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The Texas Tax Lawyer

2013

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Chair's Message

Thank you for the privilege of serving as the 2013 – 2014 Chair of the Section of Taxation of the State Bar of Texas. Things are already off to a fast start thanks to the hard work of my fellow officers, Andrius Kontrimas (Chair-Elect), Alyson Outenreath (Secretary), and David Colmenero (Treasurer), as well as the efforts of all of our Council Members, Committee Chairs, Vice-Chairs, and the many other members who volunteer, without whom our Section could not be a success.

Continuation of New Programs. Once again, we find ourselves in the fortunate position of seeing new programs come to fruition which were begun under the leadership of our immediate past Chairs, Tina Green and Mary McNulty, specifically:

- **Tax App**. The Section worked with the Computer and Technology Section to develop a Tax App to access Federal and Texas state tax materials on your iPhone®, iPad®, and iPod Touch®. We also have a web-based Tax App for Blackberry®, Android™ and other web-based phone users, which can also be accessed on your desktop computer via the Internet. The Tax App gives you fingertip access to the Internal Revenue Code, Treasury Regulations, tax treaties, AFRs, IRS guidance, cases, Texas Tax Code, Texas Administrative Code, and much more! Go to the Section home page at www.texastaxsection.org/ for instructions on installing the new Tax App.

- **Leadership Academy**. This past year, we graduated 20 young tax lawyers as the inaugural class of the Tax Section's Leadership Academy. The Leadership Academy allows young tax lawyers to develop their leadership skills as well as network with other tax lawyers throughout the state. The criteria for selection is:

  - Three to six years' experience;
  - Member of the State Bar of Texas in good standing;
  - Member of the Tax Section of the State Bar of Texas; and
  - Commitment to attend four quarterly sessions around the State.

The Leadership Academy is accepting applications for the 2014 – 2015 Leadership Class. See the application form in this newsletter. The application deadline is January 17, 2014.

Many thanks to David Colmenero for his efforts in spearheading the Leadership Academy, and Dan Baucum for continuing the effort as our Co-Chair, along with the invaluable assistance of Susan House. If you have any questions, please contact Dan Baucum at (214) 780-1470 or dbaucum@shacklaw.net.

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- **List Servs**. When you join a Committee, you will become a member of that Committee's list serv. The list serv provides you with an email forum for sharing tips, concerns, referrals and other matters with your fellow Texas tax lawyers. If you wish to opt out of the list serv, please contact Brent Gardner at (214) 999-4585 or bgardner@gardere.com. The committee selection form is available on our website at www.texastaxsection.org.

Continuing with the Section's Core Programs. This year, we will continue our core programs for the Tax.

- **COGS Projects**. Under the leadership of our Committee on Government Submissions ("COGS") Chair Stephanie Schroepfer, with new Co-Chair Robert Probasco, we have already submitted a COGS project this year discussing list maintenance rules under I.R.C. § 6708, governing material advisors in reportable transactions. Many thanks to Brandon Bloom, David Colmenero, Robert Probasco, Shawn O'Brien and Michelle Spiegel for their hard work on the comments. If you wish to get involved with a COGS project or have ideas for leading one yourself, please contact Stephanie Schroepfer at (713) 651-5591 or sschroepfer@nortonrosefulbright.com or Robert ("Bob") Probasco at (214) 969-1503 or robert.probasco@tklaw.com.

- **24/7 Free CLE Library**. The Tax Section has implemented a 24/7 library of free CLE Webcast programs accessible at any time to Section members through the Section of Taxation website. We now have over 50 CLE audio and video programs available free of charge to our members broken out into the following categories:

  - Compensation and Employee Benefits
  - Corporate Tax
  - Energy & Natural Resources Tax
  - Estate & Gift Tax
  - International Tax
  - Partnership & Real Estate Tax
  - Property Tax
  - Small Firm & Solo
  - State & Local Tax
  - Tax Controversy
  - Tax Exempt Organizations

  In addition, there are videotaped interviews with Texas Tax Legends, including Stanley Johansen, Charles Hall, David Glickman, Larry Gibbs, Richard Freling, Buford Berry, Ronald Mankoff, and Bob Davis. If you have any questions, please contact Michael Threet, the head of our CLE Committee, at (214) 969-2795 or mthreet@akingump.com.

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- **Live CLE**. The Tax Section sponsors and conducts live CLE programs, including the annual Property Tax program, the annual International Tax program, State and Local Tax Committee events and a Tax Law Survey in a Day program. In addition, the Section co-sponsors various live CLE programs, including the Texas Society of CPAs Free CPE Day and the Advanced Tax Law Program conducted by the TexasBarCLE, which will be held this year August 27 – 29, 2014, at the Westin Galleria in Dallas, Texas.

  Mark your calendars for our 16th Annual International Tax Symposium to be held at The Center for American and International Law, 5201 Democracy Drive, Plano, Texas, on November 8, 2013, and on November 7, 2013 in Houston, Texas (location TBA). For further information, contact Deidra Hubenak, Chair of the International Tax Committee, at (713) 986-7000 or dhubenak@lrmlaw.com.

- **Pro Bono**. The Tax Section assists pro se taxpayers during Tax Court calendar calls in Dallas, Houston, Lubbock, El Paso, and San Antonio. Check the calendar on the Tax Section's website for the next calendar call in your city and contact Juan Vasquez, Jr., Pro Bono Chair, at (713) 654-9679 or juan.vasquez@chamberlainlaw.com. The Tax Section also provides support to appropriate charitable and governmental programs such as Texas C-Bar and VITA.

- **Texas Tax Lawyer**. Thanks to the hard work of Rob Morris, the Tax Section publishes three issues of the Texas Tax Lawyer each year. The Texas Tax Lawyer is distributed to members electronically and, upon request, in hardcopy. The issues include articles on hot topics, substantive outlines from Committee Webcasts, COGS submissions, and annotated forms. Please contact Rob Morris at (713) 651-8404 or robert.morris@nortonrosefulbright.com.

- **Law School Outreach**. We hold luncheons each year with students at the SMU Dedman, University of Texas, University of Houston, and Texas Tech University Schools of Law. Every other year, we hold luncheons at Baylor, LSU, and South Texas Law Schools. We also would like to hold luncheons periodically at Saint Mary's, Texas Southern, and Texas Wesleyan Law Schools. If you wish to serve as a panelist, please contact the head of our law school student outreach program, Abbey Garber, at (972) 308-7913 or abbey.b.garber@irscounsel.treas.gov.

- **Outstanding Texas Tax Lawyer**. Congratulations to Ira B. Shepard, Professor Emeritus at the University of Houston School of Law, for being selected as the Outstanding Texas Tax Lawyer for 2013. This year's nomination form is on our website and is included in this issue of the Texas Tax Lawyer. Nominations must be made by January 15, 2014. Please take a few minutes and consider nominating a worthy individual for this award.

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- **Annual Meeting and Tax Legends Lunch**. The Section Annual Meeting this year will be held in Austin, Texas on June 20, 2014. It will include CLE programs and our Legends Lunch. Stay tuned for more information.

Nominating Committee

The Tax Section's nominating committee for 2013 – 2014 consists of Dan Micciche as Chair and Patrick O'Daniel, Mary McNulty, Tina Green and me as an ex officio member. Nominations for Chair-Elect, Secretary, Treasurer, or an Elected Council Member position can be submitted to any member of the nominating committee or to any Officer of the Section at any time on or before March 1, 2014.

Act Now/Get Involved

If you are not already involved in the Section's activities, I strongly encourage you to get involved. Contact one of the chairs of the above activities or join a committee.

If you are not sure who to contact and what would be the best fit for your skills, then email me at elizabeth.copeland@strasburger.com. You will help us build an even stronger Tax Section and have some fun in the process!

Thank you and I look forward to working with all of you for a great year!

Elizabeth Copeland
2013 – 2014 Chair

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SECTION OF TAXATION
OF
THE STATE BAR OF TEXAS

2013 / 2014
CALENDAR

June 2013	
1	Deadline for Student Paper Competition
6-7	29th Annual Texas Federal Tax Institute – Hyatt Regency Hill Country Resort, San Antonio
20-21	SBOT 2013 Annual Meeting – Dallas – Hilton Anatole
20	**Council Retreat** Hosted by: Thompson & Knight, LLP (Bob Probasco) 1722 Routh Street, Suite 1500, Dallas, Texas 75201 214-969-1700 1:00 pm – 5:00 pm
21	**Tax Section Annual Meeting** 8:00 am – 4:45 pm (post on website at least ***20 days in advance***; elect 3 new Council members)
July 2013	
26	**Bar Leaders Conference – New Chair and Treasurer Orientation** Westin Galleria – Houston 10:00 a.m. – 3:00 p.m.
23	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
August 2013	
14	**Tax Law 101 CLE** Norris Conference City Centre, 816 Town & Country Lane, Suite 210, Houston, Texas 77024 713-590-0950
15	**Officer's Retreat** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100, Houston, Texas 77010-3095 210-224-2000 11:00 a.m. – 3:00 p.m.
15-16	**31st Annual Advanced Tax Law Course** Norris Conference City Centre, 816 Town & Country Lane, Suite 210, Houston, Texas 77024 713-590-0950
20	**COGS Call** (2nd Last Tuesday) Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
30	**Council and Committee Chairs and Vice Chairs Meeting** **MANDATORY IN PERSON ATTENDANCE FOR CHAIRS AND COUNCIL** Hosted by: Meadows, Collier, Reed, Cousins, Crouch & Ungerman (David Colmenero) The City Club, 901 Main Street, Suite 6900 (Bank of America Bldg.), Dallas, Texas 75202 214-748-9525 10:30 a.m. – 12:30 p.m.
September 2013	
16	Pro Bono Committee Calendar Call Assistance (regular and small case) United States Tax Court El Paso, Texas
17	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
19	Deadline for appointing Nominating Committee (list in *Texas Tax Lawyer* and on website)

19-21	ABA Joint Fall CLE Meeting, San Francisco, CA
23	Pro Bono Committee Calendar Call Assistance (regular and small case) United States Tax Court – Lubbock, Texas
27	Article Deadline – Fall 2013 issue of the *Texas Tax Lawyer*
30	Pro Bono Committee Calendar Call Assistance (small case)\United States Tax Court San Antonio, Texas
October 2013	
7	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court – Dallas, Texas
22	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
25	Publishing Deadline – Fall 2013 Issue of the *Texas Tax Lawyer*
November 2013	
7	16th Annual International Tax Symposium – Place to be determined, Houston, Texas
8	16th Annual International Tax Symposium – The Center for American and International Law 5201 Democracy Drive, Plano, Texas 75024
8	**Council Meeting** Hosted by: Strasburger Price Oppenheimer Blend (Elizabeth Copeland) 901 Main Street, Suite 4400, Dallas, Texas 75202 214-651-4300 10:30 a.m. – 12:30 p.m.
19	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
December 2013	
2	Pro Bono Committee Calendar Call Assistance (small case) United States Tax Court Houston, Texas
2 and 9	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court Dallas, Texas
17	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
January 2014	
15	Deadline for annual meeting program agenda Nominations due for Outstanding Texas Tax Lawyer (Council vote follows January 17th meeting)
17	Leadership Academy Application deadline
17	**Council and Committee Chairs and Vice Chairs Meeting** Hosted by: Strasburger & Price, LLP 2201 Broadway, San Antonio, Texas 78209 210-224-2000 or 210-250-6121 10:30 am – 12:30 pm
21	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
TBA	ABA Tax Section Midyear Meeting
February 2014	
TBA	Tax Law For the Rest of Us
7	Article Deadline – Winter 2014 issue of the *Texas Tax Lawyer*

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14	Tax Court Pro Bono Program Annual Renewal
18	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
March 2014	
3	Nominations due for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members
3	Publishing Deadline – Winter 2014 Issue of the *Texas Tax Lawyer*
18	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
TBA	**Property Tax Conference**
20-21	**Leadership Academy Meeting** San Antonio, Texas Hosted by: Strasburger Price Oppenheimer Blend (Elizabeth Copeland) 2201 Broadway, San Antonio, Texas 78209 210-224-2000 or 210-250-6121
April 2014	
4	Nominating Committee's Report due to Council
18	Article Deadline – Spring 2014 issue of the *Texas Tax Lawyer*
18	**Council Meeting** Hosted by: Strasburger & Price, LLP 2201 Broadway, San Antonio, Texas 78209 210-224-2000 or 210-250-6121 Election for Chair-Elect, Secretary, and Treasurer 10:30 a.m. – 12:30 p.m.
22	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
May 2014	
8-10	**ABA Section of Taxation 2014 May Meeting** – Grand Hyatt, Washington, DC
20	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
TBA	**Free CPE Day** – Dallas, Texas
June 2014	
TBA	**30th Annual Texas Federal Tax Institute** – Hyatt Regency Hill Country Resort, San Antonio
6	Publishing Deadline – Summer 2014 issue of the *Texas Tax Lawyer*
17	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
18	Leadership Academy Group Evening Event
18	Deadline for appointing Nominating Committee (list in *Texas Tax Lawyer* and on website) – Sept. 19th
18 – 20	**Leadership Academy Meeting – A**ustin, Texas
20	**SBOT 2014 Annual Meeting** – Austin, Texas
July 2014	
August 2014	
27 – 29	**32nd Annual Advanced Tax Law Course and Tax Law 101** Westin Galleria – Dallas, TX
September 2014	
October 2014	
November 2014	

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December 2014	
January 2015	
15	**Leadership Academy Meeting –** Dallas, Texas
September 2015	
25 – 26	**Leadership Academy –** Houston, Texas

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CALL FOR NOMINATIONS FOR
OUTSTANDING TEXAS TAX LAWYER AWARD

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

Nominations should be submitted to Alyson Outenreath, either by email (Alyson.outenreath@ttu.edu) or fax 806-742-1629) no later than January13, 2014. The award will be presented at the 2014 Annual Meeting of the Tax Section in Austin, Texas on June 20, 2014.

NOMINATION FOR OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Mailing Address: ____

____

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

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

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Program Dates:

1. March 20-21, 2014
   San Antonio

2. June 25-27, 2014
   Austin
   (in conjunction w/ SBOT Annual Meeting)

3. Sept. 25-26, 2014
   Houston

4. January 15, 2015
   Dallas

Let the State Bar of Texas Tax Section Help You

TAKE YOUR TAX CAREER TO THE NEXT LEVEL

Leadership Academy Application Deadline

January 17, 2014

(application included in publication)

Sponsored by:

- ***Capshaw Green, PLLC***
- ***Meadows, Collier, Reed, Cousins, Crouch & Ungerman, L.L.P.***
- ***Norton Rose Fulbright***
- ***Strasburger & Price, LLP***
- ***Thompson & Knight LLP***

The Tax Section of the State Bar of Texas is pleased to announce the 2014-2015 Leadership Academy developed to assist the next generation of Texas tax lawyers with taking ownership of their careers by providing:

- *Opportunities to get involved in the State Bar of Texas Tax Section leadership committees*
- *One-on-one mentoring from Texas Tax Section leadership*
- *Educational programs on topics every successful tax lawyer should know (CLE credit provided for some topics)*
- *Networking opportunities with tax professionals throughout the state*

Tax Section of the State Bar of Texas
2014-2015 Leadership Academy

Application Form

Eligibility Requirements:

- Must have three to six years experience regardless of age.
- Must be a member of the State Bar of Texas in good standing.
- Must be a member of the Tax Section of the State Bar of Texas. (If not a member, must join prior to the commencement of the Leadership Academy.)
- Must be willing to commit to attending all four sessions.

- ***Note: Only one candidate per firm office may be accepted from firms with more than one office.***

Tentative Meeting Dates and Cities:

- March 20-21, 2014 – San Antonio, TX
- June 25-27, 2014 – Austin, TX (in conjunction with the State Bar of Texas Annual Mtg.)
- September 25-26, 2014 – Houston, TX
- January 15, 2015 – Dallas, TX

Cost and Payment:

- The admission fee for the SBOT Tax Section Leadership Academy is $750.00.
- Payment will be requested for each applicant upon notification of acceptance to the program.
- Scholarships are available, on a limited basis, for qualified applicants to cover the admission fee.
- Each participant is responsible for their travel and hotel expenses.

Application Process: **<u>DEADLINE: JANUARY 17, 2014</u>**

To apply for the SBOT Tax Section Leadership Academy either:

- Complete and scan the application and email with any attachments to:
- shouse@meadowscollier.com.
- Complete the application and mail with attachments to:

SBOT Tax Section Leadership Academy
901 Main Street, Suite 3700
Dallas, TX 75202
ATTN: Susan House

- The Leadership Academy committee will consider and respond in writing to all applications received.

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Application Form

Section I – Personal Information

____
First Name Middle Initial Last Name

____
Firm

____
Firm Mailing Address

____
City State Zip Code

____
Work Telephone Number Mobile Number

____
Email Address

____
State Bar Number

Gender: ☐ Male ☐ Female

Section II – Work Experience

Number of years working as an attorney: ________
Areas of expertise ____

____
Include a summary of your work experience or attach a copy of your resume. _________
____
____
____
____
____

Section III – Recommendation

Attach a letter of recommendation from your Supervisor, Manager or Partner/Shareholder or other attorney with prior approval from the Leadership Development Committee. To obtain approval for a letter of recommendation from someone other than a Supervisor, Manager or Partner, please contact Susan House by email or by phone at shouse@meadowscollier.com or 214/749-2411.

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Section IV – Personal Statement

Why are you interested in participating in the Tax Section of the State Bar of Texas Leadership Academy? (Attach additional pages, if necessary.) ______________________

____
____
____
____

Section V – Participant Commitment

I commit to actively participate in the Tax Section of the State Bar of Texas Leadership Academy (LA) and attend each session.

____
Applicant's Signature

______________________________ ______________
Print Name Date

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PROFESSOR STANLEY JOHANSON INTERVIEW

Bill Elliott	Hello, I am Bill Elliott, former chairman of the State Bar of Texas' Tax Section and I'm bringing you today an interview with Professor Stanley Johanson of The University of Texas Law School, a Texas tax legend. Since 1963, that's 50 years, he has been teaching Property, Wills, Estate Planning here at The University of Texas. In addition, he's been teaching every Texas lawyer that I know who does anything near estate and gift tax and probate CLE sessions for this almost this entire time. Ever since I was a young lawyer I have been listening to Stanley Johanson teach me, a practicing lawyer, about estate and gift tax, probate, wills, trusts and so on. He's an extraordinary individual; at age 79 has the energy level of someone twenty years his younger. Aside from his extraordinary lively personality, you're going to find this interview to be most entertaining. As a special treat, we were given permission to film him in his classroom this morning. He taught a first year, second semester Property course. He's in his third week of this Property course and we filmed it. You'll find that entire class setting attached to this program and you can watch that separately. It's a very interesting remembrance of what a classroom is like, and to see Stanley Johanson teach in the classroom is most extraordinary. Like all the legend interviews, this is absolutely amazing, what a terrific guy, entertaining, fun as well as brilliant. He personifies estate and gift and estate planning as far as I'm concerned. I hope you enjoy. I did. Thank you. Professor Johanson, thank you for letting us subject you, barrage you with questions about your life. Thank you very much. Your enthusiasm for teaching after half a century, 50 years, is one of the characteristics that continues to amaze. At a point in time when others are thinking about slowing down, you have exhibited enthusiasm even this morning teaching your first year Property. What is, do you think, the key to your continued enthusiasm at teaching?
Professor Johanson	I wish I knew; I wish I could bottle it and, in fact, frankly I wish I could copyright it. It's just there; I just came out that way. I think it is fairly evident that I enjoy what I am doing. I think it is also one of the keys or the secrets – these young men and women that go to law school, they are a pretty impressive bunch to be around, and I do think that it's impacted me physically and mentally as well as personality wise to be associated with such fine young people, and have them respect me. So that's the pay I get. I don't know what it is, I just enjoy what I'm doing.
Bill Elliott	When one reads about how to make a presentation, you always read bring energy, bring energy to your presentation. You really don't need a how-to on bringing energy to your presentations.

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Professor Johanson	Yes, I think that's fair enough. I was speaking, as a matter of fact, let's see, on Friday out in Newport Beach at a CLE program and coming up at just before lunch, and the question was "what is he going to do?" Some of the audience knows me, most they don't, and so how to catch their attention – I start by singing "Don't be cruel to a heart that's true, I don't need no other love, baby – I'm sorry, that's the wrong venue, that's Saturday in Vegas at a club." So anyhow somehow that created the right levity, or the right atmosphere for my very boring speech.
Bill Elliott	Can you take us through briefly your family history – your parents and where you were born and your early days?
Professor Johanson	I would be most happy to. Both my parents were from Norway. They came in the 1920s when things were not too good in Norway and Europe and they came through Canada down to Seattle. Since my father was from Alesund on the West Coast, a fisherman and my mother was from Bergan on the West Coast, they didn't stop in Minnesota; they were smart enough to stay on the train and go out to the Northwest. My father was a commercial fisherman. He left Seattle in the middle of April every year and came back from Alaska in the middle of October, and did the same thing in California in December, fishing for herring until they disappeared in the 50s. My mother did what they genteelly called day work; she cleaned other people's houses. Born in 1933, raised in the depression, but nobody told us we were poor. They weren't keeping statistics at that time. We just had a very comfortable lifestyle with it would be fair to say a low-income environment.
Bill Elliott	How many siblings do you have?
Professor Johanson	I have two older brothers. I'm number three.
Bill Elliott	What's the age difference between you and them?
Professor Johanson	Well my older brother, Einer, is 83 – let's see, just became 84. My second brother, Paul, he was 80 when he passed away in a home accident. My whole family and my wife's family, Gerrie Johanson's family, were from the Northwest; we still have family there.
Bill Elliott	You claim Portland as your home?
Professor Johanson	No. Seattle.
Bill Elliott	Seattle, I mean.
Professor Johanson	Yeah.
Bill Elliott	And your primary education was in the Seattle schools?

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Professor Johanson That's right. Whittier Grade School, James Monroe Junior High School and Ballard High School. Incidentally, at Ballard High School -- this was the era – 75% of the students were of Scandinavian heritage. Over 50%, were like me, first generation – bunch of fishermen.

Bill Elliott So when it came time to graduate from high school, you went to Yale?

Professor Johanson Yes. Yes, I was a very good student in high school and before, and Yale had a very strong alumni representation in Seattle and they were fishing around for people, literally fishing around you might say. They and MIT both offered me scholarships. Thank God Yale offered more money.

Bill Elliott Did you enjoy Yale?

Professor Johanson Out of this world. Ecstatic. Unbelievably good; fantastic opportunity and I fit in rather well and had a lot of close friends there and I thrived academically and of course not much you can do socially at an all-male school, but I enjoyed all four years.

Bill Elliott And your course of study was?

Professor Johanson It was called industrial engineering. It was a combination of science, engineering and economics. Because when you go to Yale you're not preparing to be an engineer, you're preparing to be a captain of industry.

Bill Elliott Yale was male only?

Professor Johanson Oh yes. Until the 80s. Absolutely. Mid-70s, it was male only, very controversial as to whether they should go co-ed.

Bill Elliott So then when it came time to start approaching the end of your college years, where did law school enter your calculation?

Professor Johanson Very briefly, it turns out the high school I attended in Seattle, Ballard High School, it was very strong in science and math. In fact, I had a course in "math analysis" which is after you have taken trigonometry and calculus. It is very high level and so I went to Yale – you understand that when you come from the background I had, my parents with 7th grade educations, why do you go to college? You go do college to get a job. Why would anyone major in English unless they wanted to be an English teacher? Same for History. And so it made sense, and by the way I had virtually no background in, we had English, of course, but it was not -- I had never heard of Shakespeare when I got to Yale, it just didn't come up. And so I majored in engineering and industrial administration. The first year of physics was a review – I get these powerful grades. First year math – review – and so I do extremely well, except in labs. I had no, unlike my forebears, no physical acuity at all. And that's why my dad's boat, the only thing I could handle was exterior paint. Anything more sophisticated was

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beyond my ability, but thank God in the United States you could make a good living even if you didn't know how to do anything. But very briefly, I don't want to spend too much time on this but, junior year—senior year at Yale, I started taking interviews with American Brake Shoe, Proctor & Gamble, United States Steel and I'm only gilding the lily a little bit when I say that whoever interviewed me from Bethlehem Steel or whatever, he explained how my career would start and his eyes started to moisten up and in about 10-12 years you might be the manager of a steel plant in Western Pennsylvania. So I go home for Christmas break and talk to my then fiancée, "what I have done, I'm on the wrong career path" – swear to God – she says why don't you go to law school? Since you go to a school like Yale – law school is something you talk about so why not and since it also gave me the opportunity to defer an Air Force commission, it made sense to go to law school.

Bill Elliott — And so you went to The University of Washington?

Professor Johanson — The University of Washington School of Law in Seattle. Yes.

Bill Elliott — And that was to be near your home, to be near your fiancée?

Professor Johanson — Well, a variety of reasons. Number one, Gerrie, Mrs. Johanson was in a five-year nursing program at The University of Washington with one year to go; and number two, when I say I was a scholarship student at Yale, it's fair to say I was a scholarship student at Yale, and the idea of going anyplace else didn't come up.

Bill Elliott — Did you know any lawyers in your acquaintance growing up?

Professor Johanson — I don't believe I had ever met a lawyer until maybe some of the guys that interviewed me for Yale. No, they were not in my family. They were not anywhere in my life.

Bill Elliott — What was you experience in law school when you attended?

Professor Johanson — I really enjoyed it. I was really good at it. I enjoyed particularly - probably why I'm teaching Property and Wills. I enjoyed particularly courses where they had answers and rules and outcomes that you could predict and so I was a very good student. I was editor of the law review and enjoyed the experience enormously. I fit.

Bill Elliott — As you approached the end of your law school years, how did you approach your next career move?

