court acknowledged that the taxpayer had four objectives in forming the partnership: i) very long-term growth; (ii) asset preservation; (iii) asset protection; and (iv) education.[45] The Tax Court did not discuss whether any of these objectives could serve as a sufficient basis for ascribing independent significance to the formation of the partnership.

As the Tax Court discussed in *Holman*, courts have employed judicial doctrines to invalidate transactions designed to minimize or avoid estate and gift taxes.[46] The *Heyen*[47] case illustrates the application of a judicial doctrine in a gift tax case. In *Heyen*, the taxpayer made gifts of stock in a family business to various donees who, shortly after receiving the gifts of stock, make further transfers of the stock to the taxpayer's family members. The taxpayer claimed that the gifts of stock to the third party donees qualified for the annual gift tax exclusion under Code Section 2503. The court applied the substance over form doctrine to treat the taxpayer as making gifts directly to her family members.[48]

In that case the step of transferring the stock to the third party donees was disregarded because the subsequent actions of the donees indicated an intent that they not actually enjoy the benefits of the ownership of the stock. If in *Holman* or *Gross*, the partnership were dissolved soon after the gifts of the partnership interests were made so that a portion of the underlying assets were then distributed to the children or their trusts, it would be understandable if the court were to disregard the contribution of the assets to the partnership as transaction lacking independent significance. However, the Tax Court's focus on the change in value of the underlying assets rather than the partnership itself seems misplaced. The fact is that in both *Holman* and *Gross* the taxpayer gifted partnership interests which is a very different asset than the gift of the underlying marketable securities.

Planning and Defending Gifts or Sales of Partnership Interests

1. Ensure Proper Documentation and Order of Events. In order to avoid the indirect gift argument which

proved successful in *Shepherd* and *Senda*, it is important that all steps necessary to form, fund, and transfer the partnership interests are completed in the proper order. Such steps should include the following:

a. Identify the initial partners;
b. Determine the capital contribution of each initial partner;
c. Validly form the partnership for state law purposes;
d. Prepare necessary conveyance documents to document the contribution of assets to the partnership;
e. Establish appropriate capital accounts for each initial partner;
f. Prepare assignments of partnership interests;
g. Adjust the partnership books to reflect the assignment of partnership interests.
h. Report the gifts of partnership interests on a Form 709 (Gift Tax Return); and
i. Ensure that the Form 1065 (Partnership Tax Return) reflects the transferees as owning the transferred interests.

2. Future Capital Contributions. While *Shepherd, Jones, Senda, Holman,* and *Gross* all addressed the issue of indirect gifts upon the formation of a partnership, the issue can arise in the event of subsequent capital contributions under the indirect gift through a capital contribution theory described in Treas. Reg. § 25.2511-1. While this regulation addressed capital contributions to corporations and the Tax Court in *Jones* acknowledged that contributions to partnerships are different than contributions to corporations because partnerships have capital accounts[49], it is important that taxpayers appropriately document additional capital contributions. Failure to adjust partnership ownership percentages after a large capital contribution could result in a deemed gift of a partnership profits interest to the other partners. The steps necessary will likely be as follows:

a. Review the partnership agreement to determine the procedure for approving additional capital contributions and prepare any required documentation;
b. Prepare necessary conveyance documents to document the contribution of the additional assets to the partnership;
c. Comply with the terms of the partnership agreement regarding the adjustment of capital accounts and ownership percentages for the additional capital contribution;
d. Credit the capital account of the contributing partner; and
e. Ensure that the Form 1065 (Partnership Tax Return) reflects the updated ownership percentages and adjustment to capital account of the contributing partner.

3. Time Between Formation and Transfer of Interests. The steps outlined in 1 and 2 above address the proper ordering and documentation of a partnership interest transfers. It is also advisable to wait some period of time between funding and gifting the partnership interests. If the Tax Court were to decide *Jones* again under the rationale employed in *Holman* and *Gross*, it appears that the step transaction might disregard the formation of the partnership. For taxpayers forming partnerships with marketable securities or other volatile assets, *Holman* seems to suggest that a six day period between funding and transfer of interests is sufficient, although the Tax Court did state that it was not creating a bright line test.[50]

For taxpayers with less volatile assets such as real estate or mineral interests, this question is more difficult to answer. In *Senda*, the IRS conceded prior to trial that the step transaction doctrine did not apply to a gift of partnership interests 42 days after the funding of the partnership. Similarly, in *Holman* 63 days elapsed between the funding of the partnership and gifts made in 2000 to which the IRS did not argue that the step transaction applied. For situations involving less volatile assets, the IRS may argue that the step transaction covers a longer time period between funding and transfer for less volatile assets based upon the language in *Holman* and *Gross* so these 42 and 63 day periods may not be viewed as safe harbor time periods. Certainly if a taxpayer can demonstrate a change in value of underlying assets between date of funding and the date of a proposed gift of partnership interests, the taxpayer would have more comfort in using a shorter time period.

4. Demonstrate Independent Significance of the Creation of the Partnership. For taxpayers with completed transactions or for future transactions in which it may not be possible to structure a longer time period between the funding and transfer, it may still be possible to argue that the step transaction should not apply by focusing on the formation of the partnership as an independent action. Taxpayers should be able to demonstrate the benefit provided by the formation of the partnership. For example, if the purpose was to consolidate assets for more efficient management, the taxpayer should show how costs saving were achieved or how the aggregation of assets enabled the partnership to meet a minimum investment requirement of a money manager. Taxpayers should also ensure that the partnership is operated in compliance with the terms of the partnership agreement and that adequate books and records are kept which would indicate an intent to form and operate a valid partnership rather than to simply take advantage of discounts for transfer tax purposes.

Conclusion

The decisions of the Tax Court in *Holman* and *Gross* indicate a willingness of the Tax Court to apply the step transaction doctrine to the formation and subsequent transfer of partnership interests. Taxpayers should proceeds cautiously when executing wealth planning strategies with partnership interests.

ENDNOTES

1 Daniel H. McCarthy dmccarthy@theblumfirm.com.
2 *See Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Hillgren v. Commissioner*, T.C. Memo 2004-46; *Estate of Abraham v. Commissioner*, T.C. Memo 2004-39, *aff'd*, 408 F.3d 206 (1st Cir. 2005); *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005), *aff'd*, T.C. Memo 2003-145, on remand from 293 F.3d 279 (2002), *aff'd in part, and reversing and remanding in part* 115 TC 478 (2000).
3 *Holman v. Commissioner*, 130 T.C. No. 12 (2008); *Gross v. Commissioner*, T.C. Memo 2008-221.
4 *Shepherd v. Commissioner*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).
5 *Id.* at 379.
6 *Id.* at 380.
7 *Id.* at 381.
8 *Id.* at 382.
9 *Id.* at 383-4.
10 *Id.* at 384.

11 *Id.* at 387.
12 *Id.* at 388-9.
13 *Shepherd v. Commissioner*, 89 AFTR 2d 2002-1251, *aff'd*, 115 TC 376 (2000).
14 *Id.* at 1253.
15 *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001).
16 *Id.* at 122-3.
17 *Id.* at 124.
18 *Id.* at 126.
19 *Id.* at 127.
20 *Id.*
21 T.C. Memo 2004-160, aff'd.
22 *Id.* at 952.
23 *Id.* at 953.
24 *Id.*
25 *Id.*
26 *Id.* at 956.
27 *Senda v. Commissioner*, 97 AFTR 2d 2006-419 at 422.
28 *Shepherd vs. Commissioner*, 89 AFTR 2d 2002-1251 at 1253.
29 *Holman v. Commissioner*.
30 *Id.* at 102-103.
31 *Id.* at 104.
32 *Id.* at 106-7.
33 *Id.* at 108-9.
34 *Id.* at 110-11.
35 *Id.* at 111-12.
36 *Id.* at 113.
37 *Id.*
38 *Id.* at 114.
39 *Gross v. Commissioner*, T.C. Memo 2008-221.
40 *Id.* at 1164.
41 *Id.* at 1169.
42 *Id.* at 1168.
43 *Id.* at 1170.
44 *Id.*
45 Holman at 103.
46 *Id.* at 113; *See* Harrison and Held, *Sham Transaction Doctrine*, Trusts and Estates (February 2003).
47 *Heyen v. US*, 68 AFTR 2d 91-6044.
48 *Id.* at 6047.
49 Shepherd at 389.
50 *Holman* at 144, footnote 7; *See also* Gross at 1170.

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ARE ALL SETTLEMENT PAYMENTS DEDUCTIBLE?