Professor Johanson — Well at Yale I was in the ROTC, like virtually the entire entering class in the fall of 1951 because Korea was going on, but then by 1953 the idea of more second lieutenants was not a good thing for the Air Force or the Army, so they had what could only be called a purge and they went from

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about 400 people in Air Force ROTC down to 50. I was a survivor, but then when it came to graduation in 1955, Korea was now history. Even less did they want second lieutenants, so they all but invited you to please go to graduate school if you can find one. And so now after graduating from law school in 1958 they gave me an option with no guarantees where I wanted to serve and I selected the northeast and I was in a base outside of Boston – Bedford, Massachusetts for 3 years in the Air Force. So I did what they call contract work in the Air Force, but being a base connected with MIT, Lincoln Laboratories, there were more civilians than military on the base. Do you remember what was the name of the movie, "On the Beach," Neville Shute, where the submarine is down below and . . .

Bill Elliott — Gregory Peck and Ava Gardner

Professor Johanson — And everybody else is killed. There's nobody on the face - that's what it's like to be at an Air Force base – 4:58, typewriters clacking and going on, 5:02, you would think a nuke had wiped everybody out, they were all on the parking lot. But anyway, and the "contract work" were not really contracts. We gave money to scientists at The University of Utah and Cal Tech to send balloons in the air, so the contract had to have a Davis/Bacon clause, have a no discrimination clause, but anyway that was 3 years very nice in the Air Force and then a few courtmartials. And then literally because I lived in the Northeast I literally fell into a teaching fellowship at The Harvard Law School and that started my career.

Bill Elliott — Had you thought about being a law teacher? I guess that's where you made a career choice – that you wanted to teach law and that you wanted the fellowship or did the teaching come out of the fellowship?

Professor Johanson — The reason I fell into the – now here I am in the spring of my third year in the Air Force, this was spring of 1961 and let me tell you I was a very good student in law school, but the big firms in Seattle and elsewhere they didn't have recruiting coordinators in those days, so when I interviewed the two large firms downtown Seattle, Holman, Mickelwait (now Perkins Coie) and Bogle, Bogle & Gates, I took a trolley car down and knocked on doors. So when coming out of the Air Force I thought I'd check in with those people because I had been sort of a leader in our law school study groups, and I wrote the Dean, George Neff Stevens, at my law school. Just to show you how naïve I was – "Dear Dean Stevens, I think I might be interested in teaching. Do you have any openings in the fall semester?" And back comes this letter from Dean Stevens, who was kind of an interesting fellow – "Dear Stanley, I am sure pleased to hear of your interest in law teaching. I have to tell you we have no openings in the fall, however, I have information that they are looking for a legal writing instructor at Willamette Law School in Salem, Oregon." So I get this letter from the Dean and you talk about somebody looking down on Stanley Johanson. It just happened that he posted my letter and his response on the faculty

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kitchen bulletin board up there at The University of Washington and Black Jack Richards, Torts professor, although I didn't have him for Torts. I took Admiralty from him, I was in the lower half of, worst grade in law school. Two days after I hear from Dean Stevens, I get a letter from Mr. Richards whom I was not close to – "Dear Stanley, I'm certainly interested in your interest in legal education but let me tell you something. If you were seriously interested in law teaching, the worst possible career move you could make would be to begin as a legal writing instructor at Willamette University, and the next paragraph said my Harvard Law School classmate, Livingston Hall, has a program at The Harvard Law School. I recommended you for a teaching fellow." And two days later, I get a call from this Harvard professor and get interviewed down there and it turns out that that was an extraordinary pipeline for people that thought they might be interested, and I was there 3 or 4 weeks and I come back to Mrs. Johanson and she said "God bless, and, if you can make us a decent – we can raise a family, make a decent living, this is it man" so I became . . .

Bill Elliott: What was the program, teaching assistants?

Professor Johanson: Well they called it the Group Work Program. Don't ask me why, but essentially to put a human face on the first year of law. The law school at the time, not quite as bad now as I understand it, they were very aloof, the faculty. Students were sort of an inconvenience and if a student went by, I'm exaggerating and being unfair to some of them, but not all of them, a student comes by and the professor, either out loud or to himself, "I'm very busy, do you understand you're using up my time?" There were six of us and each of us had one course, I took Property. We met every day – section 1 on Monday, section 2 on Tuesday – and just talked about what's going on and so, made a rapport with the students, gave them practice tests, talked about what they were doing in the classroom and so on and so on. And so that's what I did and after a few weeks, I think I'll stay a second year if they'll take me and they would, so I got an LLM also.

Bill Elliott: When I think about the Hall of Fame Honor Roll of Harvard faculty, of course, James Casner, Mr. Estate Planning himself, comes up first.

Professor Johanson: Yes.

Bill Elliott: Could you describe how he interacted with you? What impact that had on your ultimate career choice?

Professor Johanson: I chose Property and very interesting because then as now all the young people, what do they want to teach? They want to teach Con Law, Federal Courts and Criminal Law, and here's a young guy not too swift but reasonably, he wants to teach Property Law and Wills. You know everybody needs him. So I sat in on all the professors. Mr. Sutherland, he was a historian and not a very good teacher so I quit going to his class. Jim

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Logan from Kansas went back to be the Dean and then the 10th Circuit; he was very good, young but very good. W. Barton Leach, the perpetuity scholar; he was over the hill I hate to say it but very gentle and nice to me; Charlie Harr taught Land Use Planning. I had no clue what Land Use Planning was and then there was one other guy and Casner. I was hooked on Casner – very acerbic, reputedly. Who was Professor Kingsfield in the Paper Chase and the consensus was an amalgam of Harvard professors, probably one of whom was A. James Casner and the other Clark Bies. Acerbic – questions, no answers and so . . .

Bill Elliott 100% Socratic.

Professor Johanson Yeah. Maybe 90%. No information was given intentionally and so I sat through virtually every class taking down notes as to his questions – couldn't care less of the answers – trying to figure out his strategy. I had my pedagogy sitting through those other courses. The other lesser but mostly Casner and so it happens that Mr. Casner was not somebody you got close to, that was not his style.

Bill Elliott So it would be incorrect to call him a mentor?

Professor Johanson In that sense, he was very, powerfully influenced my impact as the Estate Planning course was most, I took that for my LLM and so he had that impact, but he was not somebody you'd drop by and talk about future careers. But then he comes into play when I'm coming back from the Law Teachers' Convention after my second year or halfway through my second year and a lot of schools have interest in me for being a member of their faculty – Georgetown, North Carolina, Colorado, Northwestern, Texas Washington – and so Mr. Casner invites me up from coach to his compartment.

Bill Elliott On the train?

Professor Johanson On the train – back from Chicago to Boston and I have a scotch and with some degree of pride I show him this list and Mr. Casner says, "There's no issue. Take the Texas offer." I did; didn't ask any questions. And to say it worked out, and I can speculate looking back, I didn't ask him why – you didn't do that with Mr. Casner, he doesn't answer questions, he asks them; okay? But I'm thinking there's no state in the country that compares to Texas. Now that I realize when I've been here for a while, you've got serious estates. In Texarkana, in Lufkin, in Beaumont, in Wichita Falls, in San Angelo – not to mention Dallas and Houston, and so on – so if you are into estate planning, go to where to estates are.

Bill Elliott The phrase "big rich" is coined about Texas estates, isn't it?

Professor Johanson Yes. That's right. So it turned out extremely well. Very nice and needless to say – Oh, I have to tell you that when I told Mrs. Johanson "we're going

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to Texas" – now keep in mind I had been in Texas in the Air Force twice flying through; I was not a pilot – hops they call it when you go from one to the other and one of the times from Seattle to Lancaster, California out in the desert and then to Dallas Naval Air Station and I figured there's something wrong with that geography. Is there a naval air station in Dallas? And then we took a bus over to Greenville where there was a SAC repair base and then flew back and driving out from Dallas to Greenville this would be in the early 60s, there was a big banner across the street. Do you know what that banner said?

Bill Elliott — Yes.

Professor Johanson — "Welcome to Greenville, the blackest land, the whitest people," and it has been – I testified on that particular episode in the Hopwood case. I've been told that, no, it does not mean what it seems to say, but it didn't leave a very favorable impression.

Bill Elliott — What did you take with you in your teaching career from Harvard? With all those esteemed, legendary people. I mean you even mentioned in passing Roscoe Pounds still walked the halls when you were there, of all people.

Professor Johanson — Yes. Well yeah, that's right. It was an extraordinary bunch of people and right at the top of their field and I sat in on, took courses, I sat in on Henry Hart, Hart & Sachs. Al Sachs, I took a course on local government law. I had a couple, just a couple, but a couple of really good teachers in The University of Washington Law, but these guys knew how to teach. But I don't know what I picked up, but it was good and again the entrees that I had, the opportunities that would never have been – I can assure you I would not be sitting here, number one, if the Dean had not posted his and my letters on that bulletin board and, number two, I don't think I would be here if I started teaching at Willamette Law School as a legal writing instructor either – maybe I would, because I would write something brilliant. Lon Fuller, who was the big contracts guy at Harvard, he started at Oregon and wrote one article and they hired him at Harvard.

Bill Elliott — What was – when I think of UT in Austin in 1963, I think of the Towers shooting.

Professor Johanson — Yeah.

Bill Elliott — But what was UT like when you arrived?

Professor Johanson — It was very bucolic. Well a lot of vignettes. It was still a pretty sleepy town. And when we read up on Austin, before we came down here, one of the things they advertised in these books that we found was the Moon Towers. They had about – they're still here down by off of West Lynn. It was a very sleepy town, number one. Number two, I recall this so vividly,

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I'd never experienced anything in my life, Spring of 1964 I'm walking down San Jacinto right over here, and there was an elderly black man coming the other way and he steps off the street so I can walk by. And I'm saying what the hell is this. But anyhow it was a sleepy town. You mentioned that . . .

Bill Elliott Was it favorable to you?

Professor Johanson Oh, yeah. Well, I'll tell you what was favorable is, Mrs. Johanson, when we came down, she was pregnant with number four. And she had something because of that diethylstilbestrol that was designed to stop a placenta previa. She started bleeding again. And the first doctor said, I won't mention his name, well you know, you might carry it if you – might not. It's up – you know, things, as whatever it was that Forrest Gump said, X happens. That was not a good answer to Mrs. Johanson. So she went to another doctor. Said if you want the baby, go to bed. So she was there four months in bed. I carried her out to the living room for Christmas Eve. And along in February she went to the hospital, couldn't walk. And we got there. But in the meantime, the faculty, and the faculty wives were beyond good and decent. Extraordinary generous people. If you were writing a low-key brochure touting the values and benefits of Texas, you'd talk about those women and how gracious they were. And that made a powerful impression. Mrs. Johanson was very skeptical – skeptical about coming to Texas, but she was won over.

Bill Elliott The Dean was Page Keaton?

Professor Johanson Dean was W. Page Keaton; his wife Madge. They were among the charming people. Evelyn Johnson, Corwin Johnson's wife was extraordinarily helpful. And Zelda Weintraub – the Weintraubs didn't come for a couple of years. They were all very – they were just nice people and fun to be around. And so we – so it made an extraordinary impression.

Bill Elliott What was your first academic year's teaching assignments?

Professor Johanson Fall of 1963, I taught first year Property, and also Wills and Estates. I came in and that that's essentially what I taught. You mentioned the Tower. I think it was the summer of 1965, but I was teaching Trust law, and Mike Cook was one of my students in that Trust course. And he likes to remember this too. Because I'm teaching Trusts, you know, and then one of the classrooms over there. And somebody shortly before the class is over slams the door open and my – what the – don't you realize I'm teaching? – Then he says don't anybody leave the building.

Bill Elliott That was the year of the shooting.

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Professor Johanson	That was the year . . .
Bill Elliott	. . . I was off a couple of years.
Professor Johanson	I think it was the summer of ’65. I may be wrong on that, but I think it was the summer of 1965. And so that was a powerful – a powerful event; sad.
Bill Elliott	Maybe ’63 is UT was the national champion that year. Football – did you catch wind . . .
Professor Johanson	. . . ’63, yes. In fact, one of my good friends up in Fort Worth, Mike Bourland, who was a Baylor Bear, just to show how the world has changed, he was an all-conference guard and about 5’ 10” and 185. Now, they wouldn’t let him play defensive back, you know. But he describes – well I have purposely mis-described how it was that he missed a tackle and that’s how a Texan Duke Carlisle was able to score. Bat down what would have been the winning pass. But anyhow . . .
Bill Elliott	So it’s Bourland’s fault then?
Professor Johanson	Yeah. Well, I tried to put it on Bourland. But my basic point here is I saw that game again, this would be December whatever it was when we just barely beat Baylor because Duke Carlisle swatted down the pass, they threw him in as a defensive back even though he was a quarterback. And that when Mrs. J was back in the bedroom carrying David, but the other thing about 1963 is Mr. Kennedy was shot. And it happened on a Friday when our group was playing golf. And we came around the first nine and said President Kennedy had been shot up in Dallas. Oh, my God. Didn’t know he had died.
Bill Elliott	Was doing that teaching your first year difficult on you as a first year professor?
Professor Johanson	Well, yeah. I worked my tail off. And the interesting thing is I don’t think I’m being modest when I say I didn’t – I didn’t have a clue. I didn’t know what was except my mentors from the past, I followed – tried to emulate what they had taught me. And it turns out I was good at it. I had fallen into something I could handle. And so some of the first students in that first year we reminisce about it. David Epstein from Temple went on to be now a very distinguished law professor and Dean at Arkansas and Emory and now he’s teaching at Richmond because his grandchildren are there.
Bill Elliott	A UCC professor as I recall.
Professor Johanson	Say what?
Bill Elliott	Uniform Commercial Code is his area.

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Professor Johanson	Yeah. Right. He was a Contracts guy. And John Massey who's done very well in Dallas investments, he was in that class. And they liked what I was doing. And I just sort of had even though I purported to be a little more Socratic, a little more steely than I am now. I'm a marshmallow now.
Bill Elliott	Do you recall about the class size roughly? What is it today? About 400 today?
Professor Johanson	No, about 500. It would be roughly 500 every entering class. Five sections.
Bill Elliott	What was it back then? Same?
Professor Johanson	Yeah, that was what it was then. It started – we started paring back about five years ago. And now the market is turning back – helping us pare back because law school application for admission from 2010 to 2011, they went down 20% nationwide. And this last year another 20% nationwide. Application to law school – showing that the young people aren't as dumb as you might think. They can read tea leaves in the market, and so the number of young people wanting to go to law school has declined sharply, and the size – we had started to downsize already, but the market helped us downsize this last year.
Bill Elliott	Did you find that as you went through your first teaching year that your expectations matched up with reality so that you found it satisfying?
Professor Johanson	Oh, yeah, very much so. Again I had to work real hard to prepare for every class. I would go home about five o'clock and help Gerrie feed the kids and put 'em to bed and come back at eight o'clock and stay until midnight most weekdays of the week. So I worked hard being prepared for class, and it just – somehow I was in the right place for a person of – I'm not being immodest when I say of limited and marginal talent. I made good use of them.
Bill Elliott	You already referenced the hospitality of the faculty, maybe the faculty wives, but how did you find your professional collegiality and satisfaction from the relationship?
Professor Johanson	Well, that grew as well. One of the things, and I don't want to be too unkind to my colleagues, but I'm a teacher, but I regard myself as a lawyer, and I really like lawyers that I associate with. And I – this – I think this shows in my teaching, it may have not shown in today's classroom, we were talking about adverse possession to first year Property students, but the classes, upper classes that I teach were geared to what these young men and women would need to know if they were to find themselves in this area of the practice. And so I've always been practice oriented. I've always had contact and connection with lawyers. They – the first annual short course on whatever they call that thing that meets every June, the three day

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. . .

Bill Elliott . . . Advanced . . .

Professor Johanson . . . Advanced Estate Planning thing. I was there the first one in 1977 because they had just announced rules for specialization. And I've lectured there every year since 1977 at various locales, and get – I know a lot of lawyers, and a lot of lawyers like me. I fit.

Bill Elliott So when you started, it was Property and Wills were your two courses, your mainstays. What was your vision about estate planning, estate gift tax as you saw your career unfold, was that an interest you wanted to move toward.

Professor Johanson Well, it sort of evolved. If you are dealing with wills and estates and doing anything useful. The interesting thing is when I started teaching, the exemption on the estate tax was $60,000. And so, and then as inflation started, all of a sudden middle America has to worry about – well tell me about those trusts again. And I remember vividly discussing down in Houston with some Vinson & Elkins lawyers, it was not unusual for some of our really big family wealth in Texas, I will not mention the name of the Dallas person whose estate I was involved in, where the sons – their trust terminated one-half at thirty-five and the other one half at forty. Whereas the daughters, the girls, well hey they're girls; they need to be trusteed for life. Yeah they're female, right? Well guess who got the better part of that bargain. The girls go through life with Spendthrift protection from creditor's claims, and the boys, being as entrepreneurial as their father, they start from scratch. They don't have the cocoon of a trust. So the basic point is as I grew and evolved and started teaching a seminar in Estate Planning probably the early '70s and I didn't have a clue. I knew some of the techniques, but I didn't have – know a whole lot of the techniques. But then I, the seminar got better and then I started teaching a course on Estate Planning, which as I mentioned over lunch today, it was about 90% tax. The basic courses where we cover trusts and the spendthrift clause and powers of appointment, this upper class course we concentrated on techniques. Why . . .

Bill Elliott Did the student demand, respond to the tax orientation that you were offering?

Professor Johanson Yeah, well, yeah. I haven't really looked at statistics, but maybe as recently as ten years ago, I had about 75 students in the Estate Planning course. But then this last year I taught it had about 40 to 45, but it was pretty much around that . But it was a very – for people who thought they might like to go into this area, it was a good foundation. My game plan, I had – what is my objective in teaching this course. Answer: I'm going to assume that you or you or you are going to be a first year associate at

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Hughes & Luce, that's a name we used to use in Dallas, or a first year associate at Fulbright & Jaworski or joining some law firm in El Paso. I want you to hit the ground running. So you know the vocabulary, you know if the client is charitably inclined, what the options are; what is a charitable foundation; what is a charitable lead annuity trust as distinguished from the charitable remainder annuity. It was all geared to my hypothetical student finding himself either under the wings of a longtime practitioner in Beaumont or a medium size or large firm in Dallas, a firm in Dallas or San Antonio. And so that's what guided the curriculum.

Bill Elliott	I'm sensing a different direction in that philosophy than the perception of law school pedagogy, which is theory, not all that interested in practical application and so on. Were you out of sync with the mainstream faculty philosophy?
Professor Johanson	I wasn't then, but I am now. But things are going to come back. I hope the ship will be righted. Not to be unkind when I say colleagues this is not just the University of Texas, it's any school that aspires to be national. I probably am not – I am exaggerating, yeah. But they wouldn't hire me today because I don't have a PhD in philosophy or a PhD in economics or a PhD in you name it. And the emphasis now to make it in the law teaching field now is "scholarship." Writing something that will change the world which is utterly delusional for most of the people that are writing something cause it ain't worth reading except by somebody in their field. And I'm – I tend to exaggerate to make a point. But I think there's more truth than less that what I always thought was the primary mission of a law school was to prepare young women and men for the practice of law is now secondary. And I regard that as most, not just unfortunate, but misguided. The realities of what has happened, our economy in general and the economy in the legal practice and in law teaching in universities, the ship may well be righted. But I think the ship has been in the wrong direction for a few years.
Bill Elliott	Dean Keaton lasted as Dean until when?
Professor Johanson	'73, that's the old year he had to retire, at 65. What a stupid rule.
Bill Elliott	For the first ten years of your life here, you were under the leadership of Dean Keaton?
Professor Johanson	W. Page Keaton, who was a giant. He was a giant in every way you measure gianthood.
Bill Elliott	When did you achieve tenure?
Professor Johanson	Oh, about five years in, I guess. Maybe three or four. That's the thing about law schools. Simply because we have to compete with the legal profession, we get paid more than professors of history or social work.

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And we essentially skip associate professor, assistant to full. And I'm not sure when I got tenure; three, four, five years in.

Bill Elliott — As you looked at your first ten years of practice, what do you think were your key benchmarks of jumping to the next level? Was it a gradual progression, did doing this, doing that, give you a boost that you can recall?

Professor Johanson — Well everything just worked. Some – I just – everything worked for me. First of all I fell into this – fell into going to law school; fell into going to Yale from a – to say our family was blue collar would be fairly generous. Then I fell into going to the law school and fell into the Air Force right outside of Boston and Harvard. And I fell into that and then I fell into teaching. And so things have just happened in a positive way. And I can't say that there was any – it's just been an upward progression. And again to my delight looking back, I was good at this. And making a very comfortable living. And then the other – the outside thing started to happen.

Bill Elliott — Today, of course, you're outside activities are and have been, for as long as I can remember, extensive CLE teaching to lawyers. Second, the Bar Review.

Professor Johanson — Extensive Bar Review lecturing and in recent . . .

Bill Elliott — And then third, your writing; your case book, your annotated probate code, and so . . .

Professor Johanson — . . . and also more than a modest amount of consulting.

Bill Elliott — And then the Vinson & Elkins, Of Counsel, role which we'll talk about in a moment.

Professor Johanson — Yeah. Quite candidly, well, I'll just say there's not a better bunch of lawyers in this universe than those people at V&E. I just really impressive. But . . .

Bill Elliott — When did the Vinson & Elkins relationship arrive to you?

Professor Johanson — It started I think about 1979. I got a call from Mr. Harry Reasoner who is – to say he's a superb lawyer would be sort of an understatement. And the essence of the conversation was will you – Stanley, you interested in being a partner at Vinson & Elkins? And I said, oh lord, you know. Thanks a lot, but I really enjoy what I'm doing. So I said thanks but no thanks. Then within a day or two, wait a minute. That's kind of unusual, you know. Somebody – it wasn't guaranteed, but he's offering me a partnership in one of the best firms in the country. And all I say is thanks. So I wrote a long letter saying, Dear Harry, I'm flattered and honored. So

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let me tell you, I'm doing da da da da da da. But out of that they said well, why don't you come down here and we'll pay you salary to come down here every other Friday. And I think it's fair to say that at the time as strong as Vinson & Elkins was across the board, they were not as strong in the estate – the taxation and estate planning was not at the same level that Fulbright was or that Baker Botts or perhaps even Butler Binion – well yeah, they were better than. But the big . . .

Bill Elliott	. . . they had Marvin Collie.
Professor Johanson	And Pete Bushman who was – he had just passed away when I joined up.
Bill Elliott	. . . and then later Bill Linden was one of their guys
Professor Johanson	. . . they had – don't get me in the . . .
Bill Elliott	. . . but they were not estate planners.
Professor Johanson	That's right, they were not estate planners. They had Chapotin . . .
Bill Elliott	. . . Buck?
Professor Johanson	Yeah, Buck Chapotin. They had their income tax thing, too broad a brush there. But their estate planning section was not – it was not the way Fulbright – they had these people up the kazoo.
Bill Elliott	But on the other hand, they had clients.
Professor Johanson	Yes, oh . . .
Bill Elliott	. . . a whole lot of money. So they had the need.
Professor Johanson	Yeah. And so somehow it was thought that my being around would help them, and . . .
Bill Elliott	Was that satisfactory relationship?
Professor Johanson	It was enormously satisfactory from Stanley's standpoint. Whether V&E got anything out of it, I'm not sure. But it sure was wonderful to be around those people for – until – and then what happened, they opened an Austin office and not the first, but the second manager, Don Wood, another superb tax lawyer. But ironically the estate stuff didn't come up to Austin. It stayed down in Houston. And they, like more than a few firms, within the last two years, they parted company. Several people, retired, Roger Beebe retired and Boone Swartzel and so on. And Yolanda Knull and some of the other people, Eric Viehman, superb lawyer, they went separate ways. So I was going to no longer be with them, but I opted out because the last three or about the last three years, up to this last year, the consulting was getting

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out of hand. And the timing was perfect. It never interfered with my teaching. More than a few times when I would go down in July and August and rack up big money. The idea that I was to be a revenue, cash cow for V&E, was – no. So anyhow, so I stepped down two years ago. And now I'm on my own, and so I know whatever I make consulting is not a salary, but . . .

Bill Elliott When did Bar Review activity start for you?

Professor Johanson It started in 1971. The story behind that - when I joined the faculty in 1963, every city, I don't know who the Dallas guy was, but we had Arthur Mitchell in Austin, somebody in Houston, and Page Keeton thought they weren't very good. He thought that they were one guy giving all the lectures. And so he commissioned one of our older students, Willard Finklestein to start a law – a Bar Review course about '65. And I lectured with him, as did more than a few faculty members. But not going into details, we had a falling out, Stanley and Mr. Finklestein. And so I quit. When a couple of guys from Chicago started BARBRI, B-R-I it was then, and they came down and Lew Collins went through the lounge, said if we started BARBRI here, who would you have on the faculty? And they recommended me, and I started with them in 1971. Been lecturing with them since 1972. Still lecturing for them.

Bill Elliott It was kind of at the time revolutionary to have a new Bar Review show up. I remember people going – there's a new outfit in town.

Professor Johanson Yes. Yeah. Well, let me tell you, I think the most dramatic thing was when Bar – they, BRI, Bar Review Inc., joined with BAR Bay Area Review. And I think it was probably '75, maybe three years after I was there, they took on the New York market. Somebody called PLI, Practicing Law Institute. You talk about a lock on the market, all the midtown Wall Street firms paid the tuition for their new associates to take PLI. And here these new kids on the block come in, talk about an era that – don't they know? Within two years, PLI left the scene cause BARBRI was that good. They had people who knew how to lecture. They had up-to-date materials. PLI had a bound volume. You can't do that with law. With Property law or Wills or even Contracts or Con Law. So anyhow, in two years they went from nowhere to be king of the hill in New York cause they were that good, cause they had people who knew how to teach.