By Robert W. Wood[1]

As a rule, plaintiffs in litigation have become pretty sophisticated about tax issues. Some plaintiffs even consult tax counsel as they are framing their complaint, ever vigilant that some tax-related seed planted early in the dispute might grow into a prodigious tax benefit down the road. Most plaintiffs are not quite that proactive about tax issues, but do start thinking about the tax implications of a recovery as a case is winding up. A few plaintiffs don't consider tax issues until tax reporting time the year following the settlement.

Defendants, on the other hand, have never been as sensitive to tax issues for several reasons. For one, by the very nature of litigation, the defendant is in a largely reactive mode, mostly trying to make the matter go away. Second, even for defendants who become convinced they will eventually have to pay something to settle the matter, paying something normally involves fewer opportunities for tax planning and orchestration than the act of receiving something.

Besides, in my experience, most defendants seem to think that *anything* they pay in this context, whether legal fees or damages, will be deductible no matter what. They can perhaps be forgiven for such blanket deducti-mania if they are operating a trade or business, and the lawsuit relates to their operation of that trade or business. In that context, most (but certainly not all) settlements and judgments are deductible. Nevertheless, I've long thought we would see an increasing volume of authorities exploring a largely factual (or perhaps combined factual and legal) question: are amounts paid to dispose of claims deductible (as most taxpayers usually think they are in every case) or rather non-deductible as penalties? In my experience, there is often considerable room for taxpayers to negotiate language in settlement agreements that can help them when it later comes tax time.

It can also help in a subsequent tax dispute. First, of course, one must recognize the issue and know something about the legal landscape. Frequently, one can plan around some of the minefields. That is good, because the minefields seem to be increasing. Several prominent Senators (among them, Senator Grassley of Iowa) have castigated the IRS and Justice Department for failing to ensure that non-deductibility of many prominent settlements.[2] Such scrutiny should serve to heighten taxpayer interest in this topic.

Yet, it also seems to be heightening the IRS's scrutiny of the deductibility of damage payments. There are several recent cases that give evidence of this trend.

Wellpoint Case

In *Wellpoint, Inc et al vs. Commissioner*[3], the Tax Court considered a company's deduction of three settlement payments totaling over $113 million made to resolve lawsuits brought against the company by the Attorneys General of the states of Kentucky, Ohio, and Connecticut. The first issue in the case was whether these amounts were business expenses or penalties. The second issue was whether the legal and professional expenses Wellpoint incurred in defending these lawsuits were also deductible.

In a decision that will almost surely be appealed, Judge Kroupa ruled that both the outsize settlement payments and the related legal expenses were capital expenditures that could not be deducted. As is so often the case in Tax Court litigation, many of the facts were stipulated. Wellpoint provided commercial health insurance through its subsidiaries doing business in all of the states in question. Many of Wellpoint's subsidiaries were Blue Cross/Blue Shield licensees.

In Kentucky, Ohio, and Connecticut, Wellpoint merged with Blue Cross and Blue Shield Plans, the latter of which had stated charitable purpose provisions in their governing documents. Post-merger, the Attorneys General of Kentucky, Ohio, and Connecticut began investigating some of the constituent companies, and they did not like what they found. There was clearly nothing charitable going on.

The basic complaint in each state was the same: that Wellpoint's subsidiaries continued to have lofty stated charitable purposes in their governing documents. That meant they had received beneficial federal and state law treatment. To the three states, that meant Wellpoint should be viewed as holding these assets impressed with a charitable trust. In essence, the Attorneys General in the three states argued that no charitable purposes were being met, and that the respective states therefore should logically be entitled to those assets.

Settling Up

After a period of scuffling, Wellpoint and its subsidiaries resolved the litigation in all three states by a transfer of cash. Yet, this was not the usual transfer of cash in a settlement payment. Indeed, in Kentucky, Wellpoint paid over $45 million, transferring the money to the Commonwealth of Kentucky for the specific purpose of creating a section 501(c)(3) organization to promote Kentucky healthcare.

In Ohio, Wellpoint forked over $36 million, the money being used to establish the Anthem Foundation, also targeting healthcare. In Connecticut, where the settlement payment was slightly more than $40 million, the money went directly into a newly formed charitable corporation to serve the health needs of Connecticut. The amounts to the three states were paid in 1999 and 2000 tax years. Between these two tax years, Wellpoint deducted all the settlement payments, along with approximately $800,000 in related legal and professional fees.

Although these settlement agreements may sound unusual, in at least one respect they were not. The three settlement agreements made it quite clear Wellpoint was not admitting any liability, and was only entering into each of the settlements as a compromise and to avoid further litigation. Consider that denial of liability question while reflecting on the Tax Court's decision.

Harsh But Fair?

Much of the Tax Court's opinion in *Wellpoint* is predictable. That is, the court starts with an analysis of the origin of the claim doctrine, noting that it had to determine the nature of the claim in each of the respective lawsuits. Few of us get a chance to talk about the *cy-pres* doctrine outside of academia, so this is a rare opportunity. The basic claim of the Attorneys General in all three cases, said Judge Kroupa, was *cy-pres*.

For those (like me) with little Latin and even less Greek, *cy-pres* means that, when it would be impossible or illegal to give an instrument its literal effect, you should construe it so the intention of the party is carried out as near as it can be.[4] Thus, if property is dedicated to a particular charitable purpose, and that purpose is not being carried out, a *cy-pres* proceeding would seek to carry out the charitable purpose in a way that is as close as possible to the original purpose, even if the original cannot be replicated.

For example, Suppose that a charitable gift is made for the purpose of abolishing slavery. A gift to abolish slavery becomes impossible to satisfy because slavery has already been abolished. Consequently, the gift might be reformed to provide necessities for victims of slavery.[5] Examples from a storied legal literature include many such quirky fact patterns.

With the assumed relevancy of *cy-pres* authorities, the Tax Court goes on to answer the question whether payments to resolve litigation over the *cy-pres* doctrine should be treated as deductible under section 162, or rather must be capitalized under section 263. Some of you may be scratching your heads thinking that whatever creative arguments the three states Attorneys General made, this sounds like roll-up-your-sleeves business litigation. Indeed, you might think that business expense deductions here would be obvious. Another alternative might be charitable contribution deductions, but we'll come back to that subject later.

Nevertheless, the Tax Court weighed in with the usual smattering of cases that say the costs of resolving litigation over title to property involve capital expenditures. From the usual cases standing for the proposition that title to property equals capitalization, the court went on to say that settlement payments and legal fees expended to resolve disputes over the ownership of assets are also capital in nature. The court cites *Anchor Coupling Co. v. U.S.*[6] In contrast to the capitalization authorities, the court admits that a deduction is usually allowed for expenses incurred in defending a business and its policies from attack.[7]

Title Fight vs. Just Business.

Were these three lawsuits fundamentally about title to assets, or were they rather about Wellpoint's business and its ability to keep operating? You might think the company had a pretty good argument that dealing with the respective Attorneys General of these three complaining states was really about Wellpoint's manner of conducting business. As such, Wellpoint argued that this should make the three settlement payments (along with the related legal fees) deductible. Indeed, Wellpoint noted that the lawsuits did not actually challenge title to specific items of property. According to Wellpoint, that made capitalization inappropriate.

Interestingly, the Tax Court actually agrees that it was Wellpoint's business practices that were being assaulted in these cases. Yet, that concession turned out to be a hollow victory, for here, the Tax Court diverged from the Wellpoint script. The Tax Court bought the argument that the origin of each claim was a dispute over the equitable ownership of assets allegedly impressed with charitable trust obligations.

Unfortunately for Wellpoint, the settlement agreement seemed like a good roadmap on this point. In each case, the settlement agreement called for the assets to be transferred to a section 501(c)(3) organization conforming to the charitable purpose the state Attorney General sought to enforce. The Tax Court applied its logic to each of the three pieces of litigation separately, although with common effect.

For example, in the case of Kentucky, the court found that the complaint, the settlement agreement and the parties' respective descriptions of the nature of the suit all suggested that the Kentucky case was actually about title to the alleged charitable assets. Indeed, with a kind of hoist-by-your-own-petard flair, the Tax Court pointed out that the $45 million Kentucky payment went to establish a section 501(c)(3) organization to address health care needs. Clearly, that sounded like an admission to Judge Kroupa.

As for Ohio, the complaint there also asserted that assets were impressed with a charitable trust. The Ohio Attorney General sought the return of those assets to charitable purposes. That sounded just like the Connecticut filing, which also focused on the ownership of trust assets. The Tax Court pointed out that even the petitioner in the case (in financial statements and annual reports) had characterized the Connecticut suit as a dispute over title to assets allegedly impressed with a charitable trust. Talk about being hoisted by your own financial statements petard.