Bill Elliott As a frame of reference, today you said you teach in about five states.

Professor Johanson Um hm.

Bill Elliott Bar Review. How does that compare to the say the arc of your . . .

Professor Johanson . . . Well, let me just say I'm sort of like – Take the salesman, on the wall with the pins. I have lectured in the past; just think about this, Florida,

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	Virginia, D.C., Pennsylvania, Ohio, Missouri, California, Arizona, I think that's it. Today I am "only" lecturing in Texas, of course, Nevada, Illinois, Michigan and Massachusetts.
Bill Elliott	And Wills are state law and so is property.
Professor Johanson	Yes.
Bill Elliott	Local law, so you had to . . .
Professor Johanson	. . . yeah, I don't lecture Property. That's one of the multi-state topics. I lecture Wills and Trusts which means I do have to stay abreast of change in law and just a – I write the outlines. About maybe 12 years ago, 10 years ago, Michigan enacted the Uniform Probate Code. About 5 – well, effective last year, Massachusetts enacted a half, one-half of the Uniform Probate Code and one-half of the Uniform Trust Code. And so I have to stay abreast on that. But that's what I do. You know, I'm good at writing; I'm good at synthesizing and good at – deciding what to cover, what they need to know in three and a half hours of lecture, keeping them awake.
Bill Elliott	One phenomena since 1963 is the explosion of CLE.
Professor Johanson	Yes.
Bill Elliott	I can recall growing up in Sherman. My dad was a lawyer. How it was just sort of around the periphery of the discussion.
Professor Johanson	Yeah.
Bill Elliott	And then when they introduced the professional responsibility department . . .
Professor Johanson	. . . Yes.
Bill Elliott	. . . at the Texas Bar. Then all of a sudden today, it's really big business . . .
Professor Johanson	. . . mandatory CLE across the nation – this great nation of ours.
Bill Elliott	So take us through the arc of your career as your CLE component kicked in. A lot of it, of course, is free teaching.
Professor Johanson	Yes.
Bill Elliott	You don't get paid to go to Dallas or . . .
Professor Johanson	. . . well, a sizeable number of – well let me – it starts with me in, I think, it was 1965, there was something in Dallas, started on SMU campus, called the Southwestern Legal Foundation. And they parted company. They had

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	some arguments as to SMU as to – so they – the first two years I lectured for them was on the SMU campus; then we went to different places. That's now the Center for American & International Law in Plano. But very briefly, Andrew Cecil who was then the Chairman of Southwestern Legal Foundation . . .
Bill Elliott	. . . I remember him.
Professor Johanson	He was – boy what a – he was a Prussian, and there was two sides to his personality. I would hate to work under him. But boy was he charming. And he called . . .
Bill Elliott	. . . was that your first major connection in terms of the CLE teachings?
Professor Johanson	Yes. He called Dean Keeton and said you got anybody who could help us and Andrew Cecil told him, oh, yes, Professor Johanson he's going to be a star. And so here I am now in 1965, we've got five kids, and Andrew Cecil says, you come to Dallas for a week. We'll put you up at this hotel on North Central Expressway called the Hilton Inn with a Trader Vic's in the basement for a week. Two rooms poolside. And we'll pay you a modest fee as well. And I'm thinking, are you serious man. So we had a week – now not a whole lot of people would think a week in Dallas at the end of June would be a bargain you understand, but here they put us up for week, two cabañas. And so that's what started it. And then just to show you by God, five days a week, it went from 9 a.m. Monday 'til 4:30 Friday. I lectured three and a half hours every day, and sometimes the whole day. There would be out of ten lectures in those slots, I would cover six or seven. And on top of that, this became one of – it's not going on any more but at the end of day, 4:30, okay, we got a 15 minute, 20 minute potty break. Come on back and here was the thing, and it started early, somebody had to get me a double Chivas on the rocks. And the Q and A thing after the day would start, and the announced ending was when I started to slur. Then we'd close. And we did that – people remind me of this and so I had this incredible energy and it worked very well. And that was the first major involvement in CLE was the old Southwestern Legal Foundation where they paid me. I don't know, what was it, maybe a $1,000 on top of free room and board for a week, whoa.
Bill Elliott	In 1970?
Professor Johanson	Yeah, 1960s.
Bill Elliott	'60s, yeah. So as time went on, I guess, Bar Associations were looking for speakers to try to teach these complicated specialized subjects.
Professor Johanson	Yeah.

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Bill Elliott	So the invitations started coming your way.
Professor Johanson	Yeah. That's right. And there was a period of time I had three day longs. One of my former students was the trust officer out at Texas Commerce Bank, a name from the past, in El Paso. And then one of my former students was down in McAllen. And then one of my buddies was up in Amarillo. Three times a year I lecture the whole day; start at 8:30 and go to 4:30 with a lunch break and a couple of coffee breaks in the middle. And they were very – I no longer do that. The last full day long was about three years ago. But I still – in the end of February are going to spend three and a half hours in El Paso. I gave up on McAllen. The calendar didn't fit. I still go every Spring to Amarillo for now three and a half hours rather than seven. And they pay. I get a modest remuneration on that. But most of . . .
Bill Elliott	. . . You said earlier today, you estimated these days about 17, 15 to 20, 17, right in there.
Professor Johanson	Yeah. I counted . . .
Bill Elliott	. . . CLEs a year.
Professor Johanson	Last year was 17.
Bill Elliott	That's usually an out-of-town trip, might include an Austin appearance perhaps.
Professor Johanson	Yeah, a couple. The Austin estate planning – Central Texas Planning Council, I open their program. And the University of Texas Taxation Conference, that's two. And I'll probably give – I always give an ethics luncheon speech here in Austin for the Austin Bar. But most are out of city or out of state.
Bill Elliott	There are some listening to this film who wonder how in the world do you do this. As for myself when I give a CLE presentation, modest though it may be, it wears me out.
Professor Johanson	Right. I can understand that.
Bill Elliott	Getting on the Southwest Airlines plane going to Houston, giving a talk for an hour and coming home, just put me in an institution for a couple of days to get over that. How have you handled this load . . .
Professor Johanson	Well . . .
Bill Elliott	With all of this going on?

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Professor Johanson	Well, it's interesting. I just have the – some capacity for doing this and I enjoy, believe it or not, I enjoy traveling. And we get some real good trips out of this. Mrs. Johanson now virtually always goes with me. And now what has happened, is you see the problem is I have a fairly good combination of substance and style to keep people awake and so the invitations, they're getting a little out of hand.
Bill Elliott	Still.
Professor Johanson	Yeah. They're still coming in more than I can handle which is – so let's see now just a small indication here. This last weekend, last Friday, I spoke in Orange County at a – at a big CLE program probably about 300 in attendance. And this weekend no CLE cause they're giving a Bar Review lecture in Chicago on Thursday. And then the week after that I fly to Portland, Mrs. Johanson and I for a nice weekend trip, I'll speak there. That's paid. And then the week after that, let's see, two weeks after that we go to Lubbock – no, the next week we go to Lubbock. That's a freebie for my buddy Gerry Beyer up in Texas Tech. And the week after that we go to El Paso for three and a half hours, get paid a modest honorarium. But they treat us nice. One of my former students, I'll have dinner with him and his wife. One of my first students, Russell Hill, practices health law in El Paso. And then – then later on in March we go to Fort Worth; that's an annual event. The honorarium there used to be playing at Colonial, but I don't play golf no more . . .
Bill Elliott	. . . I presume Mr. Bourland writes those honorary checks personally . . .
Professor Johanson	Yes. . .
Bill Elliott	. . . in Fort Worth. Is that the way I should take it?
Professor Johanson	. . . that's right. Well, that's right. He – and the nice thing about Mr. Bourland is when I get to introduce him when he speaks down here at Texas and I like to point out – gosh what an upper this must be for a guy like Bourland, spending seven years in Waco, Texas at Baylor. And then being asked to speak at The University. That's pretty serious stuff.
Bill Elliott	So you really can't understand Mike Bourland unless you grasp the idea of seven years at Baylor.
Professor Johanson	That's essentially it. And to show – just to show you what's great about America, no matter how humble your background, you can make a decent living. That's Mr. Bourland for you.
Bill Elliott	You can overcome all those things . . .
Professor Johanson	. . . that's right.

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Bill Elliott . . . and still do well. I was joking with him the other day about did he feel badly over the fact that he has so much Dallas business. And then all these Dallas lawyers want more business, and he's got all this business from Dallas.

Professor Johanson Yeah.

Bill Elliott And he said he had no remorse whatsoever.

Professor Johanson No, that's alright. See they don't teach shame at Waco, that's the problem.

Bill Elliott Alright, in preparing for my interview with you today, I called various and sundry old friends, just use that expression. And one of the things they kept telling me is you have the same fact patterns and characters in your hypotheticals, and they all have, over the years, these become people you almost feel like you know.

Professor Johanson Oh, yes.

Bill Elliott I'm just – Hobie Gates.

Professor Johanson Hobie Gates, aw, yes . . .

Bill Elliott . . . so can you tell us about your philosophy of your characters . . .

Professor Johanson . . . well . . .

Bill Elliott . . . that are in your examples.

Professor Johanson Oh, by the way, Hobie is married to Winkie, and either it's their child or sometimes by her first marriage she has child called Mookie. Hobie and Winkie, but Hobie Gates. That is a – it starts slow but builds up in my Bar Review lectures and to some extent in the classroom. And the end result is, it's always Hobie Gates and H and W, husband wife. But after the second lecture, who is Hobie Gates. And so there becomes almost a fetish that they want, and so my line is when somebody really presses me – who is Hobie Gates. And I say if you were into Zen Buddhism, someday, some morning when you are enlightened – oh, yes, I understand – Hobie Gates. Well the upshot is, oh, I've got the pictures up in my office if I can find 'em. A student, I don't even know if it was our graduate, "Professor I think I got it. I was up in Vermont and walking through a Vermont cemetery and I think I got it." And because he's got two tombstones, one says Hobart and that one says Gates. And, "is that it?" And I write back, "nice try." Hobie, I've shared that with Hobie, and he had a good laugh. So the legend of Hobie lives on.

Bill Elliott Surely Hobie is not a flinty New Englander. He has to come from Texas.

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Professor Johanson	Well . . .
Bill Elliott	. . . Surely.
Professor Johanson	Well first of all, I'm not sure where he comes from, but second of all, don't call me Shirley. I, of course, borrowed that line. But Hobie – he is what you make of him. And he's a – but I see him from time to time. Now the other things is – the other characters that come – the first edition of the case book, we have to have a mythical family. And that is Howard and Wendy Brown, H&W. And they have two children, Sara 14 and Stephanie 11. Wendy has a child, a 21 year old Michael, by her first marriage. And Michael is living with his 34 year old live-in, Candace. And they have a non-marital child, little Andy who's one year old. So in today's world when we started the first edition of the case book, that was sort of unusual. But that's almost the American family today. Second marriage, children by a first marriage and a non-marital grandchild.
Bill Elliott	I'm wondering if you have moved into transgender and same sex relationships as part of your presentation.
Professor Johanson	Well, we cover that . . .
Bill Elliott	To quote Jerry Seinfeld, "Not that there's anything wrong with it."
Professor Johanson	Oh, yeah. Alright. No we cover it, but it's kind of a more sensitive issue than it used to be. And now one of the cases, needless to say, we're covering, and we have to be very careful as to how this is presented into the kind of audience we have now, is *Windsor v. United States*, where Ms. Spyer and Ms. Windsor got married in Canada after a 40-year engagement, and then they moved to New York and Ms. Spyer dies. And the question is, does the property she left to her spouse, same sex spouse, qualify for the marital deduction? That's going before the United States Supreme Court. So it's kind of interesting issues we cover now. But I have to tell you that we do have – I do not spend a lot of time, I just tell the students if they want to read it, go ahead and read the text on the test tube babies.
Bill Elliott	We'll come back to other little snippets that I've been given by some of your friends.
Professor Johanson	Erstwhile friends, yes.
Bill Elliott	Your friends. Your case book. Let's talk about your case book. It's on Wills and Estates and it's used at 120 law schools . . .
Professor Johanson	. . . around that, yes.

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Bill Elliott . . . and it arguably is the dominant case book in that subject in the United States. How did that come to pass?

Professor Johanson Well, 1967 I accepted an invitation to visit, and I taught at UCLA for the year in Los Angeles. Just a marvelous experience. So we had – we were then, there were four of us – no excuse me, five of us out there; five of the six Johansons. And we had a marvelous year, and this was a match made in heaven. On the UCLA faculty, my counterpart was Jessie Dukeminier and he was having the same dissatisfaction I was having with the casebooks at the time. They were not very good in the Wills area. And so I was in the process of developing my own teaching materials, and they were probably an inch and a half thick. And Mr. Dukeminier was doing the exact same thing. And from a publisher's standpoint a match made in heaven. Now let me back off – back up and point out this was 1972. Yes, we did have typewriters, but they hadn't even invented the Selectric then. And so everything was manual with carbon paper and so on. So it was a little different from what it is today. But the bottom line is, the first edition of the case book published in 1972 by Little Brown was called Family Wealth Transactions, subtitle: Wills Trusts and Estates. Now that's one of the few mistakes that we, I should say Mr. Dukeminier, cause he was the dominant partner, we made. That's not good marketing because professors at the University of St. Louis or Nebraska are saying what the hell is Family Wealth Transactions. It didn't go over big. And so we changed, I think the third edition, to Wills Trusts and Estates. And the reason the book is good is not only are the cases selected in a very appropriate manner, timely and so on, interesting, but the footnotes – it's the only – I'm not exaggerating when I say, if not the only book, but it's number one where the students want to read the footnotes cause they have no idea what gems are going to be in there. For example, when we're talking about to my wife to pay the income, to my wife for life or until she remarries. She is penalized if she remarries, and clauses "provided my son marry a Jewish woman both of his parents are Jewish within seven years after my death." It's kind of interesting. But anyhow, so you read the footnote and what is reputedly the will of Heinrich Heine, he's very well known in Germany; German poet dying in the 1840s, making a substantial bequest to his wife "on the express condition that she remarries. I want one person to truly bereave my death." So these are the kind of gems in there, Judge Musmanno who was kind of a loose cannon on the Pennsylvania Supreme Court wrote more dissents in five years than the rest of the judges in Pennsylvania done for their – since 1720. And he was Italian and one case he was offended because it said some favorable things about Leif Ericson landing first. And so this long long dissenting opinion talking about Christopher Columbus. So the thing is interesting. And the beauty of the case book, and I think it's fair to say my teaching, if you're going to take a course in law school called Wills and Estates, what do you expect?

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Bill Elliott	Dead people.
Professor Johanson	Muffled carpets. Organ music. And the first thing they discover, geez these are kind of interesting, you know. I had no idea.
Bill Elliott	Your case book, was that a difficult effort for you?
Professor Johanson	No. But once again largely because both Mr. Dukeminier and I had good starts as to what we thought should be covered, and so it was a matter of, I won't say filling in the blanks – the first edition starting work – serious work the Spring of '68 'til the Fall of '71 was very substantial, I can't say how much, but it was a very vigorous effort.
Bill Elliott	I sent off and purchased one off of Amazon about three, four weeks ago.
Professor Johanson	Wow.
Bill Elliott	I think it was the tenth edition, could that be?
Professor Johanson	No, no. The current edition is the eighth edition.
Bill Elliott	So I went back a couple of years and bought a used one.
Professor Johanson	Now, you're talking.
Bill Elliott	And didn't pay much so also I bought it from a book dealer, so no royalty to you, thank you very much. But professionally has that case book, how has that case book affected you, your teaching?
Professor Johanson	Well, just let me say this. I had to decide what Property case book to use here and the publisher send you all these books. There are probably twelve to fifteen. Wills and Estates – Wills, Trusts and Estates or however they're named, there are probably twelve to fifteen and a lot of professors, we got the Michigan case book and we got the Columbia case book and so on. And so the field is crowded. And for one book to have not just a plurality but a majority of the law schools, it's a commentary that it's a very good and effective teaching tool. And it, yeah, so people know who I am in part because of the case book.
Bill Elliott	Do you still use it yourself?
Professor Johanson	Needless to say, yeah, even though I'm no longer on the spine, you read about me in the preface. Yes, it's still very good. And they got two people, Mr. Sitkoff, Northwestern, now Harvard – Northwestern Columbia, now Harvard, and Mr. Lindgren at Northwestern, are very good people. And Sitkoff especially is carrying the ball with the same kind of verve that Mr. Dukeminier brought to it.

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Bill Elliott: Let's talk about teaching tax and legal concepts over the years. Would you think that the process of teaching law students has changed in your 50 years?

Professor Johanson: Well, it's hard for me to say cause I know what I do and I know what my colleagues do in the tax area. And again my Estate Planning course is applied – I call it applied estate and gift tax. When it comes to income tax, I don't know what Bob Peroni does. I know that it's very well received and he's gifted. And my expectation was if I taught income tax, one of the comments I made when I was honored with this extraordinary tax lawyer of the year by the taxation section of the Texas State Bar – pretty good for a guy who can't handle a 1040EZ, so I'm not into income tax except as it overlaps with estate and gift. But what I do in estate and gift tax, and I'm sure that Mr. Peroni does, they keep changing the damn rules. They keep enacting statutes. They keep enacting regulations, winding and unwinding. But the issues faced by clients don't change. The rules that apply to their transaction may be different so you focus on a transaction, and then you talk about the extent to which it's important to know the current rules, that's fine, but remind the students when we talk about the current rules, they may change. But the problems the clients bring tend to be eternal. Certain things will come into play and certain things will phase out. So I, for good teachers, I don't think teaching – you get better, hopefully as you evolve. And we're blessed to have Mr. Peroni and Mr. Ascher teaching income tax cause they know how to do it.

Bill Elliott: But insofar as you're concerned, your courses, you haven't changed your style over the years particularly.

Professor Johanson: No, not especially. Let me tell you, I started – when I started estate planning with Alice Adams, who was then in her late 60s a widow, now in the last edition she was in her late 70s, but she's still a widow with – and she kept getting a raise every year cause they kept changing the exemption equivalent. And the idea is, what is what does a lawyer need to know. When Alice Adams comes in with, we call it clean, this liquid, her wealth is in stocks and bonds and an IRA rolled over from her husband. And so we – that's where we learn the basics of transfers with a retained life estate, revocable trusts and so on. And gifts to the grandchildren; what forms do they take and so on. And then the second clients we meet are Hugh and Wilma Bronson, H&W, get it. And we talk about basic marital deduction – marital planning. And bypass trusts and now we get into the generation-skipping transfer tax because they got – well, again they keep getting raises. Had I taught this course this time, they'd be anywhere from 8 to 12 million. And then after we talk about Hugh and Wilma Bronson, we talk about Howard and Wendy Chase, C for community property. How does it differ if the Bronsons were the Chases and they lived in California or Texas? What problem would they face, and so on and so on. But you notice the thrust of that teaching is clients and what lawyers would do in

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dealing with those clients. What tools would be in the toolbox for those particular clients. I don't know what Mr. Peroni does as income tax or some of the other gifted teachers do in income tax. But I strongly suspect it's not my style, but something along that style where you don't focus on the code provisions; that's a losing battle. You focus on the problems that clients face and what are the current opportunities and obstacles.

Bill Elliott	One change over your years has been technology has been revolutionized and yet you do not allow a laptop computer in your classroom.
Professor Johanson	Yes.
Bill Elliott	Can you talk about your approach to this issue?
Professor Johanson	Well, a couple of things. The first thing is, I can get away with it. That is to say I can apply it, and because if you don't want to take Johanson's course, that's fine, somebody else is waiting to get in. But why no laptops? You saw just a small smattering in my class today. I use a lot of overheads in Wills. And I used a lot of overheads in Estate Planning where I would have the summary of the facts. The problem hypo might be in the materials. But I would have an overhead. I don't use PowerPoints, I use overheads. And or there would be a rule or something I would have. And one time a really good student sitting right over there, and I have this overhead, a hypo, a problem. He's typing away on his laptop. And I say Mr. Jones, what do you think the government would argue here or what should the taxpayer say. And for the first time Mr. Jones is reading as distinguished from transcribing. And as I have told students ever since, if this was a school for court reporters that would be great, but that's not the idea. And so I'm not concerned about people playing poker or sending messages to the other side of the room. I want them to concentrate, and also there's – to the extent I'm more than a modest amount of paternalistic, take down the notes and then transcribe them into your laptop because, and I like to site Marcel Proust from Remembrance of Things Past even though I quit reading the damn thing in about 40 pages, given new meaning to the concept of turgid, but anyhow, one of the things he said, see if I can remember, "That which we are not forced to decipher, to make clear by our personal effort, that which is made clear before, is not ours." And translated in English, if it's laid out for you and you write it down and you swallow it, it's not yours. You have to work on it. You have to decipher it. You have to struggle it. And you cannot transcribe your notes unless you copied them. You think about what your putting into the notes. And that's a very good pedagogical saying, and that's what I, that's my . . .
Bill Elliott	There must be something about the brain and the handwriting that really focuses your mind on what you're doing.

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Professor Johanson: That's right. You have to think about what – typing is pretty mechanical, you know. Typing is – especially if someone is reading to you or back in the old days when we used to use cassettes, Dictaphones, you're not thinking, you're just . . .

Bill Elliott: . . . when you write, yourself, what are your habits? How do you write? With a computer?

Professor Johanson: Yeah. I – one of the things you learn of necessity if you're a law professor is you – the idea of having your own secretary, I mean, get out of here man. Debbie Steed whom you met who is extraordinary person as well as gifted assistant, she now has four of us. And she only works 19 hours a week because this is what she can do since she's took formal retirement. The bottom line is she can do it, but you don't call on secretaries; you learn to type yourself. You – that's just the way the law teaching profession is.

Bill Elliott: How do you find law students at UT today as compared to periods in your past? And what are your perceptions of what you have in front of you today?

Professor Johanson: Well, I can speak to that. Because we are Texas, because we are the University of Texas, even when I first began, there was always the people, Steve Susman is a perfect example. He graduated from Yale a few years after I did. And he was destined to come back to Texas. We have these people who go to Stanford, maybe to Northwestern or maybe to Rice, but if they want to go to law school, Texas is high on their list. We have always had the Steve Susmans or the Steve Akers or other people who are just good. They come to Texas because that's their school, whether they went to college in state or out-of-state, they come back. When I first began teaching it was – I can't remember how many Fs I gave my first year. But flunking out, all you had to do to get admitted to University of Texas was be breathing and be able to take the LSAT. It didn't matter what your score was, we admitted you unless you couldn't walk or couldn't breathe. And so the upshot is somewhat democratic, you could try law school and if you didn't make, well go home. Everybody had a chance. On the other hand it was a waste of resources because people left with spending a year taking a seat. But anyhow, the bottom line is and it started changing late '60s early '70, '72, as soon as women were represented more than token, as soon as it began 15%, 20, 25, 35 and now 48%, even if you taken the same 500 entering students, it used to be 490 were men and 10 were women. But now it's 260 men, 240 women. And what has happened? You've dropped the bottom half of the class. They don't come anymore. The bottom half of the class doesn't exist, and it hasn't existed at the University of Texas since sometime in the '80s. And for a student – now we do make mistakes in the admissions because we do – there are slackers out there in our society, and sometimes they get into law school, and we try to weed them out. I'm good at weeding them out, because I'm one of the few

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professors that flunk people. You've got no guaranty of four credit hours in Professor Johanson's course. Not big, 3 out of 197, but there's that odor in the air. He gives Fs, and that's a very very useful atmosphere to have. So anyhow, what has happened, and we've always had the cream of the crop, but what has happened now is the top half is much stronger than it was in the past. I should say, there's more of them.

Bill Elliott: How do you apply the Bell curve in light of that phenomenon?

Professor Johanson: Well we just do. And now that's the other thing. This started from day one. And it's true today and it's also true at our most select schools. We're talking, not just Harvard which is big, but Yale with 140, 150 entering class. Stanford, Chicago, 200, whatever. They come with the most incredible credentials. Magna or Summa Cum Laude from Swarthmore in philosophy. Or the same, equivalent from Stanford or from Wake Forest, and so on. And high LSATs. And incredibly you've got these people that are the top 5% of our college, not just society, our college. They come to law school and magically they separate. We have at the top of the list some names we've mentioned over dinner last night. We have the Larry Gibbs and we have the Lynn Barbees and . . .

Bill Elliott: . . . Ralph Millers.

Professor Johanson: Yeah. And the Ralph Millers. Their credentials are the same coming in but somehow this clicks, they're in the right spot. And they blossom. And now these other people, they drag – I won't say they drag – but they're good, but they're not uncannily good. So somehow someway we have a way of measuring them, and that takes care of the Bell curve. Now in my class, my students, boy, especially that first essay which turned out to be very good, I modeled it on some ideas from a recent Bar Exam question in Texas and I gussied it up, and it was fantastic. The students, they impressed me overall as to how much they had learned and how effective they were. And yet, there were some students – I shouldn't say this on tape, but I will say it, that if they were trying and not trying to wing it as a, trying to go through, sort of a loss for the word there for a minute, it'll come to me. Boy did we make a mistake, they have no business being in law school; they have no business being in law school. And so by the curve, I'm not able to give as many A+ as I would like, but I'm also not able to give as many Cs and Ds as I would like. There's some people that don't do very well. And if they're a slacker, that's the word I – if they are slackers, they get their just desserts.

Bill Elliott: I'm impressed by how you and your wife know your students personally. That's seems to be a priority with you.

Professor Johanson: Well, yes. In fairness, there's – with a 197 last semester in two sections, I didn't know them all. But we work at that. We will have my – my first

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year class cause it's almost manageable, 75 to 80. When we had the Estate Planning course in the Spring, either two or three days we would have one-half or one-third of the class over for barbecue, children invited.

Bill Elliott — Your wife said to me last night with great joy, we just love the first year students.

Professor Johanson — Yeah.