Not surprisingly, of course, the settlement documents in all three states deny the existence of a charitable trust, and assert something that is undoubtedly true: that Wellpoint was making the payment to avoid the interruption of its business or loss of goodwill. Instead of arguing the facts, the Tax Court simply said it found this argument irrelevant. A taxpayer's motive for settling a case is not controlling in determining the deductibility of the settlement payment, said the court. For this proposition, Judge Kroupa cites *Woodard vs. Commissioner*.[8]

Strictly Business

Backed into a corner, with Judge Kroupa giving no quarter, Wellpoint found itself arguing that these settlement payments were per se deductible because they were necessary to defend its business. Two cases underscoring such a rule are *BHA Enterprises Inc v. Commissioner*[9], and *AE Staley Manufacturing Co and Subsidiaries v. Commissioner*.[10] The *BAH* case involved a taxpayer fighting to keep the FCC from revoking its broadcasting licenses, and settlement payments there were held to be deductible.

Still, Judge Kroupa found BHA inapposite, castigating as "uncorroborated and self-serving" the testimony presented by Wellpoint's witnesses that they could no longer do business if they lost these suits. *AE Staley* involved deduction for investment banking and printing costs incurred by Staley in an unsuccessful effort to defend its business against a takeover. Those costs were held to be deductible, because they produced no future benefit.

Yet, Judge Kroupa also found *AE Staley* distinguishable, because she found the future benefits accruing from the defense and settlement of these *cy-pres* cases to be manifest. They arguably enabled Wellpoint to convert the assets from charitable to income-producing purposes.

Legal Expenses

This brings us to legal expenses. Few readers at the end of this sad opinion would expect the legal expense issue to go the taxpayer's way. Predictably, in a short paragraph, Judge Kroupa concludes that the legal and professional expenses, like the settlement payments, are controlled by the origin of the claim doctrine. The Tax Court summarily concluded that the legal and professional fees here arose from defending against claims that had their origin in the equitable ownership of assets. Therefore, no deduction!

In some ways, of course, Judge Kroupa seems correct in her origin of the claim analysis. After all, the three cases here were brought seeking the imposition of a charitable trust. Not only that, but that's the unequivocal way all three cases were settled. Still, I can see Wellpoint's well, point. It reminds me a little of *U.S. v. Gilmore*[xi], where the taxpayer argued convincingly that the origin of his huge legal bills was an attempt to retain his business despite a bitterly fought divorce. The IRS argued even more convincingly that the origin of the claim *was* the divorce. As a divorce was purely personal—whatever might be its disastrous financial effects—Gilmore could claim no deduction.

The origin of the claim doctrine is like that, sometimes capable of more than one view, depending on the beholder and his particular lens.

Forest or Trees?

When litigating the common deductible or capitalizable question, it's always appropriate to stand back and look at the forest. By that, I simply mean that timing must be considered. So, while pondering the door number one of a deduction vs. the obviously less attractive door number two of capitalization, think about the real dollar difference.

If the pertinent asset has been disposed of, either immediately or at least by the time of the tax litigation, the timing difference between a current deduction and capitalizing the payment may not be too severe. In fact, a year or two of timing difference can look like a virtual rounding error. Such an analysis in this case would be truly interesting, but there is nothing in the case to indicate exactly what would happen next.

Indeed, if Judge Kroupa's decision sticks on appeal and Wellpoint has to capitalize the entire amount, does it then amortize the amount? If so, over what period? To what asset does it attach?

In fact, isn't it clear that Wellpoint parted irrevocably with the monies going to the respective charities? Even assuming that Judge Kroupa is correct, I'm unclear whether Wellpoint would *ever* receive any tax benefit from these payments. But, that brings us to the next chapter in this mess.

Charitable Contributions

Every reader will have thought about the charitable contribution angle, at least in passing. If you can't deduct one way, why not another! These payments were, after all, payments to charity.

A footnote in the opinion even notes that in the case of the Ohio litigation (with $36 million going to the Anthem Foundation), Wellpoint actually got an $8 million credit (from the state of Ohio) for Wellpoint's prior charitable contributions. That meant Wellpoint was only required to pay $28 million in cash of the $36 million settlement to resolve the Ohio case. This should make you wonder whether a charitable contribution deduction here wouldn't be unassailable.

But would it? There are cases in the charitable contribution arena that say you must have a donative or charitable intent. And, there are cases that deny charitable deductions when there is a *quid pro quo* for the "donation." Of course, there are also percentage limitations on charitable contributions. Nevertheless, perhaps we should assume Wellpoint could claim a charitable contribution deduction even if it meant taking it over several years.

As to donative intent and *quid pro quo* issues, however, how does one determine if a purported gift is in the nature of a transfer for value, rather than being purely motivated by charity? The *quid pro quo* problem can arise with a charitable contribution made in exchange for something given now or in the future. Conveying an asset to a charitable organization as part of a deal or arrangement to get something back from the organization taints the contribution.

It can be viewed, in short, as merely a business deal.[12] One would think that there would be a fair amount of case law on the application of the *quid pro quo* concept. Most of the cases concern developers and real estate.

For example, in *McConnell v. Commissioner*[13], the Tax Court disallowed a deduction for a contribution of property to a municipality on the grounds the transfer was motivated by an anticipated benefit "beyond the mere satisfaction flowing from the performance of a generous act." The court found the McConnells' motives in transferring their interests in donated streets and sewers were: (1) to avoid responsibility for future maintenance of the streets and sewers; and (2) to enhance the value of their interest in the remaining property. In the Tax Court's view, this rendered Section 170 inapplicable.

Similarly, in *Sutton v. Commissioner*[14], the donor granted a perpetual easement that the court found was for the primary purpose of allowing the donor to develop his property. Thus, a charitable contribution deduction was denied. In contrast, in *McLennan v. U.S.*[15], a deduction for a scenic easement was allowed notwithstanding a retained right to develop. The Claims Court held that the McLennans had transferred the easement with donative intent, and with an exclusive conservation purpose.

In the court's view, the McLennans were concerned about the pristine quality of the surrounding land, and were also aware that the grant of the easement would reduce the total value of their property. The government contended that the McLennans were motivated by tax savings rather than by a desire to preserve and protect the land. Here, the Claims Court was convinced that the taxpayers met the donative intent and conservation purpose thresholds, so allowed the deduction.

Contributions to charity to resolve litigation seem relatively uncommon, but there is at least some practical precedent. Some of the landmark state antitrust litigation against Microsoft was resolved in part by "charitable" contributions of Microsoft products to schools.[16] I don't know, but I expect Microsoft deducted those charitable contributions. Presumably if they were not charitable contributions, they were business expenses.

<u>Plan B?</u>
It is also worth reflecting briefly on what Wellpoint could have done differently. Normally, I would advocate drafting a settlement agreement to focus on tax issues. Here, that might have meant underscoring (in recitals or elsewhere) the fact that Wellpoint was having its manner of doing business challenged in these three states. Moreover, it might be wise (even if self-serving) to indicated that Wellpoint was making the settlement payments to be able to continue in business. Arguably, that's what the suit was about.

Even so, I am not so sure that would have helped here. Indeed, the three states had each framed the dispute as involving title to assets. Yet fundamentally, there was no court ruling that said the states owned the assets and that Wellpoint did not. Instead, there were three settlement agreements each of which explicitly called for a transfer of assets (cash) to some entity at the behest of the state.

Maybe it's a dumb question, but on these facts, if one thinks about the legal expense first, and concludes that capitalization is appropriate, to what would you capitalize it? With no court ruling that the assets were always owned by the state (or by a charity), the assets were presently owned by Wellpoint until the time of the transfer. The transfers occurred over 2 years, between 1999 and 2000. One might think that if legal expenses were incurred with respect to capital assets in those 2 years, and the assets were disposed of in 1999 or 2000, that disposition would trigger the loss.

Clearly, that must not be the case, since this relatively small timing difference would probably have been resolved before trial, and there is no discussion in the case of how capitalization would work here. Nevertheless, it is tempting to think that Wellpoint would be capitalizing the property it gave away. If this theory were correct, there would presumably have been no Tax Court case. Wellpoint would surely have simply agreed to capitalization followed by immediate disposition of the capitalized asset.

Instead, what the IRS and Tax Court presumably had in mind is that Wellpoint would capitalize the amounts with respect to its own stock. Thus, it would achieve a tax benefit only on a sale or liquidation of the company. Even with all this, it is still possible that creative drafting in the three settlement agreements might have given Wellpoint some better arguments in this case.

<u>Private Letter Ruling</u>
The second piece of unhappy news on this topic comes from the IRS itself in Field Attorney Advice 20084301F.[17] This Field Attorney Advice involved facts that, although different from the Wellpoint facts, raise related issues. As in Wellpoint, three states are involved in the Field Attorney Advice.

Here again, the question is whether ordinary and necessary business expense treatment is available. Rather than the alternative of capitalization as presented in Wellpoint, though, the question here was whether 162(f) instead prevented a deduction entirely.

In the list of potential taxpayer nightmares, 162(f) treatment is arguably even worse than capitalization treatment since 162(f) prevents any deduction ever. The key, of course, is just what is considered a fine or a penalty within the scope of 162(f).

In Field Attorney Advice 20084301F, Electrotoy was a consumer products manager operating in states X, Y and Z. The respective states sued in federal district court accusing the company of price fixing. The states claimed Electrotoy's practices were anticompetitive. The three states sought injunctions, as well as civil penalties. Eventually, the parties filed a consent decree and final judgment.

In it, Electrotoy agreed to an injunction against dictating the price of its products to retailers and agreed to pay an amount to the three states. The money was to be earmarked for the use by the state Attorney General for antitrust enforcement, for a consumer protection fund, or any other function allowed under state law. Significantly, Electrotoy admitted no liability, claiming that the consent judgment could not be used in any proceeding to show its guilt.

The Field Attorney Advice includes a discussion of the Sherman Anti-Trust Act and the way in which states can participate and receive fines in the case of anti-trust enforcement. In addition, each of the three states in question had state laws against price fixing and restraint of trade, and those laws provided for fines or penalties for violations.

<u>Nondeductible Fine</u>
After reviewing pertinent state law, the Field Attorney Advice concludes that Electrotoy's payment to all three states to settle the antitrust suits under federal and state laws was not deductible under section 162(f). The Field Attorney Advice comments that the settlement agreement did not explicitly allocate monies between federal and/or state law violations. Nevertheless, all three state statutes spoke only of fines being available to the states, not damages.

Moreover, the Field Attorney Advice noted that the amount Electrotoy paid was below the maximum amount the law allowed for a penalty. Thus, if 100x was the maximum potential penalty, and Electrotoy paid 80x, the Field Attorney Advice found that this by itself was evidence that the entire payment Electrotoy made was a fine or penalty. This fact by itself should suggest that the taxing authorities may be expected to draw inferences from the mere amounts involved. Some thought should be given to what (if any) evidence can be gathered to rebut such an inference.

The Field Attorney Advice does recognize some ambivalence in the law of State Y and State Z as to whether anti-trust monetary judgments were penalties or instead were compensatory damages. Nevertheless, the Field Attorney Advice notes that States Y and Z also filed their complaint under federal anti-trust statutes, and that the aggregate Electrotoy payment was well within the federal penalty limits.

Based on that, the Service said it means the payments here "can reasonably be treated as a penalty." Finally, the Field Attorney Advice notes that the plaintiffs' complaint in all three states specifically requested civil penalties, and did not specifically request compensatory damages. For all of these reasons, the Field Attorney Advice concludes that allowing any portion of Electrotoy's settlement payment to be treated as deductible damages was not in accord with the facts.

"No Admission" Language

Interestingly, the Field Attorney Advice recognizes that Electrotoy could well argue that its payment was compensation for damages in the three states, or that it represented an amount outside of the anti-trust law to settle the suit. Noting the (arguably boilerplate) statement in the settlement agreement that Electrotoy admitted no wrongdoing, the IRS flatly states that the admission of wrongdoing is not necessary for the deduction prohibition of section 162(f) to apply. It is only necessary that the payment be most properly characterized as a penalty, the IRS said. The National Office found that here in spades.

Why? Electrotoy had simply paid money to settle antitrust allegations which (if proven at trial) could have lead to a fine of up to $10 million. Electrotoy paid less than that, but the fine or penalty characterization stuck, said the Service.

Conclusions

It is probably not likely that defendants will become as tax savvy as plaintiffs when settling litigation. Ultimately, most defendants probably do not need to be. In a large number of cases, the defendant will be engaged in a trade or business, and there will be some kind of tax benefit available for making settlement payments and paying legal fees to attorneys. In a majority of these cases, the tax treatment is likely to be full deductibility as an ordinary and necessary business expenses, or at least as an investment expense.

Nevertheless, defendants too need to be concerned with tax issues. At one extreme, there are still cases where neither legal fees nor settlement payments are deductible, because of the personal nature of the dispute. Then, along the continuum come cases in which either Section 212 or Section 162 expenses are differentiated, as well as the dreaded capitalization concept. At the other extreme of the perspective, we would find non-deductibility under Section 162(f).

Particularly as the economy falters, defendants who do have to pay lawyers' fees and settlement or judgment amounts will want a tax benefit to ease the pain. Consider these issues as early as you can.

ENDNOTES

1 Robert W. Wood practices law with Wood & Porter, in San Francisco (www.woodporter.com), and is the author of Taxation of Damage Awards and Settlement Payments (3d Ed. Tax Institute 2005 with 2008 Update) available at www.taxinstitute.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.
2 See Wayne, "3 Senators Protest Possible Tax Deduction for Boeing in Settling U.S. Case," The New York Times, July 7, 2006, p. C3. See also Senate Finance Committee Memorandum to Reporters and Editors, from Jill Gerber for Grassley, regarding the potential deductibility of Boeing's government settlement, July 26, 2006.
3 TC Memo 2008-236, Tax Analysts Doc 2008-22814, 2008 TNT 209-7.
4 See Black s Law Dictionary page 387 (6th edition, 1990).
5 See *Jackson v. Phillips*, 96 Mass, 539 (1897).
6 427 F 2nd 429 (7th Cir. 1970).
7 See *INDOPCO Inc v. Commissioner*, 503 U.S. 79 (1992). See also *Commissioner v. Heininger*, 320 U.S. 467 (1943).
8 397 U.S. at 578.
9 74 T.C. 593 (1980).
10 199 F 3rd 482 (7th Cir. 1997).
11 372 U.S. 39 (1963).
12 See Regulations Section 1.170A-14(h)(3)(i).
13 55 T.C.M. 1284 (1988), *aff d w/o opinion*, 3d Cir. 1989.
14 57 T.C. 239 (1971).
15 92-1 U.S.T.C. 50,447 (Cl. Ct. 1991).
16 See Markoff, "Microsoft Finds Some Doubters for the Motives of Its Largesse," The New York Times, May 26, 2003.
17 Tax Analysts DOC # 2008-22706, 2008 TNT 208-16.

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2008 CURRENT DEVELOPMENTS IN TEXAS MARGIN TAX AND TEXAS SALES & USE TAX

By Cheri Whiteside[1]

This article presents selected 2008 developments relating to the Texas Margin Tax[2] ("TMT") and Texas Sales & Use Tax ("Sales Tax"). Section I of this article discusses the TMT generally, the Comptroller's Frequently Asked Questions ("FAQ") webpage on the TMT, and recently issued Comptroller letter rulings on the TMT. Section II of this article provides a general description of the Sales Tax and a discussion of selected 2008 developments.

I. Texas Margin Tax

A. General Overview

The TMT, which became effective on January 1, 2008, expanded the scope of business entities taxed, broadened the tax base, and lowered the tax rate. Certain entities previously free from taxation under the prior Texas franchise tax system – such as limited partnerships – found themselves now subject to the TMT.[3] Generally, under the TMT, all entities organized in Texas or otherwise doing business in Texas that have liability protection are "taxable entities." Some of the entities not subject to the TMT include sole proprietorships, general partnerships where direct ownership is composed entirely of natural persons, and certain "passive entities."[4] To qualify as an exempt passive entity, the entity must be formed as a limited partnership or trust (but not a business trust), and 90% of such entity's federal gross income must come from certain statutorily defined "permissible" investments.[5] Examples of such permissible investments that generate "passive" income for TMT purposes include dividends, interest, royalties, bonuses, capital gains from the sale of real property, and certain oil and gas income such as royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests. Notable among income that is not considered "passive" for TMT purposes is income generated from rent.[6]

Not only are more entities subject to taxation under the TMT, the revised tax base is broader than its predecessor system. In contrast, under the prior Texas franchise tax system, the tax base for earned surplus purposes was computed on a "net income" basis. Under the TMT, the computation of an entity's margin is based on the entity's total revenue, the starting point of which are *gross* numbers from the entity's federal return. However, in light of the expanded scope of entities taxed and the broadened tax base, the TMT tax rate was lowered to one percent.