Bill Elliott — And I took that to say, you take a special glee in teaching first years, which is actually counterintuitive to what I was expecting.

Professor Johanson — No. Well, this is no knock on the upper class students cause I like them too. But you're – and one of the reasons I was not disappointed in my decision to go back teaching first year, you have an impact on them that you don't have two or three years in. About – because one of the things we teach is law but also values. I have a value system. Good, bad or indifferent, I sure as hell have one. And inculcating students with what I know about being a lawyer, what kind of character, and characteristics, but character make for good lawyer. I think I know, and to the extent I exhibit those characteristics, you can impact minds that are still open and malleable. And they – you could see that in a class today. And they really seem to like being there, and we had fun talking about building the fence on the wrong line. And they saw that as interesting, and also Judge O'Keefe's paintings and how it got into the Franks' living room and so on.

Bill Elliott — That's the other dimension that is quite striking. Your intellectual enthusiasm for the case that you're discussing. You had great fun talking about Georgia O'Keefe's missing paintings today.

Professor Johanson — Yes. And also the entrance to the Marengo Cave in southern Indiana. And that's the nice thing about when you got the right cases, that makes it fun because the students can relate to that.

Bill Elliott — . . . I was also struck by the teamwork with your wife.

Professor Johanson — Yeah.

Bill Elliott — Your wife is right there with you in terms of being in sync with your thinking, your approach, her awareness of the students and that is really a wonderful phenomenon.

Professor Johanson — Well, I worked hard in my early years of teaching. I still work reasonably – not as hard now, but I could never have done it – she worked hard too. And she continues – I mentioned earlier how lucky I've been when different things happened, how I got to Yale, and how I got to Harvard Law School, and how I got to Texas and so on. The best decision I ever made was marrying Gerrie Cunningham, Geraldine Cunningham. Because

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	it's not enough to say she's been supportive, we are an incredible team, and I tell you the best way to measure a person is look at their children. And our children are – all parents hopefully are proud of their kids, but we have reason, I mean our kids are off the chart.
Bill Elliott	You have four children?
Professor Johanson	Six.
Bill Elliott	Six children.
Professor Johanson	Six children. And there again that just shows you what I married – who I married. When we were engaged, when we were going together in high school, in Ballard High School in Seattle, she said when we get married, we're going to have six children.
Bill Elliott	You all were high school sweethearts.
Professor Johanson	Yeah. Met in Latin class. And so I – she said we're going to have six children. I said okay. And she's a woman of her word. We had six children.
Bill Elliott	Can you pull up a Latin phrase that would entertain us?
Professor Johanson	Yes, I can do the one that everybody knows. Omnia gallia in tres partes divisus est. That's Julius Caesar. All of Gaul can be divided into three parts, but that's it. Aside from per stirpes and per capita, that exhausts my Latin repertoire.
Bill Elliott	Let's take an interlude here and revisit the little insights from your friends out in the world who said, be sure to ask him about.
Professor Johanson	Okay.
Bill Elliott	Now, Mr. Bourland, I believe was the one who said that if I ask, you will give us a rendition of one of your songs for which you are noted.
Professor Johanson	Yes. Yes.
Bill Elliott	And he said, don't give him any advance notice, just spring it on him.
Professor Johanson	Um hm.
Bill Elliott	I guess that's the Baylor way.
Professor Johanson	Yes. Yes.
Bill Elliott	Spring it on him.

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Professor Johanson	Well, let me tell you . . .
Bill Elliott	. . . what is the story of you singing in class?
Professor Johanson	Well, this one I reserve not for class, but I can do it in class, but for years we have Assault and Flattery at the law school, the variety show where the students have fun and poke fun at their professors and so on, and I have appeared on the show. A student wrote a song for me, and it fits so good, I don't know how long I've been doing this, but it is a marvelous song because it encapsules estate planning or the wills course because if I can – sings: "If ever I would leave you, it wouldn't be intestate. If it were intestate, the neighbors would know. How much did I leave you. How much could you spend. For it's all public record right down to the end. And could I trust an executor to hold the line against a tax collector screaming everything is mine. Whatever I would leave you, it wouldn't be in trust dear. If it were in trust dear, I'd lose all control. Not intestate or probate. Not in trust for a fee. Perhaps I'll choose to spend it on me." I left out a verse, but you get the bad bad bad – so that's the one.
Bill Elliott	The other tip was to ask about your 1:35 p.m. Friday afternoon golf foursome . . .
Professor Johanson	. . . Yes.
Bill Elliott	. . . which you've given up now, but for years that was a regular feature of your life . . .
Professor Johanson	. . . Yeah, yeah.
Bill Elliott	. . . Can you tell us briefly about that?
Professor Johanson	Well, yeah, that was one of the things, I think we mentioned this when I joined the law faculty, I joined the Austin Country Club at $26.00 a month. And this really really, rain or shine, middle of August, middle of January, sleet, not very often in Austin, but it does happen, we would tee off at 1:35. Charles Alan Wright, Keith Morrison, Parker Fielder – some wonderful names from the past – Albert P. Jones, they called him Pappy Jones, the Procedure guy; he did real well as a torts lawyer in Houston and came back to teach Procedure at Texas. And I may be leaving some – then – if we didn't have a foursome, Frank Crawford, a local, would play with us. And . . .
Bill Elliott	How many years did you play with this group?
Professor Johanson	Well, until I started getting busy with Vinson & Elkins in late '70s. So about - at least 15 years. And Charles Alan Wright was not particularly good at golf, but his wife Custis was very good. And one time I was

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chatting, you know, it's kind of interesting, I do pretty good the first nine, high 30s, 38, 39, and then I shoot a 45 or 46 the back nine. What's going on? Then Custis said, you're walking, aren't you? By God she was right. I just ran out of energy. I remember one time when we were playing, the old ninth hole, the par 3 that you could hit about 170 yards, and we're playing with our foursome and Harvie Penick the pro comes by, he's got this young guy saying you mind if we hit through. The word was we're trying to recruit him to go to the University of Texas; he's a pretty good golfer. Was Ben Crenshaw, about 17 years old, a junior at Austin High; and of course, he was a whiz at that time. So that was every Friday rain or shine, we played golf.

Bill Elliott	Now you travel to CLE speeches.
Professor Johanson	Now almost every Friday I'm giving a CLE speech somewhere. And it used to be my honorarium up at Fort Worth Estate Planning Counsel was either Colonial or some other course up in the Fort Worth area that Marvin Leonard, the department store magnate, he had several courses, so that was – but now we've hung up our cleats. We don't play golf no more.
Bill Elliott	If you were to do it over again, would you still teach Wills, Property, Estate Planning?
Professor Johanson	Well, let me tell you this. I wouldn't dare try to do it over again because as it happened, it turned out so well. I'm not sure I would be that fortunate the next time. But absolutely. Wills, I really enjoyed it. And now one of the things I have done early on in my teaching, I have a log, class log, after each class, I type out what worked, what didn't work, what I want to next time. You may or may not have noticed in my class today I had a script. I carried notes. I don't read my script, but it reminds me what I want to cover. It's a little crude this first time in Property, it'll be better next year, but Wills! Every class I go in with a script, and like a good actor, I'm a pretty good actor, I don't read the script. But I know what I want to cover and so I have a paragraph, this went well or the next year, don't cover that. You heard me say, don't cover problem three. Who cares about adverse possession of intangibles. We've got enough on our plate.
Bill Elliott	What is your optimism about the future of being a lawyer today for these students who are leaving Austin?
Professor Johanson	Well my optimism is there because if you have good fortune and end up landing in the right spot doing the right kind of thing, it's hard to imagine a more satisfying life, if you can make enough money to pay the mortgage company. And so, it's – I remain optimistic in the sense that if you make it into this field, you can have a very enjoyable and reasonably comfortable life. I – at the same time, the economics are such that it's going to be hard for these young people to find a place to land. And I also recognize talking

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to former students, you have to find an area of the practice that brings out your passion. You have to want to do it. I keep, I shouldn't pick on my daughter Carolyn up in Denver, she went to Emory Law School, came back to Austin, and she thought she was going to be in the business section of a firm, Wright & Greenhill, but they sort of slowed down and she did – business insurance defense, and she was good at it. But it's fair to say in that field of practice, you're learning curve stops at about year five. What are you going to do? What else is there to know? You know how to object, you know how to plead, you know how to voir dire the witnesses, and that's the end of it. But Estate Planning, Wills, there's no explaining the capacity of people that bring something that is never – just like they used say on StarTrek, where no man has gone before. They stay fascinating. Dealing with human beings with all their good sides and all their dark sides. So this area of the practice, I just push it as much as I can.

Bill Elliott — Somebody told me once that estate planning is the last true general practice.

Professor Johanson — I think there's a lot to be said for that with good lawyers. And you're talking about – now Steve Akers doesn't have clients any more with Bessemer Trust or he does but indirectly. But good lawyers like Alvin Golden and Mike Bourland, for example, or any other outstanding lawyers that we have in this State, Steve Saunders here in Austin is another perfect example of how you build a relationship with people. You build a rapport with people. You have that capacity if that's your ability. There are some as you well know, there's some lawyers that manage to strike out no matter what they do because they don't have people skills. They don't have empathy skills. They can't relate to their clients. But a good estate planning lawyer is – becomes a member of the family. And it's kind of nice to have people respect you and make serious life decisions based on what you suggest to them. Pretty fun.

Bill Elliott — Thank you for your time. It's been a joy to talk to you for this couple of hours.

Professor Johanson — Well, it's very – been a joy to me too that somebody wants to hear what I have to say, you know. That's pretty impressive. But . . .

Bill Elliott — . . . Well, they have since 1963 . . .been pretty interested in what you have to say

Professor Johanson — . . . That's right, coming up on 50 years which is pretty astonishing and that's – I have to share this one. My late sister-in-law up in Seattle, we were visiting one time, this is, well she had been gone for about 12 years. Somebody says, "Stan, when are you going to retire?" And my sister-in-law Dodie pipes up, "from what?" And the basic point is, if I had a job, you know, I'd think seriously about retiring, but geez, come on, man. And

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	the first of – no, actually the 31st, last day of the month, somebody pops a big check in my checking account down at Chase Bank. Why would I walk away from that, this – what passes as work. Come on man, I'm not dumb. So I'm slugging it in. And someday I will start the class, and they'll carry me out.
Bill Elliott	Thank you very much.
Professor Johanson	Okay, thank you. Enjoyed it.

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AFFORDABLE CARE ACT: A TRUST AND ESTATE PERSPECTIVE

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AFFORDABLE CARE ACT: A TRUST AND ESTATE PERSPECTIVE

By: Melissa J. Willms[*]

I. INTRODUCTION

The goal of this article is to give insight as to how new Section 1411 of the Internal Revenue Code applies to trusts and estates. It is not meant to be an exhaustive analysis of every aspect of the Affordable Care Act[1] or even every aspect of Section 1411 and the recently issued proposed Treasury regulations. After describing the statute and proposed regulations as they relate to trusts and estates, the article examines unique issues and problem areas, as well as potential planning ideas for these entities.

II. ADDITIONAL INCOME TAX ON TRUSTS AND ESTATES

A. <u>Health Care and Education Reconciliation Act of 2010, P.L. 111-152</u>. The year 2013 brought a new income tax to estates and trusts. The Health Care and Education Reconciliation Act of 2010 ("HCA 2010") imposes an additional 3.8% income tax on individuals, trusts, and estates. Although the tax is similar between individuals on the one hand and trusts and estates on the other, there are some differences.

B. <u>IRC § 1411</u>. The new income tax is found in new Chapter 2A of the Internal Revenue Code entitled "Unearned Income Medicare Contribution." Chapter 2A is comprised only of Section 1411. Although commonly referred to as a Medicare tax (which is understandable based on the name of the Chapter), the funds will not be placed in the Medicare Fund but will go to the General Fund of the Treasury.

For individuals, the 3.8% tax applies to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income over certain defined thresholds. For estates and trusts, the 3.8% tax applies to the lesser of undistributed net investment income or the excess of adjusted gross income over a threshold determined based on the highest income tax bracket for estates and trusts ($11,950 for 2013). For ease of reference, for individuals who are married filing jointly, the threshold is $250,000 (for married filing separately, $125,000 each) and for single individuals, the filing threshold is $200,000.

The statute as it applies to estates and trusts is as follows:

> § 1411(a) In general. Except as provided in (e) –
>
> (2) Application to estates and trusts. In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of –
>
> (A) the undistributed net investment income for such taxable year, or
>
> (B) the excess (if any) of –
>
> (i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over

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[1] The Healthcare and Education Reconciliation Act of 2010 was passed one week after the Patient Protection and Affordable Care Act of 2010 and served to modify provisions of the Patient Protection and Affordable Care Act. Together, the two Acts are referred to as the "Affordable Care Act." This article will only address certain issues related to domestic estates and trusts as a result of the enactment of the Healthcare and Education Reconciliation Act of 2010.

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(ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

Because the threshold for trusts and estates is based on the highest income tax bracket for each, the threshold is indexed each year to some extent for these entities, whereas there is no indexing for individuals.

C. Proposed Regulations. On December 5, 2012, the IRS issued a Notice of Proposed Rulemaking ("Notice") seeking comments to proposed Treasury regulations related to Section 1411 (77 FR 72611) which are expected to be finalized in 2013. As stated in the Notice, the purpose of Section 1411 is to impose a tax on "unearned income or investments." The Notice provides that for the most part, the principles of chapter 1 of subtitle A of the Internal Revenue Code are to be applied in determining the tax to be imposed. In addition, the statute introduces terms that are not defined and makes cross references to various other sections of the Internal Revenue Code; however, as pointed out in the Notice, nothing in the legislative history indicates that a term used in the statute is meant to have the same meaning as it would for other income tax purposes. The proposed regulations are intended to provide additional definitions of terms and guidance for the imposition of the tax. The proposed regulations are "designed to promote the fair administration of section 1411 while preventing circumvention of the purposes of the statute."

D. Net Investment Income vs. Undistributed Net Investment Income. Individuals, trusts, and estates now have to calculate their net investment income. Net investment income consists of the sum of three categories of income. IRC § 1411(c)(1). The first category includes gross income from interest, dividends, annuities, royalties, and rents, other than those that are derived in the ordinary course of a trade or business. Note that each of these types of income may be included even though they may be earned through an activity that may otherwise be thought of as a trade or business because to be excluded, the income must meet the specific ordinary course of a trade or business exception as set out in the proposed regulations. To meet the exception, the trade or business must be one to which the tax will not apply. In each of these categories, when the term "trade or business" is used, it is in reference to that term as defined in Section 1411(c)(2). A further discussion of what is included as a trade or business follows, but a classic example of how a business ends up not meeting the exception involves rental real estate activities of a real estate professional as described in section 6.B.i.(b)(2) of the Notice. The second category includes other gross income derived from a trade or business. The third category includes net gain from the disposition of property held in a trade or business. From the total of these categories, deductions that are properly allowed are taken. IRC § 1411(c)(1)(B). Exhibit A sets forth a preliminary attempt to diagram the calculation of net investment income.

For estates and trusts, the first component of income taken into account is "undistributed" net investment income, a term that is unique to Section 1411. Although the statute does not define what is meant by "undistributed," the proposed regulations apply rules similar to those in Sections 651 and 661 regarding the carry out of distributable net income ("DNI") to beneficiaries. Prop. Treas. Reg. § 1.1411-3(e).

Whereas for other income, DNI carries out to beneficiaries to the extent of a trust or estate's taxable income, for purposes of Section 1411, net investment income will carry out to beneficiaries (and the trust will receive a deduction) in an amount equal to the *lesser of* the trust's DNI or its net investment income. In other words, if a trust has both net investment income and other income, distributions will carry out each class of income pro rata to the beneficiaries. In turn, each beneficiary will pick up the respective classes of income for purposes of computing their income, including net investment income, and the trust will receive corresponding deductions. With the vast

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difference between the threshold for estates and trusts and individuals, the distribution of net investment income will frequently impact the overall amount of the tax paid.

The interrelation between taxable income, fiduciary accounting income, and DNI can be difficult to understand. DNI not only determines how much taxable income will be income taxed to a beneficiary. It also determines the amount that will be taxed to a trust or a beneficiary for purposes of Section 1411. Therefore, it is important that these concepts be understood. Although the examples in Proposed Treasury Regulation Section 1.1411-3(f) propose to illustrate the calculation of undistributed net investment income, the examples contain a fundamental mistake. Examples 1 and 2 of the proposed Treasury regulation describe a trust that has various receipts, including a distribution from an individual retirement account ("IRA"). The trust also makes distributions to one or more beneficiaries. In calculating DNI, the examples exclude a portion of the IRA distribution that is allocated to principal for purposes of calculating fiduciary accounting income. However, when determining a trust's DNI, any amounts that the fiduciary allocates to principal or income for purposes of fiduciary accounting income are irrelevant. Rather, when determining a trust's DNI, the *taxable* income of the trust is what is important. Therefore, when reviewing Examples 1 and 2 of the proposed Treasury regulations, keep in mind that this fundamental assumption is misstated and no portion of the IRA distribution should be excluded from DNI. Therefore, the trust's DNI should be $85,000, causing the need for an adjustment to the rest of the calculations in the examples. Presumably, because this mistake has been pointed out to the IRS and Treasury Department, these calculations will be corrected prior to the issuance of final regulations.

E. <u>Trade or Business</u>. The phrase "trade or business" is part of each of the categories of net investment income. Therefore, a fiduciary must evaluate this phrase to determine whether items of income or gain constitute net investment income. Section 1411(c)(2) defines "trade or business" as (i) a passive activity or (ii) a trade or business of trading in financial instruments or commodities. IRC § 1411(c)(2). Note that trading in financial instruments or commodities is included regardless of whether or not it is a passive activity. Because income from passive activities comprise the largest portion of what constitutes net investment income, determining what activities are passive is key.

F. <u>Trusts.</u> Although the statute indicates that the tax applies to "trusts," it does not specify which trusts are included. Proposed Treasury Regulation Section 1.1411-3(a)(1)(i) specifies that the statute applies to trusts that are subject to part I of subchapter J of chapter 1 of subtitle A of the Internal Revenue Code unless otherwise exempted – in other words, the statute applies to ordinary trusts as defined in Treasury Regulation Section 301.7701-4(a), but not to certain other trusts, including charitable trusts, grantor trusts, foreign trusts, and business trusts. In addition, because subtitle A does not include tax exempt trusts, the statute does not apply to tax exempt trusts.

G. <u>Grantor Trusts.</u> The grantor trust rules for income tax purposes are to be applied for purposes of Section 1411. Therefore, the 3.8% tax is not imposed on a grantor trust, but items of income or deductions that are attributable to the grantor (or to someone treated as the grantor) are to be treated as if the items had been paid or received by the grantor for calculating his or her own net investment income. Prop. Treas. Reg. § 1.1411-3(b)(5).

H. <u>Special Problem Areas.</u> Although the statute uses terms such as "net investment income," "adjusted gross income," "ordinary course of a trade or business," "passive activity" and "disposition," the terms do not necessarily correspond to the same terms as used in other parts of the Internal Revenue Code. Following is a discussion of some net investment income problem areas, but this is in no way meant to be an exhaustive list. The Notice also asked for comments related to foreign estates and foreign trusts but as noted above, a discussion of those issues is beyond the scope of this paper.

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1. Capital Gains. A review of the statute and proposed regulations raises a concern for existing trusts and estates with regard to the treatment of capital gains. As mentioned above, trust and estate income is taxed to the trust or estate unless the income (or more specifically unless the trust's or estate's DNI) is carried out to the beneficiaries. As a general rule, capital gains are not treated as part of DNI. This general rule applies as long as those gains are allocated to corpus and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year." IRC § 643(a)(3). However, pursuant to Section 643 and the related Treasury regulations, capital gains may be included in DNI under certain conditions and if done pursuant to local law, the trust agreement, or "a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)." Treas. Reg. § 1.643(a)-3(b).

Two of the three conditions which allow a fiduciary to allocate capital gains to DNI can invoke a consistency requirement by the fiduciary for all future years. *Id*. Most commentators and practitioners believe that in the first year that a trust or estate incurs capital gains, once a fiduciary decides to allocate the capital gains to DNI or not to do so, the fiduciary has in effect made an election that remains in place for all future years of the trust or estate. Unfortunately, there is no authority or guidance in this area to suggest otherwise. A trust or an estate may have the ability to allocate capital gains to corpus on a case-by-case basis under a narrow condition provided by Treasury Regulation Section 1.643(a)-3(b)(3), but there is no clear guidance for fiduciaries as to how to meet the condition under this so-called "deeming rule." Since many capital gains are included in net investment income under Section 1411, trusts and estates that do not include capital gains in DNI (which are most trusts and estates), or cannot "deem" capital gains to be part of DNI under the narrow condition provided in the regulations, will have this component of net investment income trapped as undistributed net investment income, taxable to the trust or estate. Section 1411 and the related proposed Treasury regulations do not address this issue for existing trusts or estates, although for other similar elections, an entity is given a fresh start to make a new election. It seems that it would be fair to allow existing trusts and estates that incur capital gains after December 31, 2012 the option to reconsider how capital gains are to be allocated since it is possible that if the tax imposed by Section 1411 had existed in the year that an existing trust or estate had first incurred capital gains, the election may have been different. The Tax Section of the State Bar of Texas, in their comments on the proposed regulations, has asked for just such a fresh look. We will have to wait for the final regulations to see whether this option will be granted.

2. Passive Activities, Passive Income, and the Passive Loss Rules. The statute does not define to what extent the passive loss rules for "ordinary" income taxes will apply. For purposes of Section 1411, passive activities are those that are included within the meaning of Section 469. IRC § 1411(c)(2)(A). According to the proposed regulations, a two-step determination is needed to determine if an activity is a passive activity. First, the activity must be a trade or business within Section 162. Second, the activity must be passive within the meaning of Section 469, which means the taxpayer must not materially participate in the trade or business. Prop. Treas. Reg. § 1.1411-5(b). Section 469 further provides that in order for a taxpayer to materially participate in an activity, the taxpayer must be involved in the operations of the activity on a *regular, continuous and substantial* basis. IRC § 469(h)(1). It appears that for the most part, the majority of passive income will be included in the calculation of the tax under Section 1411. However, there are certain exceptions where items that are generally thought of as passive are not included and vice versa, such as in the case of actively managed real estate investments. As a result, practitioners will need to not only have a good understanding of Section 469 and its related Treasury regulations to know what constitutes a passive activity but will also need to master the exceptions under Section 1411 when computing net investment income.

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a. Material Participation. Because Section 1411 defers to Section 469 to define a passive activity, we must look to Section 469. For determining the disallowance of passive activity losses and credits, Section 469 applies to individuals, trusts[2], estates, closely held C corporations, and personal service corporations. IRC § 469(a). Although Section 469 applies to trusts and estates, what amounts to material participation by a trust or estate has not been defined beyond the requirement that the taxpayer's involvement in the operations of the business must be regular, continuous and substantial. The temporary regulations outline seven separate tests that an individual may satisfy in order to meet the definition of material participation and avoid the passive loss disallowance rules. Since the statute was enacted in 1986, however, no such regulations have been issued for trusts and estates. Temp. Treas. Reg. § 1.469-5T(a), 1.469-5T(g), 1.469-8.

From Section 469 we can glean that the taxpayer's involvement in the operations is what is important. However, for trusts and estates, who the taxpayer is continues to be an issue. Only one federal case has addressed this issue. In *Mattie K. Carter Trust v. U.S.*, 256 F.Supp.2d 536 (N.D. Tex. 2003), a testamentary trust owned a cattle ranching operation. In addition to work done by the trustee himself, the trust employed a ranch manager and other employees. The work done by the trustee, the ranch manager, and the other employees was performed on behalf of the trust. The IRS argued that the trustee is the taxpayer and only his activities should be considered to determine whether the trustee materially participated in the operations. The trust argued that the trust, as a legal entity, is the taxpayer and the activities of the fiduciaries, employees and agents of the trust should be considered. The court looked to the plain language of Section 469 which states that a trust is the taxpayer, and in agreeing with the trust, held that the material participation of the trust should be determined by looking at the activities of all persons acting on behalf of the trust, not solely the trustee. The court noted that common sense says that in order to determine material participation by a trust, one must look to the activities of all of those who work on behalf of the trust.[3]

In the decade since the holding in the *Mattie K. Carter Trust* case, and with no regulations having being issued, the IRS has continued to maintain its position that only the activities of the trustee should be considered. *See*, PLR 201029014; TAM 201317010; TAM 200733023. The only source that the IRS cites for its position is language in the legislative history of Section 469 that states that "an estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating." S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986). It is important to note, however, that nothing in the legislative history indicates that looking to the actions of an executor or trustee is the exclusive way to determine material participation by a trust or an estate. In the most recent Technical Advice Memorandum, the IRS again found that the language in the legislative history is the standard to apply to trusts for determining material participation. In so finding, the IRS inexplicably comes to the conclusion that the *sole* means for making such determination is to find that in the operation of the activity, the activities of fiduciaries, in their capacities as fiduciaries, are conducted on a regular, continuous, and substantial basis. TAM 201317010.

In relying on limited language in legislative history for its reasoning in these decisions, the IRS appears to ignore the ability to consider activities of employees when determining material participation by other categories of taxpayers in Section 469. *See*, Temp. Treas. Reg. § 1.469-1T(g) (allowing activities of employees of corporation to be taken into account by virtue of the rules of

[2] Like with Section 469, the trusts at issue are non grantor trusts, since the passive activity loss rules do not apply to grantor trusts and instead are applied at the grantor level. Temp. Treas. Reg. § 1.469-1T(b)(2).

[3] In criticizing the IRS, the court went as far as to say that the IRS's position that only the activities of the trustee himself should be considered is "arbitrary, subverts common sense, and attempts to create an ambiguity where there is none." *Id*. Zowie!

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Section 465(c)(7)) and Temp. Treas. Reg. § 1.469-1T(k) (Examples 1 and 2 where activity as employee by owner of entity counts toward whether entity materially participates in a business). Although it may be understandable to disregard the activities of employees of the underlying operation who are not trustees, employees of the trust itself are not the same, and their activities should be taken into account. Unless and until the IRS reverses its narrow view of these rules, commentators suggest for trusts that own an interest in an entity such as a limited liability company, the entity might be structured to be member-managed so that the activities of the trustee (owner) count toward material participation. Of course, in this case, the trustee would owe fiduciary obligations to the company as well as to the trust beneficiaries and would need to explore how best to deal with any potential division of loyalties in exercising its fiduciary duties. For other thoughts and potential planning alternatives when a trust owns an interest in a business entity, see Gorin, *Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications* (available by emailing the author at sgorin@thompsoncoburn.com to request a copy or request to subscribe to his newsletter "Gorin's Business Succession Solutions").

One case currently before the Tax Court involves an issue of whether a trustee qualifies for a certain exception under Section 469 for real estate activities. *Frank Aragona Trust v. Comm'r.*, Tax Court Docket No. 015392-11. Because this exception involves a determination of material participation by a taxpayer, the court's ruling may have an impact on a trustee's material participation for other purposes of Section 469. The case was tried before the judge in May 2012 and briefs were submitted in October 2012. Hopefully we will receive some guidance in the near future.

Section 1411 and the related proposed Treasury regulations require taxpayers to look to Section 469 for the passive activity loss rules. It seems evident that the Treasury Department did not want to add anything new to the passive activity loss rules through Section 1411. With no regulations being issued for Section 469 to deal with passive activities and material participation for trust and estates, it seems unlikely that final regulations will be issued for Section 1411 to address these issues.

3. <u>Qualified Subchapter S Trusts ("QSSTs")</u>. In most cases, when a trust owns stock in an S corporation and the income beneficiary makes an election to have the trust treated as a QSST, because the beneficiary is treated as the owner of the stock for income tax purposes, all income from the S corporation which is attributable to the QSST will be taxed to the beneficiary. Treas. Reg. § 1.1361-1(j)(7). An exception to this rule is when a disposition of the S stock occurs. In that case, the beneficiary is not treated as the owner and any resulting gain or loss that is recognized will be reported by the trust. Treas. Reg. § 1.1361-1(j)(8). For Section 1411 purposes, neither the statute nor the proposed regulations provide any special rules that would change these results. In the Notice, the IRS has asked for comments to determine if any special rules are needed. However, as things currently stand, presumably, these same rules will apply with regard to allocating income and gain for QSSTs. As a result, a QSST's share of an S corporation's net investment income will be taxed to the beneficiary, but net investment income arising from a sale of S corporation stock will be taxed to the trust. In determining the amount of net investment income that results from a sale of S corporation stock, a four-step adjustment process may be required. *See*, Prop. Treas. Reg. § 1.1411-7(c).

As a reminder, income for trust and estate purposes is not always the same as income for income tax purposes. Section 643(b) provides that for trusts and estates, if the general term "income" is used, it means fiduciary accounting income as determined pursuant to the governing instrument and local law, and *not* taxable income. IRC § 643(b). Because a beneficiary will have to report taxable income as part of DNI but will receive only a distribution of fiduciary accounting income (if any), the distinction between fiduciary accounting income and taxable income is important when

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considering a QSST election. Accordingly, it raises the question as to whether a beneficiary should try to obtain some assurance or guarantee from the trustee regarding sufficient cash distributions, whether of income or principal, in order to pay any income tax liability that arises from the QSST election. For additional discussion regarding the income characterization issues, see Davis, *Funding Testamentary Trusts: Tax and Non-Tax Issues*, State Bar of Texas Adv. Est. Planning Strategies Course, 2013.

4. Electing Small Business Trusts ("ESBTs"). In contrast to a QSST, when a trust holds S corporation stock and the trustee makes an election to have the trust treated as an ESBT, all income from the S corporation is taxed to the trust at the highest income tax bracket, regardless of whether any income is distributed to a beneficiary and without regard to any threshold. IRC § 641(c). The portion of the trust that holds the S corporation stock is treated as if it were a separate trust. *Id*. If all or any portion of an ESBT is a grantor trust, the income attributable to such portion is taxable to the grantor. Treas. Reg. § 1.641(c)-1(c). As with other S corporation shareholders, in making an ESBT election, a trustee would want some assurance from the S corporation that sufficient cash distributions will be made from the corporation to allow the trustee to pay any income tax liability. An ESBT will have to pay income tax on its share of S corporation income at the highest marginal rate. The trustee of an ESBT, therefore, must make careful consideration before making any distributions to beneficiaries, since the trust will need to retain sufficient funds to pay any income tax liability and will not have the advantage of reducing the trust's taxable income since it will not receive a distribution deduction for these distributions.

Also in contrast to QSSTs, Section 1411 provides special rules for ESBTs. In Proposed Treasury Regulation Section 1.1411-3(c)(1), two separate computations are made to determine whether income of an ESBT is subject to the net investment income tax. In line with the proposed Treasury regulations stated attempt to preserve as much Chapter 1 treatment as possible, the first calculation requires that the amount of the undistributed net investment income be calculated for each of the separate S and non S portions of the trust. The separate treatment is disregarded, however, for the second calculation because the proposed Treasury regulations require the ESBT to then calculate its adjusted gross income by combining the adjusted gross income of the non S portion of the trust with the net income or net loss of the S portion of the trust. *Id*. In other words, the trust is treated as a single trust for determining whether the trust's adjusted gross income exceeds the Section 1411 threshold. The trust is then to pay tax on the lesser of the trust's total undistributed net investment income or the excess of the trust's adjusted gross income over the trust's threshold. Prop. Treas. Reg. § 1.1411-3(c)(1)(ii)(C). Example 3 in Proposed Treasury Regulation 1.1411-3(f) provides a detailed example of the calculation. Again, as discussed above, these calculations can be avoided if the trustee's involvement in the S corporation constitutes material participation which would prevent treatment as a passive activity and imposition of the net investment income tax.

5. Charitable Remainder Trusts. Although charitable remainder trusts are not themselves subject to Section 1411, distributions that are made to non-charitable beneficiaries may be. The proposed regulations provide that the net investment income of a non-charitable beneficiary will include an amount equal to the lesser of the distributions made for the year or the trust's current and accumulated net investment income. Prop. Treas. Reg. § 1.1411-3(c)(2). The trusts's accumulated net investment income is measured beginning with years after December 31, 2012. Prop. Treas. Reg. § 1.1411-3(c)(2)(iii). In addition, the proposed regulations impose certain character and ordering rules in order to first distribute net investment income proportionately among the non-charitable beneficiaries before any amounts of non-net investment income. *Id*. It appears at this point that for non-charitable beneficiaries of charitable remainder trusts, there is a WIFO ("worst in – first out") approach, thereby imposing another layer of tax on these beneficiaries. The IRS and Treasury Department have received comments requesting a different approach.

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6. Properly Allocable Deductions. The only deductions allowed in computing net investment income are those that are allowed by subtitle A of the Internal Revenue Code and are properly allocated to the gross income or net gain which is part of net investment income. IRC § 1411(c)(1)(B). The key is that the deductions must be allocated to the related gross income or net gain. Proposed Treasury Regulation Section 1.1411-4(f) places further limitations on the amount and timing of these deductions. In the Notice, the IRS asked for comments regarding the treatment of certain deductions, such as suspended passive losses and net operating losses.

I. Special Notes. A few additional items of note:

1. Estates of Decedents Dying in 2012. Section 1411 is effective for taxable years beginning after December 31, 2012. The consensus among commentators is that for estates of decedent's dying in 2012 before December 31, 2012, Section 1411 will not apply until the second year of the estate since the first taxable year of the estate began in 2012. Therefore, it is important to consider the application of Section 1411 when choosing the year end for these estates.

2. Tax Does Not Apply to Distributions from Qualified Plans. You will recall that there are two components of income used to measure whether the tax will apply. One type of income is net investment income and the other is adjusted gross income (modified adjusted gross income for individuals and adjusted gross income as defined in Section 67(e) of the Code for trusts and estates). Section 1411(c)(5) provides that net investment income does not include distributions from qualified plans. However, there is no exception for distributions from qualified plans for purposes of computing adjusted gross income. As a result, distributions from qualified plans may push the trust or estate into the top income tax bracket, exposing its net investment income to the 3.8% tax.

3. Nonresident Aliens. The tax does not apply to nonresident aliens. IRC § 1411(e)(1).

J. Planning for the Tax. The additional 3.8% income tax on trusts and estates can be considered an additional cost of forming a trust or administering an estate. Items to consider include:

- Planners will need to advise clients that certain investments may subject estates and trusts to additional income tax. For example, when funding testamentary trusts, it may be more desirable to transfer the homestead to the surviving spouse and make a non pro rata distribution of other assets to fund the trust so that if the homestead is later sold, any appreciation will not be subject to the tax imposed under Section 1411.
- There may be even more reason for clients to take a team approach with the attorney, accountant and financial planner to adequately plan to minimize the additional tax burden.
- Fiduciaries have a greater burden with the additional recordkeeping necessary to track assets that may be subject to the 3.8% tax, and most likely will need even more assistance than before from accountants.
- When evaluating whether to make a distribution, fiduciaries may desire additional cooperation between themselves and beneficiaries in order to better evaluate the tax brackets of each as they relate not only to income taxes, but also the tax on net investment income.
- There may be more incentive to speed up the administration of estates to minimize the potential of the additional tax that may not apply once the assets which produce net investment income are transferred to beneficiaries.
- Fiduciaries will need to weigh whether it is better to invest more in assets that are not subject to the tax, such as those that produce tax-exempt income vs. those assets that may produce a higher after-tax return regardless of this additional tax.

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- There may be more incentive to take a buy-and-hold approach to investing in order to put off the additional tax burden that may arise from recognizing capital gains.

III. CONCLUSION

The enactment of Section 1411 brings a new facet to estate and trust planning and administration. Advisors need to be familiar with these rules in order to appropriately counsel testators, grantors, executors, trustees, and beneficiaries regarding how these rules impact estates, trusts, and their beneficiaries. It is hoped that this article can provide some assistance to advisors until the IRS, Treasury Department, and case law provide clearer guidance as to how these murky rules affect trusts and estates.

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EXHIBIT A

IRC 1411 Net Investment Income (Preliminary)

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IRS REV. PROC. 2013-34 SIGNIFICANTLY EXPANDS GROUNDS

FOR EQUITABLE INNOCENT SPOUSE RELIEF

By David Gair

Various forms of relief for "innocent spouses" are found in the Internal Revenue Code; but only § 6015(f) relieves filers from responsibility for underpayments of tax shown on the face of a jointly-filed income tax return (as distinguished from audit deficiencies later determined by the IRS). Section 6015(f) provides for "equitable relief" if, based on the facts and circumstances, it would be inequitable to hold the individual liable for such taxes.

In January 2012 the IRS issued IRS Notice 2012-8 containing a proposed revenue procedure which according to the IRS is "designed to provide relief to **more** innocent spouses requesting equitable relief from income tax liability." IRS Notice 2012-8 significantly expanded the facts and circumstances (previously set out in Rev. Proc. 2003-61) which the IRS will consider in determining whether or not §6015(f) relief should be granted. On September 16, 2013 the IRS issued Revenue Procedure 2013-34 which largely adopted the procedures proposed in Notice 2012-8 with a few taxpayer favorable changes.

The IRS also issued proposed regulations on August 13, 2013 [REG-132251-11] related to limited aspects of innocent spouse relief. The proposed regulations generally relate to the time period for making a request for equitable relief – that is the request can be made any time within the statute of limitations on collection. The IRS previously issued notices regarding this change of position.

Background on Innocent Spouse Relief

In 1971, Congress amended the Internal Revenue Code by the addition of Sec. 6013(e), which provided that "innocent spouses" filing joint returns could be relieved from tax liability for omissions from reported gross income attributable to their partners under certain circumstances. The innocent spouse rules were significantly changed as part of the 1998 Reform Act to expand the possibilities for relief (including the possibility of equitable relief). The proposed revenue procedure in IRS Notice 2012-8 is one of the most significant changes to equitable innocent spouse relief since the 1998 Reform Act.

Sources of Joint Liability

IRC § 6013(d)(3) provides that married taxpayers who file joint returns will be jointly and severally liable for the income tax liabilities arising from that joint return. "Joint and several liability" covers not only the tax liabilities expressed on the face of the return, but also any deficiencies for taxes, penalties or interest that may subsequently be determined by the IRS. Filing a joint return is the rough equivalent of a married couple signing an open-ended promissory note acknowledging that either party is fully responsible for all income taxes or additions to tax for the tax year in question. The IRS need not collect

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the taxes equally from each party. It can collect all of the taxes (or any portion thereof) from the husband; or all taxes (or any portion thereof) from the wife. Divorce documents that purport to lay all responsibility for the payment of taxes on one party or the other are not binding upon the IRS. Second, community property laws also operate to create joint liability.

Laws also can give rise to a type of joint responsibility, since (absent a partition agreement or similar document) community property laws can cause half of the income earned by one spouse to be considered income of the non-earning spouse. But this is different from joint and several liability that arises from filing of a joint income tax return. If a Texas married couple files "married, filing separately" each will be liable for one-half of the community's total income, and therefore also liable for income taxes attributable to such one-half share. In contrast, if the same couple files a joint return, each party is liable for 100 percent of the taxes on 100 percent of the community's income.

First Considerations in All Cases

The initial consideration in all cases is to determine if there actually is a joint return. Was a joint return filed with a forged signature, or was it signed under duress? Was the couple legally married? There is no joint return if either individual did not intend to file a joint return or if it was not legal to file a joint return.

Types of Innocent Spouse Relief

The Internal Revenue Code provides for several types of innocent spouse relief. It is important to evaluate your client's facts and circumstances to determine what type of relief is applicable.

1) "Traditional" innocent spouse relief is provided by IRC § 6015(b). This provision type of relief is useful to eliminate liability for an innocent spouse where there has been an understatement of tax, i.e., an audit deficiency. IRC § 6015(b) does not provide for relief for an underpayment of taxes, i.e., where the amount of tax stated on the face of the joint return is not contested, but such taxes have simply not been paid over to the IRS.

2) "Separation of Liability" relief is provided by IRC § 6015(c). This type of relief can limit liability for understatements (not underpayments) to the portion of the deficiency properly allocable to that individual's earnings. Again, this provision is helpful only where there has been an understatement of tax, not an underpayment. Moreover, IRC § 6015(c) does not eliminate the force of community property laws. Relief from community property laws (i.e.limiting tax liability to income actually earned by the spouse in question) is made possible by IRC § 66, under circumstances that are parallel to the provisions of IRC § 6015(c).

3) "Equitable" relief is provided by IRC § 6015(f). This type of relief can be used to limit or eliminate liability for understatements and the <u>only</u> type of innocent spouse relief that is effective to eliminate an underpayment of tax shown on the face of the return.

According to IRC § 6015(f), relief is to be granted if based on the facts and circumstances, it would be inequitable to hold the individual liable. What "facts and circumstances" are necessary for the granting of innocent spouse relief is the focus of the article.

General Requirements for Equitable Relief according to Rev. Proc. 2013-34

The major changes to equitable innocent spouse relief under §6015(f) provided by ***Rev. Proc. 2013-34*** are discussed below.

First Step. In order to be considered for innocent spouse relief, there is a requirement that certain threshold conditions be met, as follows:

a) Joint return was filed.

b) Relief is not available through other provisions of IRC §6015(b) or (c).

c) Request for relief was made timely (i.e. before collection or refund or credit statute expires) .

d) Assets were not transferred as part of a fraudulent scheme to avoid collection.

e) Disqualified assets were not transferred.

f) Requesting spouse did not knowingly participate in the filing of a fraudulent joint return.

g) The tax liability is attributable, in full or part, to the non-requesting spouse. Several exceptions to this general rule exist:

   i) attribution solely due to the operation of community property law;

   ii) nominal ownership;

   iii) misappropriation of funds;

   iv) abuse; and

   v) fraud of non-requesting spouse.

Additionally, relief under IRC § 66 requires the taxpayer to meet these conditions as well, except conditions a and b above.

Second step. If the threshold conditions are satisfied, the IRS will make a "streamlined" determination, and ordinarily will grant relief if:

a) The spouses are:

   i) no longer married;

   ii) legally separated;

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iii) one spouse is a widow/widower; or

iv) the spouses have not been members of the same household during the past year; and

b) The requesting spouse will suffer economic hardship if the Service does not grant relief; and

c) The requesting spouse did not:

i) know of or have reason to know of the deficiency;

ii) know or have reason to know that the non-requesting spouse would not or could not pay the underpayment; or

iii) know or have reason to know of the item of community income.

Note that the existence of abuse or financial control by non-requesting spouse can satisfy this requirement even if the requisite knowledge exists.

<u>Third Step</u>. If "streamlined" relief is not available, the IRS will go on to consider other facts and circumstances to determine if it would be inequitable to hold the requesting spouse liable for all or part of the liability. The factors include:

a) Marital status (i.e. being divorced weighs in favor of relief)

b) Economic hardship (unable to pay reasonable living expenses based on rules similar to those provided in Treas. Reg. § 301.6343-1(b)(4))

c) Knowledge

i) Understatement cases – Issue is whether spouse had knowledge or reason to know of the item giving rise to the understatement or deficiency at the time the requesting spouse signed the joint return.

ii) Underpayment cases – Issue is whether spouse knew or had reason to know at the time the requesting spouse signed the joint return that the nonrequesting spouse would not or could not pay the tax liability at the time the joint return was filed or within a reasonably prompt time after the filing of the joint return.

iii) Section 66 cases – Issue is whether the spouse knew or had reason to know of an item of community income that should have been included in gross income.

iv) Similar to streamlined relief, if abuse or financial control exists this factor can weigh in favor of relief even if the requisite knowledge exists.

d) Legal obligations (i.e. one spouse has agreed to pay the liability in a divorce decree or other legally binding agreement. Note: clients are often surprised to learn that a court decree requiring the other spouse to pay is not binding on the IRS.)

e) Significant benefit beyond normal support (lavish lifestyle such as owning luxury assets and taking expensive vacations).

f) Good faith efforts to comply with tax laws (in the years following the year to which the request relates).

g) Physical or mental health status when the return was filed or at the time the requesting spouse requested relief.

Significant Changes to Equitable Relief resulting from IRS Notice 2012-8 & Rev. Proc. 2013-34

IRS Notice 2012-8 and Rev. Proc. 2013-34 very significantly alter the standards for relief as set out in previous IRS guidance such as Rev. Proc. 2003-61.

Change #1: Greater deference is given to the presence of abuse than Rev. Proc. 2003-61. Existence of abuse can outweigh or negate other factors.

Change #2: Request for equitable relief can be filed any time before the collection statute runs. Previously, the rule was that relief had to be requested within 2 years of collection action. This change actually happened in 2011 (IRS Notice 2011-70).

Change #3: Threshold conditions previously required that the income tax liability must be attributable to the non-requesting spouse. New exception exists if the item stems from the non-requesting spouse's fraud and thus gave rise to the understatements of tax.

Change #4: Streamlined determinations now apply to understatements of tax, underpayments of tax and claims for equitable relief under IRC § 66(c).

Change #5: No one factor or majority of factors controls a determination – it all depends on the facts and circumstances.

Change #6: Standards for economic hardship are revised. A lack of economic hardship will now be viewed as a neutral factor.

Change #7: A finding of actual knowledge of an item giving rise to an understatement will no longer be weighed more heavily than other factors. Abuse or financial control by nonrequesting spouse causing fear of retaliation will result in the knowledge factor to weigh in favor of relief.

Change #8: Similar to change #7 above, in a situation where the spouse had knowledge that nonrequesting spouse would not pay liability within a reasonably prompt time frame, the existence of abuse or financial control causing a fear of retaliation will cause this factor to weigh in favor of relief.

Change #9: IRS clarifies that the legal obligation of the requesting spouse is a consideration (not just whether the non-requesting spouse has an obligation to make payment to the IRS).

Change #10: The significant benefit factor will not weigh against relief if the nonrequesting spouse abused or maintained financial control over the nonrequesting spouse and the nonrequesting spouse made the decisions about living a more lavish lifestyle.

Change #11: Subsequent compliance with income tax laws will now way in favor of relief, instead of just being viewed as a neutral factor.

Change #12: Refunds are now available in deficiency cases for payments made other than through an installment agreement.

When can innocent spouse relief be requested?

Generally, an innocent spouse request is made by filing an application for administrative relief (Form 8857) with the IRS Collection Division within the appropriate time period (within 2 years after the IRS begins collection activities for IRC § 6015(b) & (c) and within the collection statute of limitations for § 6015(f)). It can also be raised in other ways, for example, as a defense in a Tax Court Petition in response to a statutory notice of deficiency, or as a defense in a collection due process hearing.

Conclusion

The IRS appears to have come to the conclusion that equitable relief really should take into account all the facts and circumstances, as IRC § 6015(f) requires. No longer do we have arbitrary requirements like the two year filing deadline for IRC § 6015(f) relief. It is absolutely vital to work diligently to understand the new rules and to work hard with your client to gather as many facts as possible to support the various factors. At the same time, it is important to neutralize unfavorable facts if at all possible. Innocent Spouse Relief cases can be a lot of fun and a chance for you to be an advocate for your client – likely someone who really needs your help.

Anecdotally, since the time period that Notice 2012-8 was published in February of 2012, the changes have been a very positive development for Taxpayers. The administrative process seems to be fairer and appropriate requests for relief are being granted with greater frequency.

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Section 336(e): A More Flexible Method to Effect Deemed Asset Sales

By David S. Peck and Robert A. Jacobson[1]

Frequently the buyer and seller of a domestic corporation that is a subsidiary member of a consolidated group or an S corporation (a "***Target***") will desire to structure the sale of the Target corporation as an asset sale for federal income tax purposes and a stock sale for legal and non-income tax purposes. Until recently, the primary means to accomplish such a transaction involved the buyer and seller jointly making an election under Section 338(h)(10)[2] (a "***Section 338(h)(10) Election***") with respect to the sale. In general, under Section 338(h)(10), a purchasing corporation that makes a "qualified stock purchase" of an eligible Target corporation can jointly elect with the seller for the transaction to be treated as though the Target sold its assets for tax purposes, even though for other purposes the transaction will continue to be treated as a stock purchase. The result is that the buyer receives a step-up in the tax basis of the Target's assets, the selling consolidated group or S corporation shareholders recognize gain or loss on the deemed asset sale, but the Target retains all of its historic assets and liabilities.

Section 336(e), added to the Code by the Tax Reform Act of 1986, granted authority to the Treasury to prescribe rules regarding when an election could be made for a sale, exchange or distribution of Target stock to be treated as an asset sale. However, Section 336(e) remained unavailable to taxpayers until the U.S. Treasury published final regulations under Section 336(e) (the "***Final 336(e) Regulations***") on May 10, 2013.[3] Importantly, as described in more detail herein, an election under Section 336(e) (a "***Section 336(e) Election***") can be made in certain transaction structures where a Section 338(h)(10) Election would not be available.

<u>Section 338(h)(10)</u>

The Final 336(e) Regulations effectively expand the situations in which the treatment afforded by a Section 338(h)(10) Election is available. A Section 338(h)(10) Election is available where the buyer of a Target corporation is itself a corporation and the buyer acquires the stock of the Target corporation in a "qualified stock purchase." A "qualified stock purchase" is a purchase of at least 80% of the total voting power and value of the Target corporation's stock within a 12 month period.

However, a Section 338(h)(10) Election is unavailable in many other common transaction structures where asset sale treatment is desired. For example, a Section 338(h)(10) Election is only available where a single buyer acquires the requisite 80% of the Target corporation; it would not be available where a Target corporation is purchased by multiple buyers, none of whom purchase at least 80% of the Target corporation's stock. In addition, a Section 338(h)(10) Election is unavailable to a buyer that is an individual or a non-corporate entity.[4] Moreover, the Section 338(h)(10) Election is available only if the Target's stock was acquired by way of a "purchase" and, therefore, is unavailable in other types of acquisitions such as taxable distributions of Target stock.