B. The Comptroller's Frequently Asked Questions Webpage

In an effort to streamline the transition from the prior Texas franchise tax system to the new TMT, the Comptroller created a comprehensive FAQ page on its website.[7] The FAQ page was formed to provide initial guidance for business entities subject to the TMT. By creating the FAQ page, the Comptroller hoped to reduce the need for the need for the issuance of multiple and redundant Comptroller letter rulings on the TMT. Along these lines, the Comptroller continues to update the FAQ with new questions and answers relating to the TMT. As of February 2009, the FAQ page currently covers the following 15 sections:

- Account and Report Form Information
- Taxable Entities
- Passive Entities
- Exemptions
- Reports and Payments
- Extensions
- Total Revenue
- Cost of Goods Sold
- Compensation
- Combined Group
- Apportionment
- Credits
- Staff Leasing Companies
- Tiered Partnership Provisions
- Electronic Reporting and Paying Technical Questions

Below is a brief summary of the topics more substantially covered by the Comptroller on the FAQ page. Within each topic summary, emphasis is placed on discussing the most recently added questions and answers.

1. Account and Report Form Information

The Account and Report Form Information FAQ section consists of questions and answers regarding TMT due dates and form requirements, as well as information regarding electronic filing. In May, the Comptroller added questions and answers discussing the requirement that each report form include both a North American Industry Classification System ("NAICS") code and a Standard Industrial Classification ("SIC") code. For federal purposes, the NAICS code has replaced the SIC code. The reason the Comptroller requires the NAICS code is because states are now required to use NAICS codes when reporting data to the federal government. Additionally, the Comptroller uses the NAICS code to generate data to make revenue estimates, answer requests from the Legislature and the public about taxable sales by industry, and provide taxpayers specific information about changes in tax laws that affect a particular industry. Taxpayers can find their NAICS codes on the U.S. Census Bureau's Web site.

Although the NAICS code has replaced the SIC code for federal purposes, the Comptroller still requires entities to provide a SIC code on the report forms. This code is necessary because it allows taxable entities primarily engaged in wholesale or retail trade, as designated by their SIC code, to use the reduced TMT tax rate of 0.5%. A taxpayer may locate their four-digit SIC code on the Occupational Safety and Health Administration Web site.

2. Taxable Entities

The Taxable Entities FAQ section focuses on questions and answers regarding the general definition of taxable entities, the exclusion of entities from such definition, and the effect that an entity's limited liability status has on its taxation. In June, the Comptroller added four questions and answers further clarifying what type of entities and actions will subject a taxpayer to the TMT. Notably, the Comptroller guidance confirms that a non-Texas entity that owns a royalty interest in an oil and gas well in Texas is subject to the TMT. This is because a royalty interest in an oil and gas well is considered an interest in real property, and owning Texas real property is sufficient nexus to cause a foreign entity to be subject to TMT. Accordingly, a non-Texas entity owning a royalty interest in an oil and gas well will be subject to TMT unless an exemption applies – such as the entity qualifying for passive entity status under the TMT.

Further, the Comptroller guidance states that, even if an entity is treated as a disregarded entity for federal income tax purposes, if such entity is a taxable entity that is organized in Texas or otherwise doing business in Texas, it is subject to TMT as a taxable entity despite being disregarded for federal income tax purposes. Unlike many states, Texas tax law does not follow the federal check-the-box rules in determining the tax classification of an entity.

Additionally, the Comptroller guidance indicates that a limited liability company that was organized to collect lottery winnings is subject to TMT. The guidance is not clear whether such conclusion relates to only an LLC organized in Texas or also a foreign LLC such that collecting lottery winnings is considered doing business in Texas for nexus purposes.

The Comptroller further provides that, while a general partnership interest held by the estate of an individual does not subject an otherwise non-taxable general partnership to the TMT, a general partnership interest held by the bankruptcy estate of an individual will subject the general partnership to TMT. The bankruptcy estate of an individual, unlike the estate of an individual, is a separate taxable entity for federal tax reporting, and will not be considered an extension of a natural person.

The Comptroller additionally provides in the Taxable Entities FAQ section that a joint venture wholly owned by natural persons is not a taxable entity.

3. Passive Entities

The Passive Entities FAQ section discusses which entities can qualify as exempt passive entities, what income is considered passive income for TMT purposes, and the additional requirements for qualification as a passive entity. Recently, the Comptroller has added questions and answers addressing the filing requirements for passive entities, the characterization of certain incomes as passive income or not, and whether a partnership that includes an Individual Retirement Account ("IRA") as a partner is a taxable entity. These issues are discussed in more detail below.

Regarding whether passive entities must file reports, the answer is yes. If an entity qualifies as a passive entity and is registered with the Comptroller's office or the Texas Secretary of State's office, then it will be required to file a No Tax Due Information Report, which can be found on the Comptroller's Web site, for the period upon which tax is based. Passive entities, however, are not required to file an Ownership Information Report. If a partnership or trust qualifies as a passive entity for the period upon which the TMT report is based, and is not registered with the Comptroller's office or the Texas Secretary of State's office, then it will not be required to register or file a TMT report with the Comptroller's office. If the partnership or trust subsequently loses its status as a passive entity, it must file a Form AP-114 or AP-224 to register with the Comptroller's office and must begin reporting tax due.

With respect to the characterization of whether certain types of income are passive or not for TMT purposes, the Comptroller guidance states that recapture of net I.R.C. § 1231 losses is not considered passive income for TMT purposes. Additionally, the Comptroller guidance states that lottery winnings do not qualify as passive income for TMT purposes.

The Comptroller guidance further provides that, if an IRA is a partner in a partnership, then the partnership is a taxable entity.

4. Reports and Payments

Generally, the Reports and Payments FAQ section addresses questions regarding entities required to file franchise reports, the revised franchise tax base, the applicable rate used, discounts, extended deadlines, and the appropriate forms to file. The most recent additions to the Reports and Payments FAQ section focus on specific filing inquiries. For example, taxable entities that file separate reports but later determine they should have filed a combined group report must submit a letter to the Comptroller with the entity's name that was filed incorrectly, the entity's taxpayer number, and the combined group's reporting entity's name and taxpayer number. The letter must state that a report was filed in error, that the entity will now report with a combined group, and request a refund to transfer any tax payment from the member's account to the reporting entity's account. Based on this guidance, it does not appear a formal amended report of the combined group must be filed.

Additionally, the Comptroller distinguishes which entities must file a Form 05-102, Public Information Report ("PIR"), and which entities must file a Form 05-167, Ownership Information Report ("OIR"). The PIR is filed by corporations, limited liability companies, and financial institutions. In contrast, the OIR is filed by professional associations, partnerships, associations, trusts, and all other taxable entities not required to file the PIR.

5. Total Revenue

The Total Revenue FAQ section provides guidance on subjects such as calculating total revenue, flow-through funds, total revenue exclusions, the effect of exclusions on the cost of goods sold or compensation deduction, and annualized revenue. In June, several questions and answers were added that addressed total revenue exclusions.

Notably as to banks, the Comptroller guidance provides that bad debt expensed for federal income tax purposes that corresponds to items of gross receipts included in total revenue for the current reporting period or a past reporting period may be excluded from total revenue. However, since the principal repayment of a loan is not included in total revenue, such amounts cannot be excluded from total revenue as a bad debt.

With respect to staff leasing services companies and temporary employment services companies, the Comptroller guidance provides that such entities may deduct from total revenue the actual amounts reimbursed by the client company for wages reported on W-2's, payroll taxes, and employee benefits including workers' compensation. However, since 1099 labor is not considered wages under the Internal Revenue Code or the Texas Tax Code Chapter 171, such amounts cannot be excluded from total revenue.

With respect to capitation awards paid by Medicare-managed care plans to health care providers, the Comptroller guidance indicates that such amounts can be excluded from total revenue. On the issue of co-payments and deductibles received from supplemental insurance for patients under Medicare, Medicaid and other programs specified in Tex. Tax Code § 171,1011(n), the Comptroller guidance indicates that such amounts may be excluded from total revenue, but the exclusion may not exceed the program's allowance amount.

6. Cost of Goods Sold

The Cost of Goods Sold ("COGS") FAQ section answers questions regarding the general definition of COGS, which entities may make a COGS election, how a COGS deduction is calculated, inclusions and exclusions, how entities make the election, and capitalizing and expensing allowable costs.

Of the recently added questions and answers, the Comptroller focused largely on further addressing who can qualify for a COGS deduction and what can be included in a COGS deduction. For example, movie theaters, cable television companies, and mixed transactions may all qualify for a COGS deduction. However, a movie theater may only take a COGS deduction for concession sales. Regarding mixed transactions, which are transactions that contain elements of both a sale of tangible personal property and a service, the transaction only qualifies for a COGS deduction in relation to the tangible personal property sold. Also includible in a COGS deduction are certain oilfield services an entity performs and labor to install tangible personal property, that is part of the construction, improvement, remodeling, repair or industrial maintenance of real property.