Section 336(e)

In contrast, a Section 336(e) Election is available where there is a "qualified stock disposition" of a Target.[5] A "qualified stock disposition" is any transaction or series of transactions in which 80% of the stock (by vote and value) of a Target corporation is sold, exchanged, or distributed, or any combination thereof, by the seller within a 12-month period.[6]

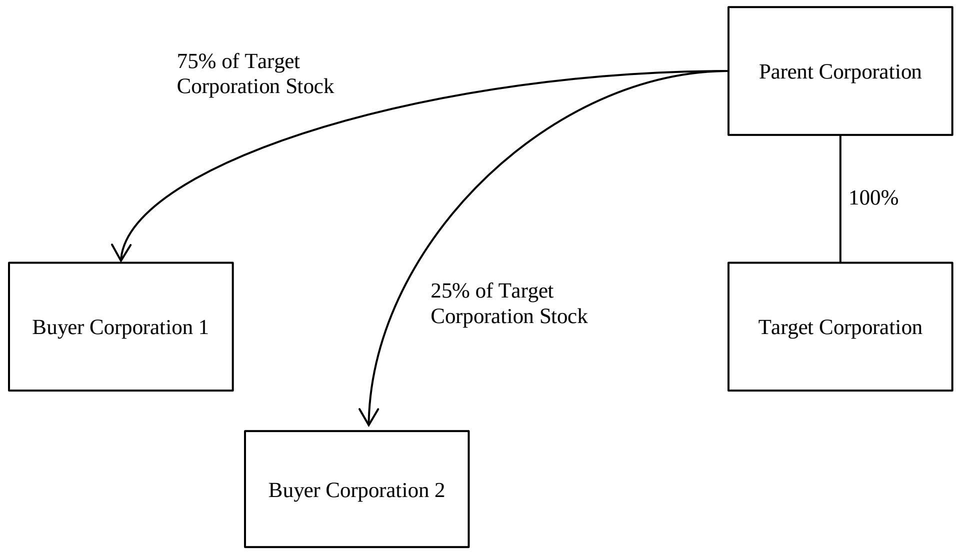
As is the case with Section 338(h)(10), the Target corporation in a Section 336(e) transaction must be a domestic corporation that is a subsidiary member of an affiliated or consolidated group or an S corporation.[7] However, there are significant differences in which Section 336(e) applies. First, there is no requirement that the buyer be a corporation. A buyer in a Section 336(e) transaction can also be an individual or a non-corporate entity. Second, there is no requirement that a single buyer acquire 80% or more of the stock of the Target—multiple buyers, each acquiring less than 80% individually, can effect a qualified stock disposition if they acquire, in the aggregate, at least 80% of the stock of the Target during a 12-month period. Finally, a "disposition" of stock that can be counted as part of a qualified stock disposition includes any sale, exchange or disposition as long as (i) the basis of the stock in the hands of the buyer is not determined in whole or in part by reference to the basis of such stock in the hands of the seller and (ii) the stock is not sold, exchanged or distributed in a transaction to which Section 351, 354, 355 or 356 applies, except with respect to a distribution of stock to a person under Section 355 where the full amount of gain would be recognized pursuant to either Section 355(d)(2) or Section 355(e)(2).[8] However, a "disposition" does not include a sale, exchange or distribution of Target stock to a person related to the seller.[9] Additionally, a "qualified stock disposition" does not include any transaction which constitutes a "qualified stock purchase" as defined in Section 338(d)(3)—in such case, Section 338 provides the sole means for obtaining elective asset sale treatment.[10]

A Section 336(e) Election must be made pursuant to a written, binding agreement between the seller and the Target corporation; no consent by the buyer or buyers is required.[11] The due date for making the Section 336(e) Election is generally the due date of the tax return for the year that includes the disposition date (*i.e*, the date on which a qualified stock disposition has occurred).[12]

The following are common transactions where a Section 336(e) Election, but not a Section 338(h)(10) Election, would be available.

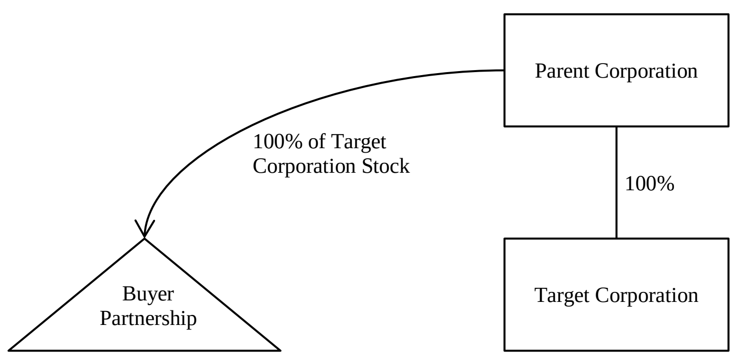
US 2100033v.6

Acquisition of Stock of Target Corporation by Multiple Buyers



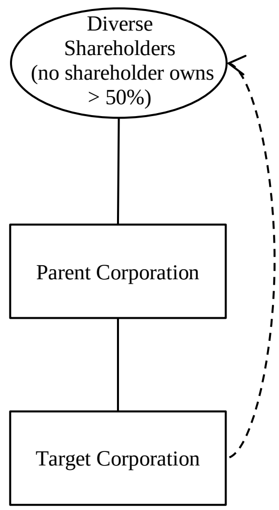
As illustrated in the diagram above, unlike a Section 338(h)(10) Election, a Section 336(e) Election is available where a selling corporation sells the requisite amount of stock of a Target corporation to multiple, unrelated buyers during a 12-month period, none of whom individually acquire 80% or more of Target's stock.

Acquisition of Stock of Target Corporation by Non-Corporate Buyer



The Section 336(e) Election makes it possible for individuals or non-corporate entities, such as private equity funds and master limited partnerships ("***MLPs***"), to acquire a Target corporation and receive a basis step-up without forming a subsidiary corporation to purchase the stock of the Target or otherwise restructuring the Target prior to the acquisition.

Taxable Distribution or Spin-Off



A “qualified stock disposition” does not need to take the form of a sale. Rather, a Section 336(e) Election could be available to step-up the inside tax basis of the Target corporation’s assets if a corporation distributed 80% or more of the stock of the Target corporation in a taxable transaction or in a distribution that is subject to Section 355, but either Section 355(d) or Section 355(e) applies and requires the seller to recognize gain with respect to the distribution of Target’s stock. Note however, that a Section 336(e) Election would not be available if more than 20% of the stock of the Target corporation was distributed to a stockholder that is related to the distributing corporation.

The following table compares and contrasts the situations where the Section 336(e) Election and the Section 338(h)(10) Election are available. As noted in the table below and described above, the Section 336(e) Election provides taxpayers a considerable amount of additional flexibility to structure transactions as a stock disposition for non-tax business purposes but as an asset disposition for income tax purposes.

US 2100033v.6

	Section 338(h)(10) Election	**Section 336(e) Election**
Who can be a Target corporation?	Subsidiary member of an affiliated or consolidated group or an S corporation	Subsidiary member of an affiliated or consolidated group or an S corporation
Who can be a buyer?	Must be a corporation	Can be an individual, a corporation or a non-corporate entity
Who can be a seller?	A group of S corporation shareholders or a consolidated or affiliated group.	A group of S corporation shareholders or a consolidated or affiliated group.
How many buyers can count toward satisfaction of the 80% control requirement?	Only a single buyer	Can be multiple buyers
How can the stock of the Target corporation be disposed of?	Must be a taxable sale	Can be a taxable sale, disposition or exchange, or any combination thereof
Who makes the election?	Jointly made by seller and buyer	Jointly made by seller and Target corporation

Planning Opportunities (And Cautions) Under Section 336(e)

Ability to Operate the Target Corporation's Business in Flow-Through Form

The Section 336(e) Regulations present several significant planning opportunities for buyers and sellers to achieve asset sale treatment in situations where a Section 338(h)(10) Election would be unavailable. A Section 336(e) Election permits an individual or a non-corporate buyer to operate the Target corporation's business in flow-through form subsequent to the acquisition. Because of the step-up in basis in the assets of the Target corporation, an individual or non-corporate buyer of a Target where a Section 336(e) Election is made could generally liquidate the Target promptly following the acquisition (including by way of conversion of the Target to a flow-through entity for tax purposes) without incurrence of additional tax liability. In contrast, operating the purchased business in flow-through form would not be possible following a Section 338(h)(10) Election as a result of the requirement under Section 338 that the buyer be a non-transitory corporate entity (*i.e.*, the buyer must be respected for tax purposes as the purchaser of Target stock which could be undermined if buyer liquidates promptly following the purchase).[13] The ability to operate the Target corporation's business in flow-through form following the acquisition may be of particular interest to private equity funds and MLPs, which often prefer to avoid C corporation subsidiaries holding operating assets.

Mitigation of Adverse Tax Consequences Associated with a Taxable Spin-off

Another important planning tool is that the Section 336(e) Election can be used to mitigate the tax costs following a taxable spin-off or a distribution of a Target corporation that constitutes a qualified stock disposition. A Section 336(e) Election can provide the Target corporation with a step-up in the tax basis of its assets that would otherwise be unavailable. In the case of a spin-off that is intended to be tax-free, a protective Section 336(e) Election should be considered to provide a step-up in the basis of the Target corporation's assets in the event the spin-off were unexpectedly treated as taxable, including as a result of a post-spin-off acquisition of the distributing or distributed corporation.[14]

Planning for (or against) a Qualified Stock Disposition

Because a Section 336(e) Election is made by agreement of the seller and the Target, a buyer of Target stock should exercise caution when acquiring Target stock that is or could become part of a "qualified stock disposition." In situations where the buyer desires to achieve the benefits of a Section 336(e) Election, buyer should require the seller and Target corporation to covenant to make the election. Alternatively, the buyer may want to contractually prevent the seller and Target corporation from making a Section 336(e) Election. For example, the Target corporation might have net operating losses or assets with tax bases in excess of their fair market values that the buyer would like to be preserved. Additionally, if a buyer acquires less than 80% of the Target stock, it may want to prevent the seller from selling additional shares of Target stock within a 12 month period and making a Section 336(e) Election, which could result in the Target corporation incurring tax liability on the deemed asset sale.

Conclusion

A Section 336(e) Election offers a significant planning tool for corporate acquisitions not otherwise eligible for a Section 338(h)(10) Election. The Final 336(e) Regulations allow the sale, exchange, or distribution (or combination of the foregoing) of a Target corporation's stock in a "qualified stock disposition" to be treated as a deemed sale of the assets of the Target corporation for federal income tax purposes, thereby allowing a buyer to obtain a step-up in tax basis of the Target's assets without requiring an asset transfer or compliance with the more limited requirements of Section 338(h)(10). The Section 336(e) Regulations will be of particular interest to non-corporate entities, such as private equity funds and MLPs, because it allows them to acquire and liquidate a Target corporation and hold assets outside of corporate solution.

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[1] David Peck is a tax partner in the Dallas office of Vinson & Elkins L.L.P. and Robert Jacobson is a senior tax associate in the Houston office of Vinson & Elkins L.L.P.

[2] All Section references are to the Internal Revenue Code of 1986, as amended (the "***Code***")

[3] The Treasury proposed regulations implementing Section 336(e) on August 22, 2008. While the final regulations were issued on May 10, 2013, they are effective with respect to qualified stock dispositions with a disposition date on or after May 15, 2013.

[4] However, individuals and partnerships can generally satisfy this requirement by forming a new corporation to acquire the Target corporation's stock. Treas. Reg. § 1.338-3(b)(1); FSA 200122007.

[5] Treas. Reg. § 1.336-2(a).

[6] Treas. Reg. § 1.336-1(b)(6).

[7] Treas. Reg. § 1.336-1(b)(6)(i).

[8] Treas. Reg. § 1.336-1(b)(5).
[9] Treas. Reg. § 1.336-1(b)(5)(i)(C).
[10] Treas. Reg. § 1.336-1(b)(6)(ii).
[11] Treas. Reg. § 1.336-2(h).
[12] Id.
[13] Treas. Reg. § 1.338-3(b)(1).
[14] Treas. Reg. § 1.336-2(j).

Same-Sex Marriages—The Quagmire Continues after *Windsor**

Charles D. Pulman, Esq., and Alan K. Davis, Esq.

On June 26, 2013, the U.S. Supreme Court struck down as unconstitutional Section 3 of the federal Defense of Marriage Act. This case extended for the first time a myriad of federal benefits, rights, and privileges to same-sex married couples. The breadth, applicability, and consequences of this decision, however, are just beginning to be analyzed and understood, with many questions still unanswered. For same-sex married couples living in states that recognize same-sex marriages, the Supreme Court decision has immediate consequences but its retroactive application is uncertain. For same-sex married couples that live in states that do not recognize such marriages, the Supreme Court decision apparently has immediate consequences in some—but not all—areas, depending on the particular federal agency. Several federal agencies have acted, including the Internal Revenue Service that issued Revenue Ruling 2013-17 on August 29, 2013. Same-sex married couples should analyze carefully their particular situation to determine what steps should be taken to take advantage of this development.

INTRODUCTION

On June 26, 2013, the U.S. Supreme Court issued a historic decision that affected the application of federal law to same-sex married couples. The breadth, applicability, and consequences of this decision are just now being analyzed and understood, with many questions still unanswered.

WINDSOR

The case of *United States v. Windsor*[1] held that Section 3 of the 1996 Defense of Marriage Act[2] (DOMA) was unconstitutional as a deprivation of liberty protected by due process and equal protection. Section 3 of DOMA stated that for purposes of federal law, the word “marriage” meant only a legal union between one man and one woman as husband and wife, and the word “spouse” referred only to a person of the opposite sex who is a husband or a wife. In effect, DOMA denied federal benefits, rights, and privileges to the partners/spouses of same-sex marriages.

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*This article is adapted from an article that will appear in the Autumn 2013 issue of *Willamette Management Associates Insights*.

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Section 2 and Section 3 of DOMA are presented in Exhibit 1.

Exhibit 1

DOMA Section 2 and Section 3

Section 2. No state is required to treat any same-sex couple married under the laws of another state as married. [NOT ADDRESSED BY *WINDSOR* COURT.]

Section 3. In interpreting any federal statute, regulation, ruling or guideline, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or wife. [DECLARED UNCONSTITUTIONAL BY *WINDSOR* COURT.]

In *Windsor*, a same-sex couple residing in New York went to Canada to marry and then returned to New York. While living in New York, one of the spouses to the marriage died and the issue was whether the decedent's estate would be entitled to the same federal estate tax benefits that would be accorded to opposite-sex marriages of persons living in New York. At the time of the spouse's death, New York recognized same-sex marriages. The *Windsor* Court concluded that Section 3 of DOMA was unconstitutional and, therefore, the decedent's estate was entitled to the same federal estate tax benefits that a heterosexual married couple would have received.

Therefore, it is clear from the *Windsor* opinion that a same-sex married couple residing in a state that recognizes same-sex marriages will be entitled to all federal benefits, rights, and privileges accorded to opposite-sex married couples in that state.

The uncertainty is whether and how all federal benefits, rights, and privileges will be accorded to same-sex couples validly married in one state but thereafter residing in another state that does not recognize same-sex marriages at the time in question. States that do not recognize same-sex marriages include Texas, Florida, Pennsylvania, and many others. *Windsor* is only the first step in unraveling the quagmire facing same-sex married couples.

The *Windsor* Court did not address Section 2 of DOMA, which states that one state does not have to recognize a marriage performed under the laws of another state.

PERRY

On the same day as the issuance of the *Windsor* opinion, the Supreme Court also issued a decision in the case of *Hollingsworth v. Perry*.[3] In the *Perry* case, the Supreme Court held that neither the Supreme Court nor the lower federal Circuit Court had the authority to decide the question of whether California Proposition 8 was unconstitutional as held by the federal District Court. California Proposition 8 stated that only a marriage between a man and woman is valid or recognized in California. The federal District Court concluded that Proposition 8 was unconstitutional. As a result of the Supreme Court's decision, the federal District Court's original

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opinion held and, therefore, Proposition 8 remained unconstitutional and same-sex marriages in California are permitted.

AFFECTED FEDERAL LAWS

The General Accounting Office identified 1,138 federal statutory provisions involving marital status as of December 31, 2003, in 13 subject categories whose applicability depends on whether a couple is married.[4]

Affected areas include, but are not limited to, income tax, gift tax, estate tax, immigration, social security, Medicare, Medicaid, family medical leave, veterans' spousal benefits, health insurance benefits for employee's spouse, spousal IRA rollovers, COBRA, employee benefit plans, defined contribution plans, qualified domestic relations orders, HIPAA, cafeteria plans, flexible spending accounts, and health savings accounts.

The General Accounting Office issued a report in 2004 that identified 198 separate Internal Revenue Code (the "Code") provisions tied to marital status.[5]

STATES RECOGNIZING SAME-SEX MARRIAGES AS VALID

At the present time, 14 states and the District of Columbia recognize same-sex marriages as valid. Those states are New York, California, Massachusetts, Connecticut, Iowa, Maine, Vermont, Maryland, Washington, New Hampshire, Minnesota, Rhode Island, Delaware and, as of October 2013, New Jersey.

States that do not recognize same-sex marriages as valid will continue to contribute to the uncertainty facing same-sex married couples. For example, in 2011, the New Mexico Attorney General issued an advisory opinion that New Mexico can recognize same-sex marriages performed outside of New Mexico even though New Mexico itself does not recognize same-sex marriages. The effect of this advisory opinion is uncertain. It has recently been reported that several counties in New Mexico are issuing marriage licenses to same-sex couples.

In Ohio, a federal District Judge ruled on July 22, 2013, in a temporary restraining order case, that it is a violation of the Fourteenth Amendment of the United States Constitution for Ohio to discriminate against (not recognize) valid same-sex marriages conducted outside Ohio when opposite-sex marriages conducted outside Ohio are recognized by Ohio.[6]

In Texas, the case of *Texas v. Naylor and Daly* presently is pending in the Texas Supreme Court wherein the issue is whether a Texas lower court had the power to grant a divorce to a same-sex couple who were married outside Texas and were living in Texas at the time of pending divorce.[7] The Texas Supreme Court announced in August 2013 that oral arguments in this case will be heard in early November 2013. Article 1, Section 32 of the Texas Constitution states that a marriage consists of one man and one woman, while *Section 2.001* of the Texas Family Code states that a marriage license may not be issued to persons of the same sex. Further, Section 6.204 of the Texas Family Code generally (i) treats same-sex marriages and civil unions as void, (ii) states that no effect will be given to a public act, record or proceeding in Texas or any other jurisdiction that creates, recognizes or validates a same-sex marriage or civil union and (iii) states that no effect will

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be given to a right or claim to any legal protection, benefit or responsibility asserted as a result of a same-sex marriage or civil union in Texas or any other jurisdiction.

RECOGNIZED MARRIAGE REQUIRED

The *Windsor* opinion requires a valid, recognized marriage. The status for federal purposes of civil unions and domestic partnerships after *Windsor* is uncertain.

In the recent case of *Cozen O'Connor, P.C. v. Tobits*,[8] the federal District Court held, "where a state recognizes a party as a "Surviving Spouse," the federal government must do the same with respect to ERISA benefits—at least pursuant to the express language of the ERISA—qualified Plan at issue here."[9]

In the *Tobits* case, the same-sex couple was married in Canada and residing in Illinois, a state that does not issue marriage licenses to same-sex couples but does have a civil union statute.[10] The *Tobits* court treated the surviving party to an Illinois civil union as a "spouse" for purposes of the ERISA plan in issue.

However, the Internal Revenue Service ruled in 2010 that domestic partners in a registered domestic partnership in California who are treated as owning community property under California law would be required to report on the partner's individual federal tax return one-half of the community income.[11] These rulings did not treat the couple as married for federal purposes or extend any tax benefits to them as married. These rulings only addressed the nature of the property interest each partner had in the property and income.

For purposes of federal law, marriage is determined by state law. As discussed below, the issue is which state's law controls—the state of marriage or the state of residency?[12]

WHICH STATE LAW CONTROLS

The uncertainty arising out of the *Windsor* opinion is further exacerbated by the fact that all federal agencies currently do not apply the same standard for determining whether a same-sex marriage will be recognized for federal purposes. The issue revolves around the question of whether the state in which the marriage ceremony is performed ("State of Ceremony") or the state in which the married couple reside at the time in question ("State of Residency") will be used to determine whether the marriage will be recognized for federal purposes.

For example, Frequently Asked Question (FAQ) A-2 issued by Homeland Security after *Windsor*, regarding an immigration visa petition, stated that "[I]n evaluating the petition, as a general matter, USCIS looks to the law of the place where the marriage took place when determining whether it is valid for immigration law purposes."[13]

In addition, on July 1, 2013, the Secretary of Homeland Security, Janet Napolitano, announced that effective immediately, the U.S. Citizenship and Immigration Services (USCIS) would immediately review immigration visa applications filed on behalf of a same-sex spouse in the same manner as applications filed for an opposite-sex spouse.

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On June 28, 2013, the U.S. Office of Personnel Management (OPM) issued a Memorandum stating that it will extend benefits to federal employees and annuitants who have legally married a spouse of the same sex. The benefits covered by this Memorandum are as follows:

1. Health insurance
2. Life insurance
3. Dental and vision insurance
4. Long-term care insurance
5. Retirement benefits
6. Flexible spending accounts

The Memorandum implied that more benefits would be offered. The Memorandum did not mention which jurisdiction would be used to determine a legal marriage. Presumably, all that is required is the couple be legally married.

The Internal Revenue Service (the "Service") did not specifically address this issue of which state law controls in Publication 501,[14] although in *Revenue Ruling 58-66*, 1958-1 C.B. 60, the Service concluded that a common-law marriage entered into in a state that recognizes such relationship would continue to be treated as a marriage for federal tax return filing purposes when that couple later moved to a state that requires marriage ceremonies. It was not clear how or if this Ruling applied to same-sex marriages.

The Service recently announced in "Answers to Frequently Asked Questions For Same-Sex Couples" that they are "reviewing the important June 26 Supreme Court decision" on DOMA and "will move swiftly to provide revised guidelines in the near future."

On August 29, 2013, the Service issued *Revenue Ruling 2013-17*, announcing that same-sex marriages will be recognized for federal tax purposes and that all federal tax laws would be extended to same-sex married couples regardless of the state in which the couple resides. This Ruling, which cited *Revenue Ruling 58-66* as precedent, will have immediate and far-reaching consequences.

Since *Windsor*, the Department of Defense announced that military benefits will be extended to spouses of a valid same-sex marriage regardless of residence; however, the Social Security Administration recently announced a policy that seemingly applies a state of residence standard for benefits.

On September 18, 2013, the Labor Department issued Technical Release No. 2013-04 stating that for purposes of employee benefit plans under ERISA, the term "spouse" includes same-sex married individuals and the term "marriage" includes a same-sex marriage as long as the marriage is legally recognized in the state where the ceremony was performed and state of residence is not relevant. Thus, a valid same-sex marriage is recognized for purposes of ERISA regardless of whether the state of residence recognizes the marriage. In addition, this Technical Release stated that domestic partnerships and civil unions not denominated as a marriage would not be recognized, whether same-sex or opposite-sex.

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Until further federal legislation (such as the proposed Respect for Marriage Act pending in Congress[15]) or case law or guidance from each federal agency is issued, uncertainty will continue to exist for those same-sex married couples that live in states that do not recognize same-sex marriages.

FEDERAL TAX LAWS

The *Windsor* opinion has significant federal income, gift, and estate tax consequences for those same-sex married couples that live in states that do recognize same-sex marriages ("Recognition States") and for those same-sex married couples that live in states that do not recognize same-sex marriages ("Nonrecognition States").

It is important to note that *Windsor* and its application only relate to federal law, as states currently are entitled to treat same-sex couples differently. Thus, a situation could arise wherein a same-sex couple is recognized as married for federal tax purposes, thus requiring a married federal tax return, and not recognized as married under the laws of the state of residency, thus requiring an unmarried state tax return.

Revenue Ruling 2013-17

On August 29, 2013, the Internal Revenue Service issued *Revenue Ruling 2013-17* (the "**Ruling**") recognizing for federal tax purposes the validity of, and extending all federal income, gift and estate tax laws to the spouses to, a valid same-sex marriage regardless of the state in which the parties reside. Specifically, the *Ruling* concludes that the terms "husband," "wife," "spouse" and "marriage" include individuals of the same sex for federal tax law purposes.

The *Ruling*, however, concludes that for federal tax purposes a "marriage" does not include, and federal tax law will not be extended to parties who have entered into, a registered domestic partnership, civil union or other similar form of relationship recognized under state law that is not denominated as a marriage under the laws of that state regardless of whether the parties to the marriage are same-sex or different sex.

The *Ruling* states that it is to be applied prospectively as of September 16, 2013. Thus, on and after that effective date, all federal tax laws will apply to the parties to a valid same-sex marriage as long as the marriage was performed in a place, whether in the United States or in a foreign jurisdiction, that recognized the marriage as valid. The Ruling, however, does not grandfather or address transactions occurring prior to that date that have continuing effect after September 16, 2013.

On the same date as the issuance of the *Ruling*, the IRS also issued *Answers to Frequently Asked Questions for Registered Domestic Partners and Individuals in Civil Unions* and *Answers to Frequently Asked Questions for Individuals of the Same-Sex Who Are Married Under State Law*. Those *FAQs* attempt to clarify the *Ruling* and address additional issues arising out of the Ruling. Of particular note, the *FAQ* dealing with same-sex spouses states in Q18 that qualified retirement plans must comply with the *Ruling* rules as of September 16, 2013, but the rules under the *Ruling* relating to filing amended returns do not apply to these plans for periods prior to September 16, 2013. Apparently, the Service will provide guidance at a later date on this subject as well as how

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these plans and other tax-favored retirement plans will be required to comply with *Windsor* and the *Ruling*.

The *Ruling* provides that taxpayers may rely on the Ruling for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund resulting from the *Ruling's* holdings as long as the applicable statute of limitations under Code Section 6511 for filing the claim has not expired. In such cases, all items required to be reported on the return or claim that are affected by marital status must be reported consistent with the married filing status.

Q2 of the *FAQ* dealing with same-sex spouses states that a same-sex married couple must file as married for tax year 2013 as well as for tax year 2012 if the spouses file an original tax return on or after the Ruling's effective date. For spouses who filed their tax returns for 2012 or earlier years or before the Ruling's effective date, Q2 of this FAQ states the spouses may, but are not required, to amend their earlier tax returns to file using married status as long as the applicable statue of limitations has not expired.

Neither the Ruling nor the FAQ addresses the situation where one spouse filed a tax return for a particular year before the effective date of the Ruling and the other spouse filed on or after the effective date of the Ruling for the same year or the situation where both spouses filed at different times their respective tax return for a particular year before the effective date of the Ruling but the applicable statute of limitations on filing amended returns has expired for one spouse and not the other spouse.

The *Ruling* provides that taxpayers may rely (subject to the conditions of statute of limitations and consistency) on the *Ruling* retroactively regarding employee benefit plans or arrangements or any benefit provided thereunder only for purposes of filing original, amended or adjusted returns or claims for refund of an overpayment of tax concerning employment tax and income tax with respect to employer-provided health coverage benefits or fringe benefits that were provided by the employer and are excludable from income under Code Sections 106, 117(d), 119, 129, or 132 based on marital status.

If an employee made a pre-tax salary-reduction election for employer-provided health coverage under a cafeteria plan and also elected to provide health coverage for a same-sex spouse on an after-tax basis under a group health plan sponsored by the same employer, the affected taxpayer may treat amounts that were paid by the employee for coverage of the same-sex spouse on an after-tax basis as pre-tax salary reduction amounts.

The IRS apparently intends to issue further guidance regarding other employee benefits and employee benefit plans and arrangements. For example, the IRS recently issued Notice 2013-61 providing special administrative procedures for employers and employees to make claims for refund or adjustments of overpayments of FICA taxes and income tax withholdings with respect to certain benefits provided to same-sex spouses and remuneration paid to same-sex spouses in 2013 and prior years.

The IRS stated in the *Ruling* that additional guidance may be provided on the subject matter of the *Ruling* and the application of *Windsor* with respect to Federal tax administration.

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Income Tax—Recognition States

As a result of *Windsor* and the Ruling, all federal income tax laws will apply to same-sex married couples beginning in the calendar year 2013. Presumably, all transactions occurring during the calendar year 2013 will be covered even though the Ruling's effective date is September 16, 2013, since the Ruling states that it applies to original returns filed on or after that date.

The breadth of selected income tax consequences affecting same-sex married couples is addressed by the Congressional Research Service (CRS) which issued on September 9, 2013, a report titled "The Potential Federal Tax Implications of *United States v. Windsor* (Striking Section 3 of the Defense of Marriage Act (DOMA): Selected Issues" (the "Report"). This Report primarily discusses selected income tax consequences to same-sex married couples as a result of *Windsor* and the Ruling (such as tax credits and tax brackets) but also discusses in general estate tax consequences, non-taxable employee compensation and filing of amended returns.

Same-sex couples who reside in Recognition States will now be required to file their federal tax returns as either married filing joint returns or married filing separate returns. Clearly, this filing status will apply for the tax return for the taxable year 2013 and subsequent years.

Prior to the issuance of the Ruling, a question existed as to whether the *Windsor* opinion applied to a taxable year prior to 2013. For example, should a same-sex married couple that lived in a Recognition State during the year 2012 and had not yet filed their 2012 federal tax return, file their federal tax return for 2012 as married or as single?

One position was that since the *Windsor* opinion was not issued until 2013, the couple during the tax accounting year of 2012 was not considered as married for federal purposes. Therefore, this couple would have been considered as not married as of the close of 2012 and would have filed tax returns as separate single individuals.

The contrary position was that the *Windsor* Court held Section 3 of DOMA to be unconstitutional, which has the effect of rendering Section 3 of DOMA void ab initio as though the statute never existed.[16] The latter argument would logically result in the conclusion that the same-sex married couple during the tax accounting period of 2012 were, for federal purposes, married and, therefore, should file as a married couple for federal income tax purposes for 2012.

Under the Ruling, if both of the married spouses file their tax return for 2012 on or after September 16, 2013, they will be required to file federal returns as married. It is not clear under the Ruling how one spouse should file his/her federal tax return for 2012, whether as single or married filing separate, after September 16, 2013, if the other spouse filed his/her federal tax return for 2012 before September 16, 2013, as single.

Although a taxpayer generally does not have an obligation to file an amended return for a prior year,[17] an issue arises whether an amended federal tax return (Form 1040X; claims for refund are made on an amended return) should be filed for a prior year with the status of married if there is a benefit in doing so. Obviously, such a question would arise only if filing as a married couple for federal income purposes would result in an overall income tax savings than the amount previously

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paid by each spouse to the same-sex marriage having previously filed separate single federal tax returns. The Report raises an interesting issue of whether an amended return filed after September 16, 2013, for a pre-2013 year for non-marital status purposes must be filed as married. This issue is not addressed by the Ruling.

Furthermore, the issue arises as to how many prior years an amended return can be filed. The normal federal income tax statute of limitations on refund claims is three years from the date the return was filed or two years from the date the tax was paid, whichever is later.[18]

However, according to *Revenue Ruling 83-183*, the last date to file a joint return for a prior year for which a single return was filed may be three years from the due date (without extensions) of the prior year. [19]

In that Revenue Ruling, however, the taxpayer could have filed a married, joint return for the prior year at the time the single return was filed. In the case of a same-sex married couple, that couple could not have filed a joint return for the prior year since federal law at that time precluded such a return. This distinction is important and makes this Revenue Ruling distinguishable from the situation confronting same-sex married couples seeking to file a married, joint return for a pre-*Windsor* year.[20]

Under the normal statute of limitations on amended returns, as of September 1, 2013, the earliest prior year for which a claim for refund could be filed would be either the tax year 2009 if the tax return was filed on October 15, 2010, or the tax year 2010 if the 2009 tax return was filed prior to September 1, 2010.

Under the Ruling, claims for refund for a prior year can be filed only if the statute of limitations is still open at the time the claim is filed. Prudence would dictate that claims for refund be filed as soon as possible for all years that would still be open under the applicable statute of limitations, provided there would be a net tax savings (refund) resulting from filing married as opposed to single.[21,22] Under the Ruling, all items and transactions for the prior year for which an amended return is filed must be treated consistent with the married filing status.

However, all transactions occurring during a prior year for which a claim for refund is being considered should be analyzed to determine if the federal tax treatment originally reported would change if the same-sex couple was now considered married in the year for which the amended return is filed. For example, if the spouses to a same-sex marriage each owned stock in a corporation and one spouse's stock was partially redeemed by the corporation during the prior year for which a claim for refund is being considered, the gain to the redeeming spouse in the original transaction might have been capital gain but now might be ordinary income because of the related-party rules (the shareholders are now deemed married in the prior year).[23]

Another issue relates to same-sex married couples that are divorced. Clearly, for same-sex couples divorced in a Recognition State, such couples will be afforded the tax benefits of Code Section 1041 (tax-free property settlement), alimony under Code Section 71 (income to payee) and under Code Section 215 (deductible to payor), and child support under Code Section 71 (exclusion from income). However, for a couple that was granted a divorce prior to June 26, 2013, or

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September 16, 2013, such couple should determine whether the property settlement and payments are entitled to a more favorable federal tax treatment than originally reported or if the divorce should be re-opened and restructured to take into account the tax benefits under the Code.

Another potential issue is whether a same-sex married couple in a Recognition State has a duty to treat an item or transaction for federal tax purposes in the current or later year consistent with the manner in which the item or transaction was treated in a pre-*Windsor* year for which an amended return is not being filed. For example, let's assume a same-sex married couple is divorced in a Recognition State in a pre-*Windsor* year, one spouse issued an installment note to the other spouse as part of the property settlement, and the note payments extended into a post-*Windsor* year. In this scenario, can the parties claim the payments are tax-free under Code Section 1041 in the post-*Windsor* year even though payments in the year of divorce were reported as taxable (Code Section 1041 did not apply during the prior year) or is the taxability of the post-*Windsor* year payments taxable because the parties were divorced before *Windsor* and the effective date of the Ruling?

Conversely, as in the prior corporate redemption example, if the redeeming shareholder received an installment note from the corporation with payments extending into a post-*Windsor* year, will the character of the gain on the redemption be (1) taxed as capital gain in the post-*Windsor* year (which is consistent with the treatment in the original pre-*Windsor* redemption year) or (2) taxed as ordinary income in the post-*Windsor*-year, since the redeeming spouse is now considered married to the remaining shareholder/spouse in the prior year? The shareholder/spouse is a related party under Code Section 318 for purposes of Code Section 302(b)(3).

Another example of the uncertainty is the application of Code Section 469(n) that attributes the material participation of one spouse to the other spouse. If the parties were married in a pre-*Windsor* year for which Code Section 469(n) was not claimed for a specific activity, does Code Section 469(n) apply to the same activity in a post-*Windsor* year? The answer should be yes.

The duty of consistency requires a taxpayer to be consistent in the treatment of tax items under certain conditions.[24] How this duty applies in the situations described above is not clear since the potential inconsistency results not from the taxpayer's error or omission but from a change in a law. The retroactive effect of *Windsor* and the *Ruling* is not clear.

The consistency position in the *Ruling* might indicate that the transaction be reported in a later year consistent with the original treatment unless an amended return for the prior year is filed. Perhaps the earlier transaction should be grandfathered. The *Ruling* did not address this type of issue.

In addition, it is not clear whether, in a Service audit of one spouse to a same-sex marriage for a pre-*Windsor* year, the Service unilaterally can treat the taxpayer/spouse as married for federal tax purposes for the audit year even though the spouse filed as a single person. The better position would be that the Service not be able to change the marital status for the prior year.

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Income Tax—Nonrecognition States

Under the Ruling, same-sex married couples that live in a Nonrecognition State will be subject to the same income tax rules and uncertainties as described above for Recognition States and will be required to file as married persons for federal income tax purposes. However, since many Nonrecognition States also have a personal income tax (presently, 41 states have a broad-based personal income tax), the same-sex married couple will not be able to file state returns as married. They will need to file state returns as single, which will require more work on an allocation of tax items, such as income and deductions, between them.

The allocation of income and deductions becomes more complex in community property states that are Nonrecognition States. For example, it would appear that the community property laws of Texas would not apply to a same-sex married couple since Section 3.002 of the Texas Family Code defines community property as property acquired by either spouse during marriage and, as discussed above, Section 6.204 of the Texas Family Code provides that no right or claim to a legal benefit exists for a same-sex married couple in Texas. Thus, it would appear that income of one same-sex spouse would not be community income, but would be the income of the spouse that earned the income or owns the asset producing the income, the same as though the two individuals were not married. As stated in Q14 of the FAQ dealing with Registered Domestic Partners, "Generally, state law determines whether an item of income constitutes community income."

In addition, the same considerations as above should be given to whether an amended return/claim for refund should be filed for all open years if a refund in tax would result from filing as married.

However, before a same-sex married couple living in a Nonrecognition State makes a final determination to file a claim for refund if such action is otherwise warranted, such couple should consider potential disadvantages from an income tax point of view from filing as married. Such disadvantages could arise in a number of areas, such as previously discussed.

A same-sex married couple that lives in a Nonrecognition State and is seeking a divorce has a fundamental problem since such couple may not be able to obtain a divorce either in the Nonrecognition State since the marriage is not recognized in that state or in any other state that requires residency as a condition of granting a divorce. However, under Code Section 1041, a property settlement between the spouses upon a split-up should be a non-taxable event since the couple would still be married for federal purposes. In addition, if properly structured and desired, cash payments should qualify for alimony or child support under the Code Section 71.

Another difference from Recognition States arises with respect to the proper parties to a Subchapter S election. In a community property Recognition State, both spouses to a same-sex marriage would sign the S election if the stock is community property. In a community property Nonrecognition State, the community property laws of that state seemingly would not apply; therefore, only the same-sex spouse in whose name the stock is registered would sign the election, absent a joint ownership arrangement between the spouses.

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Gift Tax—Recognition States

For a same-sex married couple living in a Recognition State, the *Windsor* opinion and the Ruling affords this couple many gift tax advantages. The Ruling does not specifically address the gift tax issues now applicable to same-sex married couples. Nevertheless, the Ruling will apply to gifts made on or after September 16, 2013, as well as original gift tax returns and amended returns filed after that date for a prior period for which the statute of limitations is still open at the time of filing (ie, 3 year/2 year rule described above).

Transfers of property between the spouses will be gift-tax free because the married couple will qualify for the unlimited marital deduction[25] and a gift tax return will not be required.

In addition, gifts of property to a third party will qualify for gift splitting, wherein the current $14,000 annual exclusion per donee will be available from both the donor spouse and the nondonor spouse, thus qualifying the gift for a $28,000 annual gift tax exclusion per couple.[26] The same rationale applies to a spouse's lifetime exemption amount, which is currently $5,250,000.[27]

If a transfer of property was made between spouses in a prior year for which a gift tax was paid, an amended gift tax return should be filed that claims the marital deduction and a refund of any gift taxes paid for which the applicable statute of limitations is still open. Amended gift tax returns are filed on a new IRS Form 709.

If no gift taxes were paid with regard to a prior year's transfer of property for which a gift tax return was filed but the amount of the gift exceeded the annual exclusion and, therefore, utilized any portion of the donor's lifetime exemption amount, an amended gift tax return should be filed that claims the marital deduction and thus reverses the use of the lifetime exclusion. While this course of action is available under the Ruling for all years for which the statute of limitations is still open, a question exists for all other prior years in which the couple was married and filed gift tax returns using part of the lifetime exclusion. If Section 3 of DOMA is unconstitutional, then it would seem that the use of the lifetime exclusion was improper and the portion claimed previously should still be available regardless of the statute of limitations. This issue was not addressed by the Ruling.

Gift Tax—Nonrecognition States

For a same-sex married couple that lives in a Nonrecognition State, the same gift tax rules and issues would apply as discussed above for Recognition State residents. However, gifts of property by one spouse in a community property Nonrecognition State will require additional analysis to determine the nature of the ownership of the property gifted.

Estate Tax—Recognition States

Same-sex married couples that reside in Recognition States will be entitled to all the federal estate tax benefits accorded to opposite-sex married couples. These benefits include the unlimited marital deduction,[28] which allows an estate tax deduction for the value of assets passing from the deceased spouse to the surviving spouse. The Ruling, however, does not specifically address estate tax issues for persons dying prior to September 16, 2013. Nevertheless, the Ruling will apply to persons dying after September 16, 2013, as well as original estate tax returns filed after that date for

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a prior period and amended estate tax returns filed after that date for which the statute of limitations is still open at the time of filing.

In addition, the recent addition to the Code of “portability,” which is an election made in the estate of the first deceased spouse, allows for the unused estate tax exemption of the first deceased spouse to be available to the same-sex surviving spouse.[29]

An issue relates to the portability election for the estate of the first deceased spouse.[30] Internal Revenue Service Notice 2011-82, 2011-42 IRB 516, requires the portability election for estates of decedents dying after 2010 be made on a timely filed federal estate tax return.[31] The due date of the estate return is nine months after date of death plus a possible additional extension of six months.[32] Obviously, by June 26, 2013, or September 15, 2013, the time for making a portability election has expired for some previously filed (or unfiled) estate tax returns. Whether the Service will grant additional time for the estate of a deceased spouse of a same-sex married couple to make the election remains to be seen. The Ruling does not address this type of issue. The current available option is to apply for a private letter ruling to permit a late election under Treasury Regulation Sec. 301.9100 and Revenue Procedure 2013-1, 2013-1 IRB-1, which requires a substantial user fee.

In the case of an estate tax return previously filed for a deceased same-sex spouse in a Recognition State, consideration should be given to filing an amended estate tax return to utilize the unlimited marital deduction to the extent otherwise applicable (meaning estate assets pass to the surviving same-sex spouse) and to preserve for the surviving same-sex spouse the deceased same-sex spouse’s unused estate tax exemption, if any, if the statute of limitations is still open.

Estate Tax—Nonrecognition States

For a deceased same-sex spouse in a Nonrecognition State, the unlimited marital deduction will be available. As discussed above for Estate Tax in Recognition States, an amended estate tax return should be considered for the same reasons as discussed above, including the unlimited marital deduction and the benefits of portability for any unused estate tax exemption in the estate of the first deceased same-sex spouse. One significant disadvantage of residing in a community property Nonrecognition State is the step-up in basis rules on the death of the first spouse under Code Section 1014(b)(6) for all of the community property of a opposite-sex married couple in that state may not apply to the same-sex married couple since their marriage is not recognized in that state and, thus, there is no community property. For the same-sex married couple, the step-up in basis may apply only to the decedent’s interest in the property owned by the decedent under that state’s law and not to the joint interest of the surviving spouse in the property.

ESTATE PLANNING

The dichotomy between Recognition States and Nonrecognition States will be the continual subject of future developments.

For now, planning and advice to same-sex couples requires diligence. Diligence includes both planning to obtain future benefits and advice as to claiming current federal benefits. Plans for

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same-sex couples should be reviewed and revised for the above-mentioned income, gift, and estate tax benefits.

Recognition States

In Recognition States, estate plans for same-sex couples should be immediately changed to take full advantage of marital deduction planning and split-gift planning.

In addition, plans should also be reviewed for same-sex couples as a result of this newly recognized marital status. For example, grantor retained income trusts (or "GRITs") have been a popular tool utilized for same-sex couples. This technique was available because as long as a same-sex partner was not considered to be a spouse, Chapter 14 of the Code was not applicable. GRITs are no longer available for same-sex married couples. It is unclear whether GRITs created in a year prior to September 16, 2013, while the parties were validly married, and continuing after that date will continue to be treated for tax purposes in the same manner as originally intended. The Ruling does not address these types of issues but the Ruling's position on consistency would seemingly answer this question in the affirmative. There are many such examples of planning matters that are altered due to the newly recognized marital status of same-sex married couples.

Another example is the status of existing trusts where a same-sex partner is serving as trustee. It is possible that such a trust has been converted to a grantor trust under Subchapter J due to the grantor being deemed to have the powers of his or her newly recognized spouse. The Code specifically addresses a change in marital status. The Code clarifies that one is deemed to hold the powers of a new spouse, but only for periods following the establishment of the marital relationship.[33] Again, the Ruling does not address this issue but the consistency position in the Ruling may provide an answer.

An additional question relating to the above type of trust involves the retroactive application of *Windsor*. Due to the *Windsor* opinion, could this trust be treated as a grantor trust since inception? This question remains unclear under the Ruling

Nonrecognition States

Estate planning for same-sex couples in Nonrecognition States should focus on the same issues as discussed above, as well as state-specific issues since the parties are not considered married for state law purposes. Such issues include the absence of marital and property rights afforded to opposite-sex spouses.

State Law Issues

While not a direct result of the *Windsor* or *Perry* decisions, or, for that matter, DOMA, the continual and evolutionary acceptance of same-sex couples creates some significant state law implications for planning attorneys and other professionals. The number of same-sex marriages likely will increase due to the advantage of gaining federal benefits as a married couple that are not available to a non-married couple.

Specifically, any number of planning documents that address the concept of a "spouse" should, if not already, account for whether the term includes same-sex spouses. If, for example, a will, trust or buy-sell agreement contains a general reference to "spouse," then which state law is intended to apply in determining whether one is a spouse for purposes of the document?

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Further, references to “child” or “descendant” in a document should address what is meant by those terms and what law is to apply. A will or trust could itself define the beneficiaries of the Estate or Trust or define the class of appointees of a power of appointment.

In determining whether an individual is a beneficiary of a will or trust, a drafter could (1) attempt to carefully define the term in the document; (2) rely on modifying terms such as “legitimate,” “blood,” or “adopted;” or (3) make reference to definition under applicable state law.

New estate documents should carefully consider how children of same-sex couples will be treated for purposes of the agreement. For example, assume a child is born with one parent in a same-sex couple being the biological parent. The document should address the question of whether the child is “legitimate” or whether the child is born in or out of wedlock if those terms are used in the document.

The document should also answer the question of whether such child is a descendant of the nonbiological parent. Care must be exercised in designating which state’s laws are to be applied if any reliance is placed on state law for these determinations.

Many other state law issues will arise as a result of same-sex couples validly married in a Recognition State but residing in a Nonrecognition State. A short list of issues includes the character of property as separate or community property, property management rights, creditor rights, division of property at death or divorce, availability of elective share of an estate, homestead rights of a spouse, the status of a spouse for heirs at law purposes, priorities given to spouses as a fiduciary positions, support obligations of spouses, and the ability to own property as tenants by the entity. These and other issues are sure to be the subject of future developments by state courts and legislatures.

It is expected that *Windsor* and the Ruling, as well as the applicability of other federal benefits, will result in a dramatic increase in the number of same-sex married couples due to the availability of federal economic benefits and, therefore, states will increasingly need to deal with the differing status applied to such couples and their descendants.

CONCLUSION

While the Supreme Court in *Windsor* extended federal law to same-sex married couple in Recognition States, the *Windsor* Court did not address how those same couples are to be treated in Nonrecognition States. As a result, federal agencies, including the Internal Revenue Service, are issuing guidance in this area.

Unfortunately, all federal agencies have not issued guidance as of the time of the writing of this article or have not all agreed as to which state law is to be used for determining marriage. In addition, conflict exists between federal law and Nonrecognition State law as applied to same-sex married couples.

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With time and the continuing developments in this area of law, we most likely will see more same-sex marriages and more Nonrecognition States adopt legislation (or amend state constitutions) recognizing same-sex marriages.

This area of law is developing quickly and, until fully developed, the quagmire continues for same-sex couples.

IMPORTANT TAX DISCLAIMERS

This article is intended for general information purposes. The information in this article is not intended to constitute legal advice or a legal opinion as to any particular matter. Each person must consult with a qualified professional for appropriate legal advice.

October 22, 2013

Notes:

1. United States v. Windsor, 570 U.S. _____, 133 S. Ct. 2675 (2013).
2. 1 USC §7; 28 USC §1738C.
3. Hollingsworth v. Perry, 570 U.S. _____, 133 S. Ct. 2652 (2013).
4. Letter dated January 23, 2004, from Dayna K. Shah, Associate General Counsel, United Stated General Accounting Office to the Honorable Bill Frist, Majority Leader, United States Senate. The Letter can be found at www.gao.gov.
5. This report can be found at www.gao.gov/new.items/d04353r.pdf.
6. *Obergefell v. Kasich*, 2013 WL 3814262 (DC Ohio, 2013).
7. State of Texas v. Angelique S. Naylor and Sabina Daly, 330 S.W.3d 434 (Tex. App. Austin 2011, pet. filed). A companion case is *In the Matter of the Marriage of J.B. and H.B. v. The State of Texas*.
8. Cozen O'Connor, P.C. v. Tobits, 2013 WL 3878688, E.D. Pa., July 29, 2013.
9. Id. at 4.
10. Illinois Religious Freedom Protection and Civil Union Act, 750 ILCS 75/1.
11. CCA 2010 21050; PLR 2010 21048.
12. See, Windsor 133 S. Ct. at 2689.
13. www.dhs.gov/topic/implementation-supreme-court-ruling-defense-marriage-act. See also, www.domaproject.org (foreign spouse of same-sex married couple living in Florida (a nonrecognition state) granted green card by USCIS on June 28, 2013).
14. IRS Publication 501.
15. H.R. 2523; S.1236.
16. See, Coral Springs Street Systems v. City of Sunrise, 371 F.3d 1320 (11th Cir., 2004); Summit Medical Associates v. James, 984 F. Supp. 1404 (U.S. Dist. Ct., M.D. Ala., 1998), affirmed in part and reversed in part, 180 F.3d 1326 (11th Cir., 1999); Oliver P. Field, "Effect of Unconstitutional Statute," *Indiana Law Journal*, January 1926.
17. See, Treasury Regulations §1.451-1(a) and §1.461-1(a); Broadhead v. Commission, TCM 1955-3283. Treasury Department Circular No. 230 requires a practitioner to advise a client promptly of an error or omission and the consequences thereof but does not require the practitioner to advise the client to file an amended return.
18. Section 6511(a) of Internal Revenue Code of 1986, as amended.
19. Rev. Ruling 83-183, 1983-2 C.B. 220.

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20. See, Glaze v. United States, 641 F.2d 339 (5th Cir. 1981).

21. The requirements for a claim for refund can be found at Treasury Regulations §§301.6402-2 and -3. The appropriateness and consequences of a protective claim for refund can be found at CCA 2011 36021 (9-9-11), GCM 38786 (8-13-81) and Martin v. U.S., 833 F.2d 655 (7th Cir. 1987). A claim for refund that is determined to be for an excessive amount could trigger a penalty. Code Section 6676.

22. Treasury Regulation §20.2053-1(b)(5) addresses protective claims for refund in the estate tax area for uncertain deductions under Code Section 2053. See also, Rev. Proc. 2011-48, 2011-42 IRB 527.

23. See, Code Sections 302 and 318.

24. Janis v. Commissioner, 87 T.C.M. 1322 (2004).

25. Code Section 2523.

26. Code Section 2503(b).

27. Code Sections 2505 and 2010(c).

28. Code Section 2056.

29. Code Section 2010(c)(4).

30. Code Section 2010(c)(5).

31. See also, Treasury Regulations §20.2010-2T(a)(3).

32. Code Sections 6075(a) and 6081(a).

33. Code Section 672(e).

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Windsor and the Impact on Employee Benefit Plans

Sarah Fry, Dallas, Texas[i]

On June 26, 2013, the United States Supreme Court ruled in *United States v. Windsor* that section 3 of the Defense of Marriage Act (DOMA) is unconstitutional.[ii] Section 3 of DOMA provides:

> In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife.[iii]

The Court held section 3 of DOMA unconstitutional because it infringes on an individual's due process and equal protection rights afforded under the Fifth and Fourteenth Amendments of the U.S. Constitution.[iv] Specifically, the Court found that section 3 of DOMA "undermines both the public and private significance of state-sanctioned same-sex marriages" because it "demeans the couple, whose moral and sexual choices the Constitution protects … and whose relationship the State has sought to dignify."[v] The Court ruled section 3 of DOMA unconstitutional because "no legitimate purpose overcomes the purpose and effect to disparage and injure those whom the State, by its marriage laws, sought to protect in personhood and dignity."[vi]

The purpose of this article is to discuss the effects of *Windsor* on most employee benefit plans governed by the Employee Retirement Income Security Act of 1974, as amended (ERISA).[vii] This article will not address the effects of *Windsor* on certain types of employee benefit plans, such as top-hat plans and plans subject to Section 409A of the Internal Revenue Code of 1986, as amended (Code).

Prior to the Court's ruling in *Windsor*, employee benefit plans governed by ERISA could only recognize an opposite-sex spouse because of DOMA. ERISA provides that it supersedes any and all state laws relating to employee benefit plans governed by ERISA. Because DOMA interpreted a spouse to mean an opposite-sex spouse, for purposes of federal laws effecting employee benefit plans, the term "spouse" was interpreted to mean an opposite-sex spouse, regardless of whether state law recognized same-sex marriage.