7. Compensation Deduction

The Compensation Deduction FAQ section includes questions and answers concerning making and changing the election and computing the compensation deduction. In June, the Comptroller addressed the following questions: (1) if net distributive income ("NDI") is negative, does it have to be included in compensation, and (2) How does the $300,000 cap per employee apply when W-2 wages are paid and K-1's are issued by the same taxable entity to the same person? The Comptroller guidance provides that, if NDI is a negative number, then it will be treated as a negative number in computing compensation. Comptroller Rule 3.589, amended effective January 1, 2009, incorporates the Comptroller's position regarding negative NDI. In regards to the application of the $300,000 cap, the Comptroller stated that the compensation cap would apply to the sum of the individual's W-2 wages and K-1 amounts.

8. Combined Group

The Combined Group FAQ section consists of questions and answers covering what entities are included and not included in a combined group, what ownership percentage creates affiliated status, what activities create a unitary relationship among entities, attribution of ownership, Texas nexus requirements, applicable tax rates for combined groups utilizing more than one tax rate, a combined groups eligibility for discounts and elections, and general account and reporting information for combined groups.

In June, the Comptroller added questions and answers relating to the filing requirements for combined groups. Entities that are a member of a combined group are not required to file a separate initial franchise tax report, unless the entity has an accounting year begin or end date that is outside the accounting period used by the combined group. Likewise, entities that are part of a combined group are not required to file a final franchise tax report if the entity ceases doing business in Texas. However, if the entity that ceases doing business has an accounting year begin or end date that is outside the accounting period used by the combined group, it will be required to file a separate final report.

Most recently, the Comptroller addressed whether a reporting entity must include entities in which there is less than 50% part ownership. Under these circumstances a reporting entity is not required to include such an entity. However, the Comptroller noted that this exclusion applies only to the combined report, and not to the reporting requirements for entities filing a PIR or OIR.

9. Credits

The Credits FAQ section discusses the availability and use of economic development credits, the 1992 temporary credit, and the temporary credit for business loss carryforwards. This section also discusses the effect of using the E-Z computation on an entity's use of credits and credit availability for combined groups.

Recently, the Comptroller added questions and answers covering (1) the reduction of the credit carryover for the temporary credit for business loss carryforwards for use in subsequent years and (2) how business loss carryfowards should be calculated for the temporary credit for business loss carryforwards. The Comptroller guidance states that no reduction to the credit carryover is necessary when no TMT is due, however, to the extent that there is any positive amount of tax due the amount of the credit carryover to the subsequent year must be reduced by that amount. This reduction of carryover applies even if the calculated TMT due is not owed because it is less than $1,000. Regarding the calculation of business loss carryforwards, the Comptroller stated that entity's must start with any negative amount apportioned and allocated earned surplus on the 2003 franchise tax report and add any amounts of negative apportioned and allocated earned surplus from the 2004 – 2007 franchise tax reports and subtract any amounts of positive apportioned and allocated earned surplus from the 2004 – 2007 franchise tax reports. These additions and subtractions must be made regardless of whether an entity paid tax on taxable capital or owed no tax.

C. Recently Issued Comptroller Letter Rulings Discussing the Texas Margin Tax

In addition to the significant amount of guidance the Comptroller has provided taxpayers through the FAQ page on its website, the Comptroller also continues to issue guidance on the TMT through Comptroller letter rulings. Many of the TMT letter rulings issued refer the requesting party to the FAQ page for further information and guidance on the issues discussed. The use of such references to the FAQ's suggests that the Comptroller intends to continue to use the FAQ page as a primary source of TMT information for taxpayers. The following is a sampling of the TMT Comptroller letter rulings addressing issues which are currently not reflected on the Comptroller's FAQ page.

In Comp. Ltr. Rul. 200809213L,[8] the Comptroller found that loan payoff proceeds that were held by a limited partnership were excluded from the TMT total revenue computation. The limited partnership was organized in Texas and was engaged in the portfolio asset acquisition business. The limited partnership was allowed to exclude from total revenue of the tax basis the loan proceeds to the extent that the proceeds were reported on Line 1c of IRS Form 1065.

In Comp. Ltr. Rul. 200810220L,[9] the Comptroller addressed attribution rules relating to the combined group affiliated ownership requirements. Although Comp. Rule 3.509 attributes stock owned by spouses to each other, the Comptroller stated that such attribution rules do not apply between a spouse and the spouse's estate.

In Comp. Ltr. Rul. 200810219L,[10] the Comptroller stated that bonus depreciation on production assets is not allowable as part of the COGS deduction. Such a statement is consistent with the Internal Revenue Code of 1986 in effect for the federal tax year beginning January 1, 2007, which the TMT is based on. Texas does not conform with any changes made by federal law after that date. Therefore, Texas does not conform to the Economic Stimulus Act of 2008, which introduced the current bonus depreciation rules.

In Comp. Ltr. Rul. 200807215L,[11] the taxpayer inquired how partnerships and trusts should treat revenue received from the estate of a natural person. The Comptroller responded that the partnership or trust receiving income from an estate must include the revenue amounts in the computation of their total revenue. Although Texas Tax Code Section 171.1011(c) allows partnerships and trusts to subtract from their total revenue any amount received from a taxable entity treated as a partnership or S corporation for federal income tax purposes, there is no such subtraction for revenue received from an estate.

II. Texas Sales & Use Tax

A. General Overview

Generally, the Sales Tax applies to all retail sales, leases and rentals of tangible personal property, as well as certain enumerated taxable services. The Sales Tax rate is 6.25 percent; however, Texas cities, counties, transit authorities, and special purpose districts have the authority to impose an additional sales tax of up to an aggregate 2 percent, for a combined total of 8.25 percent. Individuals and legal entities must obtain sales tax permits if they are engaged in business in Texas and either (1) sell tangible personal property in Texas, (2) lease tangible property in Texas, or (3) sell taxable services in Texas. Tangible personal property is defined as personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses."[12] A person or retailer is engaged in business if such person or retailer maintains or occupies an office or other place of business, uses independent salespersons in direct sales of taxable items, derives receipts from sale or lease of tangible personal property located in Texas, or conducts business in this state through independent contractors or agents.[13]

Certain purchases are exempt from the Sales Tax. For example, a taxable item purchased for resale is exempt from the Sales Tax if the resale is properly documented. By presenting a resale certificate, the purchaser does not have to pay tax on merchandise or taxable services if it intends to further sell, rent, or lease the merchandise or services, in the condition in which the purchaser acquires it. Additionally, certain organizations qualify as "exempt organizations" and do not have to pay Sales Tax in certain circumstances. These include religions organizations, charitable organizations, educational organizations, youth athletic organizations, volunteer fire departments, chambers of commerce and tourist promotional agencies that represent at least one Texas city or county, agencies and departments of the United States Government, or the State of Texas and any county, city, school district or other political subdivision of the State of Texas, and any organization that qualifies for exemption from the federal income tax under Internal Revenue Code section 501(c)(3), (c)(4), (c)(8), (c)(10) or (c)(19).

The use tax is another aspect of the Sales Tax. There are several common ways to incur the use tax. In the first instance, a retailer uses a resale certificate to purchase merchandise that it intends to resell. Typically, in this situation, the purchaser's supplier will not collect sales tax. However, the use tax comes into play if the purchaser uses the merchandise for another purpose before the merchandise is resold. In that case, the purchaser is liable for the use tax, because the purchaser "used" the merchandise for some other purpose. Using merchandise for display or demonstration purposes before the property is resold does not create a use tax liability. But providing free samples to customers does create a use tax liability and the retailer would owe tax on the amount paid for the samples. A purchaser can also incur use tax if items are purchased with an exemption certificate and the purchaser then uses the merchandise or service for a non-exempt purpose. For example, purchasing manufacturing equipment but using it to perform contractor work is a non-exempt use. The final common way to incur use tax involves a purchaser using property in Texas purchased from an out-of-state retailer. In general, if the purchaser buys a taxable item from an out-of-state retailer without paying Texas Sales Tax, and proceeds to use the property in Texas, the purchase is subject to use tax. The rate for the use tax is the same as Sales Tax discussed above.

B. 2008 Developments in Sales Tax

In Comp. Hearing No. 47,007,[14] the Comptroller held that a taxpayer who produced pizza and sold pizza in the taxpayer's stores, could not avoid the sales tax on the cost of repairing a pizza preparation table. The taxpayer stored pizzas in refrigerated portions of a pizza preparation table to prevent their contamination prior to use. When one of the fan motors on these tables broke, the taxpayer argued that either Tex. Tax Code §§ 151.338 relating to sales tax exemptions for repairs of tangible personal property to protect the environment, or 151.3111 relating to the repair of manufacturing equipment should exempt the taxpayer from tax. The Comptroller disagreed and held that the repair of the fan motor was not required to protect the environment, nor did it qualify as manufacturing equipment. The Comptroller stated that the requirement issued by local health departments to refrigerate pizza ingredients prior to use appears to be related to public health and safety regulations, not the protection of the environment. Additionally, the Comptroller stated that the taxpayer was not exempt from Sales Tax under § 151.3111 because the taxpayer could not show that the refrigeration units of the preparation table were used in the actual manufacturing of the pizza. Therefore, the preparation tables were merely "coolers" and not exempt from Sales Tax under § 151.3111.

In Comp. Ltr. Rul. 200712099L,[15] the Comptroller revised the agency's detrimental reliance policy regarding the scope of relief available to purchases of taxable items. The Comptroller's policy on detrimental reliance provides that where a taxpayer has been induced to act in a particular manner based on certain communications or conduct by the Comptroller's office, the Comptroller should not later adopt a contrary position or course of conduct that causes such taxpayer loss, harm, or detriment. The Comptroller's ruling provided that in certain situations related to purchases where the taxpayer has proven that the taxpayer detrimentally relied upon communications or conduct of the Comptroller's office, the Comptroller would consider a waiver of tax due, as well as penalty and interest. Previously the agency would only consider a waiver of penalty and interest. The broadened guidelines state that (1) tax will be waived on materials directly utilized and consumed in the performance of a product for an unrelated party; (2) tax will be waived for indirect materials or services when the taxpayer can prove that these items were used in computing prices or bids; (3) tax will be partially waived for assets or tools directly used in the performance of services or sales based upon their purchase dates and remaining life of the assets; and

(4) special consideration for full waiver and possible ongoing waiver will be made if a taxpayer can prove that the advice of the Comptroller's office was used in a decision to locate facilities in Texas.

In Comp. Ltr. Rul. 200805079L,[16] the Comptroller clarified which types of catheters qualified for a Sales Tax exemption under the Tex. Tax Code § 151.313(a)(15) for intravenous IV systems, supplies, and replacement parts used in the treatment of humans. The taxpayer requesting the clarification had previously been denied the Sales Tax exemption for an epidural catheter used to infuse drugs into a localized area of the body. The taxpayer indicated that such a denial was inconsistent with prior Comptroller guidance. The Comptroller held that the denial of the infusion catheter exemption was correct, and that prior guidance was superseded to the extent it was inconsistent with such a result. The Comptroller stated that the prior guidance referred to by the taxpayer addressed the taxability of intravenous IV systems, not catheters. Catheters can be used intravenously, but can also be inserted into passageways or body cavities. The Comptroller provided that because of this dual-use, a catheter does not qualify for the IV systems exemption on its own. Additionally, the Comptroller stated that the taxability of a catheter will be determined based on both its characteristics and its use. In the context of the intravenous IV systems exemption, catheters that are used as a component part of an IV system will qualify for the Sales Tax exemption. Epidural catheters are used to infuse drugs into a localized area, not placed intravenously into a vein, therefore it cannot quality for an intravenous IV system exemption.

In Comp. Ltr. Rul. 200807137L,[17] the Comptroller addressed the taxability of park model homes. Park model homes are small buildings that are designed as temporary living quarters for recreation, camping, or seasonal use. The park model homes are constructed in a manner that allows them to be transported by a tow hitch to a permanent or semi-permanent destination. The comptroller held that a park model trailer is not a "motor vehicle" for purposes of motor vehicle sales and use tax, and not a manufactured or industrialized home for purposes of manufactured housing sales and use tax.[18] The Comptroller concluded that a park model home is a portable building as defined in Comp. Rule 3.306[19] and subject to only limited Sales Tax. Subject to this rule, a manufacturer or seller of park mobile homes must hold a Sales Tax permit and must collect and remit Sales Tax. If a dealer purchasing a park mobile home issues a limited Sales Tax resale certificate on Form 01-339, the manufacturer may sell the park mobile home tax-free. In such a situation the dealer is obligated to hold a Sales Tax permit and collect state and local taxes on sales, leases, or rentals of the park mobile home.

In Comp. Ltr. Rul. 200805098L,[20] the Comptroller stated that sunscreen no longer qualifies for the Sales Tax emption for over-the-counter medications under Tex. Tax Code § 151.313(a)(3). In 2007, the over-the-counter medication Sales Tax exemption was amended to limit the exemption to only those over-the-counter medications that are required by the FDA to be labeled with a "Drug Facts" panel. Although some sunscreen packaging does contain a "Drug Facts" panel, such a panel is not *required* by the FDA. Therefore, the purchase of sunscreen over-the-counter whether or not it contains a "Drug Facts" panel, no longer is exempt from Sales Tax under Tex. Tax Code § 151.313(a)(3).

ENDNOTES

1 Cheri.Whiteside@tklaw.com, Associate, Thompson & Knight LLP, 1722 Routh Street, Suite 1500, Dallas, Texas 75201.
2 Although the Texas franchise tax, as amended by H.B. 3 and H.B. 3928 continues to be statutorily titled a "franchise tax," it is commonly referred to among practitioners as the Texas Margin Tax.
3 Tex. Tax Code § 171.0002(a).
4 Tex. Tax Code § 171.0002(b), (c).
5 Tex. Tax Code § 171.0003.
6 Tex. Tax Code § 171.0003(b).
7 Available at http://www.window.state.tx.us/taxinfo/franchise/faq_questions.html.
8 Comp. Ltr. Rul. 200809213L, 09/30/2008.
9 Comp. Ltr. Rul. 200810220L, 10/29/2008.
10 Comp. Ltr. Rul. 200810219L, 10/9/2008.
11 Comp. Ltr. Rul. 200807215L, 07/31/2008.
12 Tex. Tax Code § 151.009.
13 34 Tex. Admin. Code. § 3.286.
14 Comp. Hearing No. 47,007, 11/1/2007.
15 Comp. Ltr. Rul. 200712099L, 12/13/2007.
16 Comp. Ltr. Rul. 200805079L, 05/2/2008.
17 Comp. Ltr. Rul. 200807137L, 07/9/2008.
18 A park mobile home would qualify for manufactured house sales and use tax under Tex. Tax Code § 158.051 if the manufacturer choose to obtain an Industrialized Housing and Buildings Program decal for the unit, thus requiring it to be incorporated into realty.
19 34 Tex. Admin. Code. § 3.306.
20 Comp. Ltr. Rul. 200805098L, 05/21/2008.

SECTION OF TAXATION
State Bar of Texas

December 1, 2008

Honorable Eric Solomon
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3000 IR
Washington, D.C. 20024

Re: ***Request for Section 409A Documentary Compliance Deadline Extension***

Dear Sirs:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed set of comments.

The Comments contained in this letter are being presented on behalf of the Section of Taxation of the State Bar of Texas. These Comments should not be construed as representing the position of the Board of Directors, the Executive Committee or the General Membership of the State Bar of Texas. The Section of Taxation, which has submitted these comments, is a voluntary section of members composed of lawyers practicing tax law. These Comments are submitted as a result of the approval of the Chair of the Committee on Governmental Submissions pursuant to the procedures adopted by the Council of the Section of Taxation, which is the governing body of the Section of Taxation.

P.O. Box 4646, Austin, TX 78765
(512) 451-6960 ♦ Fax: (512) 451-2911

Request for Section 409A Documentary Compliance Deadline Extension

These comments are presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafters of these comments were Stephanie Schroepfer, David C. D'Alessandro and Felicia A. Finston. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Daniel G. Baucum is Chair of COGS and the other members of COGS include Paul Asofsky, Barbara de Marigny, Tom Helfand, Emily Parker, Vester Hughes, Steve Salch, Gene Wolf, David Wheat, Cindy Ohlenforst, Stanley Blend and Kevin Thomason.

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

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We respectfully request that the Department of Treasury (the "*Treasury*") and the Internal Revenue Service (the "*IRS*") grant a one-year extension, until December 31, 2009, of the deadline for bringing deferred compensation programs into documentary compliance with the final regulations that were issued under section 409A of the Internal Revenue Code of 1986, as amended[1] (the "*Final Section 409A Regulations*").[2] Although a full extension of the effectiveness of the Final 409A Regulations would be most helpful for taxpayers, granting the requested documentary compliance extension would not necessarily entail an extension of the effective date of the Final 409A Regulations.[3]

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[1] Section 409A of the Internal Revenue Code of 1986, as amended ("*Section 409A*"), is a tax law that imposes significant additional taxes upon service providers if the deferred compensation programs in which they participate are neither exempt from nor comply with Section 409A. All section references herein are references to the Internal Revenue Code of 1986, as amended (the "*Code*").

[2] The Final Section 409A Regulations, which were issued by the Treasury and the IRS on April 10, 2007, are posted on the IRS's website at http://www.irs.gov/irb/2007-19_irb/ar07.html.

[3] Typically, in the qualified retirement plan area, the operational compliance effective date for new regulations precedes the documentary compliance deadline. Documents are typically required to be amended retroactively to the effective date of the regulations. A similar approach could be employed in the case of the Final Section 409A Regulations.

More time is needed to bring arrangements into documentary compliance with the Final Section 409A Regulations. After consulting with practitioners in law firms in Texas, and in particular the Gulf Coast region affected by Hurricane Ike, we are convinced that despite diligent efforts by companies and their legal advisors to identify and amend compensation and benefits arrangements subject to Section 409A, due to the massive volume of contracts that must be amended, it is simply not possible for many larger and midsize companies to fully meet the December 31, 2008 deadline. Anecdotally, the responses to our inquiries suggest that the documentary compliance process is approximately two-thirds complete.

Practitioners who have the expertise to competently amend programs to comply with the Final Section 409A Regulations have been overwhelmed, but nevertheless have been diligently working for the past two years attempting to satisfy the needs of companies to bring their arrangements into documentary compliance by the deadline. We greatly appreciate the extension that the government granted last year and wish it were not necessary to request another such extension. However, since each company may have up to hundreds of arrangements to be amended, and each company in the world that covers U.S. taxpayers in its compensatory programs has a potential need for counsel from a limited number of qualified practitioners, it is unfortunately necessary to seek a final one-year extension of the documentary compliance deadline in order to avoid the imposition of taxes upon innocent service providers who have not in operation violated the Final Section 409A Regulations.

We firmly believe that most companies and practitioners have made every good faith effort to meet the documentary compliance deadline. Over the past two years economic stresses impacting many companies have deepened. Today many companies nationwide are operating in crisis mode attempting to navigate turbulent times to ensure their economic survival. As a result of layoffs caused by the financial crisis many companies do not have adequate labor resources to meet the current documentary compliance deadline. In the midst of the nationwide economic turmoil, a large part of Texas was devastated by a natural disaster. Hurricane Ike destroyed homes and buildings in many parts of Texas resulting in an unprecedented loss of electrical power to millions of businesses and homes for up to one month.[4] Even today, boarded-up windows in downtown Houston skyscrapers serve as a stark reminder of the desks, computers, papers and debris that covered the glass-strewn streets of downtown Houston this past September. Many of the offices that were damaged or destroyed were offices of law, accounting and other professional firms that deal with employee compensation arrangements and compliance.

As a result of these unexpected natural and economic crises during 2008, companies and their tax and benefit plan advisors have lost a significant amount of time that would have otherwise been available to work on Section 409A documentary compliance matters. The same practitioners who advise companies concerning Section 409A matters have spent significant amounts of time advising clients concerning matters relating to the current economic crises, including matters pertaining to funding, freezing and redesign of qualified defined benefit and

[4] Hurricane Ike, which made landfall on September 13, 2008, devastated many counties in Texas. The federal government declared the following Texas counties as a presidential disaster area: Angelina, Austin, Brazoria, Chambers, Cherokee, Fort Bend, Galveston, Grimes, Hardin, Harris, Houston, Jasper, Jefferson, Liberty, Madison, Matagorda, Montgomery, Nacogdoches, Newton, Orange, Polk, Sabine, San Augustine, San Jacinto, Trinity, Tyler, Walker, Waller and Washington counties. The IRS granted to taxpayers in these counties extensions of various deadlines. See IR-2008-107, September 18, 2008.

defined contribution retirement plans. Many companies are struggling to contain their economic costs relating to employee benefit plans in efforts to survive and to stave off further personnel layoffs and reductions in work forces. Those in the Gulf Cost area affected by Hurricane Ike lost a significant amount of time dealing with destructions and losses of property and records, as well as extended power and water outages, resulting from hurricane- and tropical storm-force winds and flooding. Further, in addition to normal ongoing required retirement plan documentary compliance work, including Cycle B filings for qualified retirement plans, there were significant unanticipated legal developments requiring legal advice and response during 2008, including changes dealing with Section 162(m) of the Code[5] and a new deferred compensation law, Section 457A of the Code.[6]

The Treasury, the IRS and private practitioners have spent countless hours working together on Final Section 409A Regulations dealing with the application of Section 409A to a massive variety of arrangements and situations. The result is a highly sophisticated and complex. Due to the volume and complexity of the issues involved, it was not possible for the Final Section 409A Regulations to be issued earlier than April 10, 2007. Thus, starting on April 10, 2007 the clock began ticking for private practitioners to digest, comprehend, communicate and apply the highly sophisticated and complex Final Section 409A Regulations to their clients' situations. While much of this process has been completed there remain many documentary compliance gaps.

We value the open communication that exists between the Treasury, the IRS and the tax professionals who advise taxpayers concerning compensation and benefits matters. We believe that this relationship is laudable and serves as a model for government and practitioner cooperation. In the compensation and benefits area, the Treasury and the IRS have historically been very practical and reasonable when establishing documentary compliance deadlines. Understanding that the qualified private bar with which they are dealing is a limited pool of individuals, the Treasury and the IRS have traditionally listened to this private bar and trusted them when messages have been delivered concerning the physical impracticability of achieving the shared goal of voluntary documentary compliance by applicable deadlines.[7]

We thank the Treasury and the IRS for the professional and collaborative relationship that they have fostered with private practitioners in the compensation and benefits area. In this spirit of open communication we are now forced to admit that, despite diligent efforts, many practitioners and taxpayers cannot meet the Section 409A documentary compliance deadline. In conclusion, we request that that an extension of the documentary compliance deadline under Section 409A be granted for all taxpayers. But if that is not feasible, we request that an extension be granted for the Gulf Coast region affected by Hurricane Ike.

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[5] Revenue Ruling 2008-13, I.R.B. 2008-10, March 10, 2008.

[6] Section 457A, a new broadly applicable deferred compensation law which was added to the Code as a result of the passage of the Emergency Economic Stabilization Act of 2008 on October 3, 2008, is effective January 1, 2009 and requires immediate action by affected taxpayers during 2008.

[7] For example, the Treasury and the IRS granted ample time during which to bring qualified retirement plans into documentary compliance with the Economic Growth and Revenue Reconciliation Act of 2001 ("*EGTRRA*"). The number of arrangements covered by Section 409A and requiring documentary review and revision exceeds by many multiples the number of plans required to be amended for EGTRRA. Section 409A potentially applies not merely to traditional nonqualified deferred compensation plans, but also to certain bonus, welfare benefits, equity compensation, severance, reimbursement, tax gross-up, foreign compensation, indemnification, noncompetition, legal settlement, and educational benefit arrangements as well as many other types of arrangements.

Respectfully submitted,

Daniel J. Micciche
Chair, Section of Taxation
State Bar of Texas

DJM|SMS/scs

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SECTION OF TAXATION OF THE STATE BAR OF TEXAS
2008-2009 CALENDAR

July	
17	10:00 a.m. – 3:00 p.m. 2008 New Chair and Treasurer Orientation Marriott Waterway 1601 Lake Robbins Drive Spring, TX (800) 204-2222, ext. 1419
August	
15	Deadline for submitting articles for the October 2008 issue of the *Texas Tax Lawyer*
27	Tax Law Bootcamp - Dallas
28-29	26th Annual Advanced Tax Law Course - Dallas
September	
5	10:30 a.m. – 12:30 p.m. Tax Section Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Ste. 4100 Dallas, Texas 75218 (214) 969-2800
11-13	ABA Section of Taxation 2008 Joint Fall CLE Meeting - San Francisco, CA
October	
1	Tax Law Bootcamp – Houston (Video)
November	
2- 3	26th Annual Advanced Tax Law Course - Houston (Video)
14	10:30 a.m. – 12:30 p.m. Council Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Ste. 4100 Dallas, Texas 75218 (214) 969-2800
December	
12	Deadline for submitting articles for the February 2009 issue of the *Texas Tax Lawyer*

January	
8 - 10	ABA Section of Taxation 2009 Midyear Meeting – New Orleans, LA
16	10:30 a.m. – 12:30 p.m. Tax Section Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Ste. 4100 Dallas, Texas 75218 (214) 969-2800
February	
March	
13	Deadline for submitting articles for the May 2009 issue of the *Texas Tax Lawyer*
April	
10	10:30 a.m. – 12:30 p.m. Council Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific Avenue, Ste. 4100 Dallas, Texas 75218 (214) 969-2800
May	
7 - 9	ABA Section of Taxation 2009 May Meeting – Washington, DC
June	
11 - 12	25th Annual Texas Federal Tax Institute – San Antonio
25-26	State Bar of Texas Annual Meeting – Dallas
26	Members' Meeting of the Section of Taxation of the State Bar of Texas – Dallas

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2008-2009
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