After the Court ruled section 3 of DOMA unconstitutional, questions arose as to the impact this would have on employee benefit plans governed by ERISA. For instance, how do you treat a same-sex spouse of an employee in a state that does not recognize same-sex marriage? President

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Obama requested the Department of Justice work with the other federal agencies in reviewing the *Windsor* ruling and implementing guidance on its implication.[viii] Many of the questions concerning the impact on ERISA-governed employee benefit plans were answered by the Internal Revenue Service (IRS) in its guidance, issued in the form of Revenue Ruling 2013-17, on August 29, 2013, and by the Department of Labor (DOL) in its guidance, issued in the form of Technical Release 2013-04, on September 18, 2013. Not surprisingly, the guidance issued by the IRS and DOL adopted a similar approach for providing benefits to a same-sex spouse under an ERISA plan. What may have been surprising was the approach taken by the agencies. Specifically, the IRS and DOL adopted a "state of celebration" approach, rather than a "state of domicile" approach, in determining whether a same-sex spouse should be recognized in determining benefits under an ERISA plan.

Overview of the State of Celebration Approach

While the Court ruled section 3 of DOMA unconstitutional, the Court did not rule on section 2 of DOMA because it was not before the Court.[ix] Accordingly, section 2 of DOMA is still in effect. Section 2 of DOMA provides that no state is required to recognize a marriage between a same-sex couple.[x] However, the IRS and DOL adopted a "state of celebration" approach in determining whether a same-sex spouse should be recognized for ERISA purposes.

In Revenue Ruling 2013-17, the IRS ruled that, for federal tax purposes, a same-sex marriage will be valid if it is valid in the state[xi] in which the marriage was performed, regardless of the couple's current place of domicile. Therefore, even if a couple lawfully married in a state that recognizes same-sex marriage and resides in a state that does not recognize same-sex marriage, the same-sex marriage is recognized for federal tax purposes, including employee benefit plans. One reason for adopting a "state of celebration" approach was to ease administrative burdens in administering employee benefit plans. Under a "state of domicile" approach, the question of whether a participant's same-sex spouse was a spouse could change during the participant's employment with the plan sponsor if the participant moved from a state that recognized same-sex marriage to a state that did not, or *vice versa*. However, under the "state of celebration" approach, a same-sex spouse is always recognized for plan purposes, provided the marriage is valid in the state in which it was performed. The Revenue Ruling further provides that domestic partnerships, civil unions, or other similar formal relationships that are not denominated as a marriage under state law are not recognized as marriages for federal tax purposes.

In Technical Release 2013-04, the DOL concluded that a spouse under ERISA will be determined based on a "state of celebration" approach. Similar to Revenue Ruling 2013-17, if a same-sex marriage is valid in the state[xii] in which the marriage was performed, then the marriage continues to be valid regardless of the couple's current place of domicile. Also in conformity with Revenue Ruling 2013-17, Technical Release 2013-04 provides that a marriage does not include any formal relationships recognized under state law that are not denominated as a marriage under state law, such as domestic partnerships or civil unions.

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While the IRS's and DOL's interpretation of same-sex marriage for federal law may ease administrative burdens for employers, what impact does this interpretation have on section 2 of DOMA? Based on the agencies' interpretation that marriage is determined in the "state of celebration", it appears that section 2 of DOMA is largely rendered meaningless for purposes of the various laws governing employee benefit plans.

Additionally, does the interpretation ease administrative burdens for employers located only in a state that does not recognize same-sex marriage? Further, do these employers understand the implications of the agencies' guidance and their need to amend their qualified retirement plans and health and welfare plans to recognize a participant's same-sex spouse? This important law change may require amendments to plan documents and revisions to summary plan descriptions and other plan documents and forms. More importantly, the employers will most likely have to adjust their administrative procedures to account for a same-sex spouse.

Effects of *Windsor* on Qualified Retirement Plans

The term "spouse" under a qualified retirement plan should be read to include a same-sex spouse. In the event a plan specifically provides that a spouse is a person of the opposite sex, then such definition should be amended to include a same-sex spouse. Some of the impacts of providing for a same-sex spouse under a qualified retirement plan include: (1) spousal consent rules for defined benefit plans and defined contribution plans, (2) hardship distribution rules under certain defined contribution plans, (3) rollovers from a qualified plan, (4) required minimum distributions, and (5) qualified domestic relations orders (QDROs).

1. Spousal Consent

If an employer sponsors a defined benefit plan (or money purchase pension plan), the normal form of benefit for a married participant is a qualified joint and survivor annuity (QJSA). In order for a married participant to elect another form of payment under a defined benefit plan, the participant's spouse must consent to the election.[xiii] Additionally, the spouse must consent to waiver of the qualified pre-retirement survivor annuity (QPSA) when the plan does not subsidize the cost of the QPSA. Prior to *Windsor*, a same-sex spouse was not recognized under qualified plans for spousal consent purposes. Accordingly, a same-sex spouse did not have to consent to a participant's election for a benefit other than the QJSA. Further, the same-sex spouse was not entitled to the QPSA benefit and did not have to consent to waiver of the QPSA. After *Windsor*, a same-sex spouse must now consent to a benefit payment other than a QJSA, and is entitled to the QPSA benefit and must consent to its waiver.

If an employer sponsors a defined contribution plan, such as a 401(k) plan, a spouse is entitled to 100% of the account balance of the participant upon the participant's death, unless the spouse has provided written consent for another beneficiary. Prior to *Windsor*, a same-sex spouse did not have to provide consent to a participant's designation of another beneficiary. Therefore, benefits may have been distributed to a beneficiary other than the same-sex spouse without such

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spouse's consent. After *Windsor*, a same-sex spouse must consent to a beneficiary designation other than the spouse.

2. Hardship Distributions

A 401(k) plan and a 403(b) plan may provide for hardship distributions from the plan. Hardship distributions for medical expenses that are deductible under Code Section 213, which allows for deduction of medical expenses of a spouse, may be allowed under a plan. In addition, hardship distributions for tuition or funeral expenses of a spouse may also be made under a plan. However, prior to *Windsor*, if a participant wanted to receive a distribution for medical, tuition or funeral expenses of a same-sex spouse, the participant would have to designate the same-sex spouse as a primary beneficiary in order to receive a hardship distribution. Also, such hardship distribution was only permitted if the plan allowed for hardship distributions for medical, tuition or funeral expenses of a primary beneficiary. The Pension Protection Act of 2006[xiv] expanded the hardship distribution rules to allow for hardship distributions for medical, tuition and funeral expenses of a primary beneficiary under a plan. However, these expanded rules were optional, meaning plan sponsors did not have to amend their plans to allow for hardship distributions on account of expenses incurred by a primary beneficiary. After *Windsor*, a same-sex spouse is a spouse for hardship distribution purposes. Therefore, a participant may receive a hardship distribution for the participant's same-sex spouse's medical, tuition or funeral expenses regardless of whether a plan sponsor amended its plan to provide for the expanded hardship distribution rules to a primary beneficiary.

3. Rollovers from Qualified Plans

The rollover rules for qualified retirement plans provide that a spouse may make a rollover of a distribution from a qualified plan to: (i) an individual retirement account described in Code Section 408(a), (ii) an individual retirement annuity described in Code Section 408(b), or (iii) a Roth IRA described in Code Section 408A (collectively, an IRA). In addition, a spouse may make a rollover of a distribution from a qualified plan to: (i) a qualified plan under Code Section 401(a), (ii) an annuity described in Code Section 403(a), (iii) an eligible deferred compensation plan described in Code Section 457(b), or (iv) an annuity contract described in Code Section 403(b) (collectively, an employer-sponsored plan). However, a non-spouse beneficiary may only make a rollover of a distribution from a qualified plan in the form of a direct rollover to an inherited IRA. Prior to *Windsor*, a same-sex spouse was treated as a non-spouse beneficiary. Accordingly, the same-sex spouse could only rollover a distribution from a deceased participant's retirement plan in the form of a direct rollover to an inherited IRA. After *Windsor*, a same-sex spouse is treated as a spouse. Therefore, the same-sex spouse may rollover a distribution from a deceased participant's retirement plan to an IRA or an employer-sponsored plan.

4. Required Minimum Distributions

A participant under a qualified retirement plan must begin receiving required minimum distributions (RMD) no later than the participant's required beginning date.[xv] Benefits paid out

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on account of a participant's death must also comply with the RMD rules. When a participant dies before RMD payments have begun, a spouse may delay distribution longer than a non-spouse beneficiary. Prior to *Windsor*, a same-sex spouse was treated as a non-spouse beneficiary, assuming the spouse was the beneficiary under the plan, and was not entitled to the delayed RMD distribution. After *Windsor*, a same-sex spouse may delay RMD distribution.

5. Qualified Domestic Relations Orders

A qualified domestic relations order separates a participant's interest in the participant's retirement benefit between the participant and "alternate payees" upon divorce of the participant and spouse. In order for the domestic relations order to be qualified, it must meet certain requirements under ERISA.[xvi] An "alternate payee" under ERISA is a spouse, former spouse, child, or other dependent of the participant. Prior to *Windsor*, a same-sex spouse generally could not obtain a QDRO because the same-sex spouse could not qualify as an alternate payee.[xvii] After *Windsor*, a same-sex spouse may be treated as an alternate payee and may obtain a QDRO. A pending question is how or whether states that do not recognize same-sex marriage will handle divorces of same-sex couples in their jurisdictions.

Effects of *Windsor* on Health and Welfare Plans

To the extent an employer's health plan provides benefits to an employee's same-sex spouse, some of the impacts of providing for a same-sex spouse under health and welfare plans include: (1) participation of the spouse in health care coverage; (2) pre-tax reimbursement benefits; (3) employment taxes; (4) COBRA[xviii] rights; and (5) HIPAA[xix] special enrollment rights.

1. Health Care Coverage

Prior to *Windsor*, if a health plan provided coverage to a same-sex spouse, the plan sponsor had to impute taxable income equal to the value of the coverage to the participant, unless the same-sex spouse qualified as a Code Section 152 tax dependent. After *Windsor*, a same-sex spouse may be covered by a health plan on a tax-free basis, *i.e.*, income is no longer imputed to the participant for federal tax purposes. This also means that an employee may elect to pay for a same-sex spouse's coverage on a pre-tax basis through a cafeteria plan under Code Section 125.

2. Pre-Tax Reimbursement Benefits

FSAs and HSAs allow a participant to place money in a notional account from the participant's compensation on a pre-tax basis to reimburse for medical expenses of a spouse or dependent. Also, a participant may contribute to a dependent care account on a pre-tax basis to receive reimbursement for the care of a child dependent or a disabled adult dependent. Prior to *Windsor*, a participant generally could not use an FSA or HSA for reimbursement of medical expenses for a same-sex spouse, unless the spouse was a Code Section 152 dependent. Nor could a participant receive reimbursement for a same-sex spouse's dependent care if the same-sex spouse was not a Code Section 152 dependent. After *Windsor*, a participant may use money in the FSA or HSA for reimbursement of medical expenses of a same-sex spouse, and may use a dependent care account for the care of a disabled same-sex spouse.

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Additionally, HSA accounts have limits of $3,250 for an individual and $6,450 for a family. Prior to *Windsor*, both individuals in a same-sex couple could establish an HSA and potentially contribute the maximum contribution for a family, *i.e.*, each individual could have an account subject to the $6,450 contribution limit (for a total of $12,900) rather than the $3,250 limit. Now, same-sex couples may only contribute up to $6,450 for the family contribution limit to an HSA because the same-sex spouse is now recognized as a spouse.

An HRA is an employer-funded account that reimburses a participant for medical expenses paid on behalf of the participant, the participant's spouse and dependents. The participant may then receive reimbursement from these accounts for medical expenses paid on behalf of the participant, the participant's spouse and dependents. Prior to *Windsor*, a participant generally could not use an HRA for reimbursement of medical expenses for a same-sex spouse. After *Windsor*, a participant may use money in the HRA for reimbursement of medical expenses of a same-sex spouse.

3. Employment Taxes

When a same-sex spouse participated in a health plan, the employer sponsoring the plan imputed taxable income equal to the value of the coverage to the participant. This imputed income was also subject to FICA taxes. After *Windsor*, income is no longer imputed to a participant for health benefits provided to a same-sex spouse. Employers may want to consider filing a refund for FICA taxes paid on imputed income.[xx] The IRS is in the process of setting up a special administrative procedure for employers to file for refunds or make adjustments for excess FICA taxes paid on same-sex spouse benefits.

4. COBRA Rights

COBRA provides temporary continuation of health coverage at group rates for qualified beneficiaries. A qualified beneficiary for COBRA is an employee, retiree, spouse, and dependent child. COBRA coverage generally continues for 18 months, but can last up to 36 months for a spouse that is losing coverage due to a divorce. Prior to *Windsor*, a same-sex spouse could not qualify for COBRA coverage. After *Windsor*, a same-sex spouse may qualify for COBRA coverage, including the extended COBRA continuation coverage for loss of benefits due to divorce.

5. HIPAA Special Enrollment Rights

Generally, an individual may only enroll in an employer-sponsored health plan as a new hire or during open enrollment. HIPAA provides for special enrollment rights in an employer-sponsored health plan when an employee, spouse, or dependent loses coverage. Prior to *Windsor*, a same-sex spouse was not eligible for HIPAA special enrollment rights. After *Windsor*, a same-sex spouse would qualify for HIPAA special enrollment rights.

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Unresolved Matters to Consider after *Windsor*

While the IRS's and DOL's guidance helped plan sponsors determine how to treat a same-sex spouse, questions still remain. For instance, how will employers determine if an employee is in a same-sex marriage? Employers may want to consider providing a notice to all employees about the *Windsor* ruling and request employees notify human resources of marital status. Employers that currently offer domestic partner benefits may want to consider contacting participants that receive domestic partner benefits and request whether such individuals are in same-sex marriages or domestic partnerships. Employers may also want to consider how they will determine if an employee is in a marriage, regardless of a same-sex marriage or opposite-sex marriage. For instance, employers may want a statement of marriage, *e.g.*, a check-the-box approach with spousal information, or they may want to receive a copy of the marriage license. Regardless of the approach taken, employers should be cognizant of treating a same-sex marriage different than an opposite-sex marriage.

One of the issues for qualified retirement plans is whether there is a retroactive aspect to the ruling in *Windsor*. For example, a participant with a same-sex spouse participates in the employer's 401(k) plan. Participant designates mother as beneficiary rather than the same-sex spouse, and participant later dies prior to the *Windsor* ruling. The plan distributes the participant's account balance pursuant to the beneficiary designation. Prior to *Windsor*, this was acceptable because the same-sex spouse was not recognized and did not have to consent to the beneficiary designation. After *Windsor*, the same-sex spouse is recognized and must consent to the beneficiary designation. Is the plan subject to liability for having paid benefits to a non-spouse beneficiary without spousal consent? This can be prevented in the future, but to do so employers should provide notice to their employees and determine which of their employees are in same-sex marriages so that the employer may obtain the proper documentation for plan purposes, *e.g.*, spousal consent forms.

One of the issues for health and welfare plans is whether the same-sex spouse has a mid-year enrollment right. This was not addressed in the IRS guidance provided. Arguably, the employee's marital status has changed for plan purposes with the ruling in *Windsor*. Accordingly, this may create a special enrollment right under HIPAA.

Conclusion

Windsor placed same-sex spouses on equal footing with opposite-sex spouses for federal benefits. The IRS's and DOL's interpretation of *Windsor* applying the "state of celebration" approach in determining a spouse in a same-sex marriage effectively rendered section 2 of DOMA largely meaningless for employee benefit plans subject to ERISA. Employers located only in a state that does not recognize same-sex marriage should take notice of the treatment of same-sex spouses for employee benefit plans. The "state of celebration" approach requires all employers with employee benefit plans to recognize the same-sex marriage for ERISA purposes and treat the same-sex spouse as a spouse for employee benefit plans. The same-sex spouse now has spousal rights under qualified retirement plans. The same-sex spouse may also participate in

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a health plan without the value of the benefit being imputed taxable income to the participant. Finally, employers should consider how they are going to determine a same-sex marriage exists while being wary of requesting additional information from same-sex couples that is not requested from opposite-sex couples, and begin the process of implementing the new rules.

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[ii] *United States v. Windsor,* 133 S. Ct. 2675, 530 U.S. __ (2013); *also available at http://www.supremecourt.gov/opinions/12pdf/12-307_6j37.pdf.*

[iii] 1 U.S.C. § 7.

[iv] *Windsor,* 133 S. Ct. at 2695-96.

[v] *Id.* at 2694.

[vi] *Id.* at 2696.

[vii] ERISA includes provisions under the Internal Revenue Code and the Labor Code. Authority to interpret ERISA is delegated between the IRS, DOL and Pension Benefit Guaranty Corporation (PBGC).

[viii] *http://www.whitehouse.gov/blog/2013/06/27/obama-administration-statements-supreme-court-s-doma-ruling*.

[ix] *Windsor*, 133 S. Ct. at 2682-83.

[x] 28 U.S.C. 1738C.

[xi] The Revenue Ruling provides that state is any domestic or foreign jurisdiction having the legal authority to sanction marriages.

[xii] The Technical Release provides that state is any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, American Samoa, Guam, Wake Island, the Northern Mariana Islands, any other territory or possession of the United States, and any foreign jurisdiction having the legal authority to sanction marriages.

[xiii] A participant may elect the qualified optional survivor annuity (QOSA) without spousal consent if the QOSA is actuarially equivalent to the QJSA.

[xiv] Pension Protection Act of 2006, P.L. 109-280 (August 17, 2006).

[xv] 26 U.S.C. § 401(a)(9).

[xvi] 26 U.S.C. § 414(p).

[xvii] A same-sex spouse may have received a QDRO prior to *Windsor* if the spouse qualified as a dependent of the participant.

[xviii] Consolidated Omnibus Budget Reconciliation Act of 1986.

[xix] Health Insurance Portability and Accountability Act of 1996

[xx] Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law, Q&A 12-14, *available at http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples*.

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Defending the §199 Deduction in Audit and Appeals

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- **Americas Capital Markets Tax Deal of the Year—High yield issuance by Linea Amarilla**

Agenda

- Background of §199
- Operation of §199
- Defending §199 Deduction in Audit and Appeals
- Current Controversy Issues Under §199
  - Support for Computing the Benefit
  - Contract Manufacturing
  - Software vs. Services
  - Acquisitions
- Final Thoughts

BACKGROUND OF §199

Enactment and Impact of §199

- Centerpiece of the American Jobs Creation Act of 2004
- Intended to enhance U.S. job growth and competitiveness
  - Provides a tax subsidy for domestic production
  - Replaced a series of export subsidies (DISCs, FSCs, and ETI) found to violate WTO obligations
- Built-in tension: While seeking to incentivize U.S. production, §199 also imposes many limitations on the ability to claim such benefits
- Highly complex and difficult to administer
  - IRS Commissioner publicly asked Congress not to pass it
  - A similar Canadian tax provision had been repealed as unworkable
- Attracts attention: Revenue impact of $76 billion over 10 years

Heightened Scrutiny for §199 Claims

- Troublesome Optics
  - Was a Tier 1 issue made to keep company with tax shelters
  - In June 2012, tiering replaced by Issue Practice Groups ("IPGs") dedicated to §199 audits
- Highly coordinated
  - Technical Advisors and LB&I attorneys regularly confer with National Office attorneys to discuss §199 technical issues
  - Training and assistance for teams auditing large §199 deductions
- Recent CCAs and TAMs interpret regulations and case law in unduly restrictive manner
  - CCA 201208029 (Feb. 24, 2012)—Deduction disallowed for the gross receipts from the sale of natural gas lease because the leasehold rights sold were the same rights that the taxpayer acquired by entering into the lease

OPERATION OF §199

§199 Overview

- Phases in a deduction for income attributable to domestic production activities, depending on beginning of taxable year—
  - 2005 or 2006 .... 3%
  - 2007, 2008 or 2009....................... 6%
  - 2010 or later.................................... 9%
- Current 9% rate $\Rightarrow$ ETR reduction $\approx$3%
- Deduction is capped at 50% of the taxpayer's wages that are allocable to its domestic production gross receipts

Calculating the Deduction

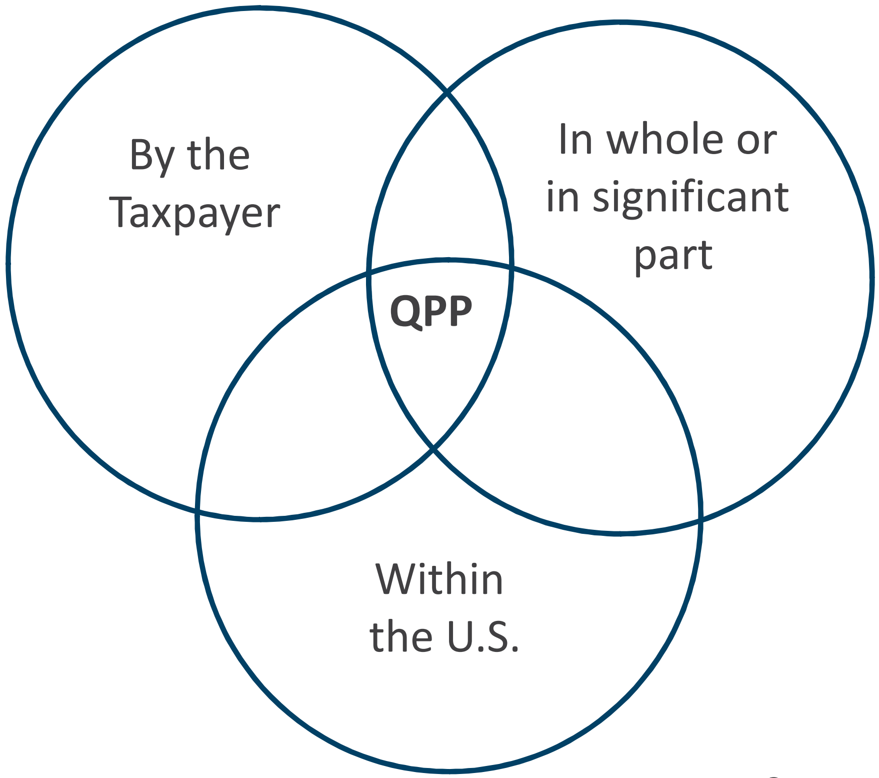
- Applicable percentage is multiplied by the lesser of:
  - Qualified Production Activities Income (“QPAI”), or
  - Taxable Income (determined without regard to §199 deduction)
- QPAI =
  - Taxpayer’s Domestic Production Gross Receipts (“DPGR”), less
  - Cost of goods sold, expenses, losses and deductions allocable to such receipts

Special §199 Rules for "Oil Related QPAI"

- For any taxable year beginning after 2009, special rules apply to taxpayers with oil related QPAI
- The allowable §199 deduction is reduced by 3% of the least of:
  - Oil related QPAI
  - QPAI
  - Taxable income (determined without regard to §199 deduction)
- Definition of "Oil Related QPAI"
  - Income attributable to the production, refining, processing, transportation or distribution of oil, gas or any "primary product" thereof during such tax year
  - "Primary product of oil" = crude oil and all products derived from the destructive distillation of crude oil (including products or commodities derived from shale oil which would be primary products from oil if derived from crude oil)
  - "Primary product of gas" = all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing

Definition of Qualifying Production Property ("QPP")

- QPP includes tangible personal property, computer software, and sound recordings that are manufactured, produced, grown, or extracted ("MPGE"):



- Each of these requirements can create factual disputes

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Definition of "MPGE"

- MPGE includes:
  - Manufacturing, producing, growing, extracting, installing, developing, improving, creating QPP
  - Making QPP out of scrap, salvage, junk, new or raw material by processing, manipulating refining or changing the form of an article, or by combining or assembling two or more articles
- MPGE does not include:
  - Packaging, repacking, labeling or minor assembly
  - Installing

Definition of MPGE (cont'd)

- MPGE activity must be "substantial in nature" based on facts and circumstances
  - MPGE of key component is not itself sufficient
  - Take into account design and development activities for computer software and sound recordings
- Safe harbor if direct labor and overhead to MPGE within the United States is ≥ 20% of cost of goods sold

Definition of MPGE (cont'd)

- FAA 2013302F (August 16, 2013)
  - A pharmacy care provider that operated photo labs was entitled to deductions for its photo processing and printing activities that resulted in photo products. The pharmacy care provider used its own equipment and raw materials to produce a different tangible product in form and function—finished photos and photo books.
  - However no §199 deductions were allowed for activities related to "the process of affixing a customer's intangible files to a CD or DVD not manufactured by the taxpayer" because "neither the intangible files nor the CD or DVD are changed to a different form" and are thus "not an MPGE activity."

Definition of DPGR

- DPGR is gross receipts derived from:
  - Any lease, rental, license, sale, exchange, or other disposition of
    - ***QPP*** which was MPGE by the taxpayer in whole or in significant part within the United States
    - Any qualified film produced by the taxpayer
    - Electricity, natural gas or potable water produced by the taxpayer in the United States
  - Construction of real property performed in the United States by the taxpayer in the ordinary course of trade or business
  - Engineering or architectural services performed in the United States by the taxpayer in the ordinary course of trade or business with respect to the construction of real property in the United States

Additional Factual Issues in Determining DPGR

- DPGR is determined on an item-by-item basis
  - "Item" is property offered by taxpayer in the normal course of the taxpayer's business for disposition if the gross receipts from the disposition of such property qualify as DPGR
  - If such item does not qualify, apply the shrink-back rule to test if a component can qualify
- DPGR does not include gross receipts from services
  - Apply Federal income tax principles to facts and circumstances
    - "Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof."
  - De minimis Rule: If 95%+ DPGR, then treat 100% as DPGR, and vice versa

Special §199 Rules for Energy Industry – Definition of DPGR

	Electricity	Natural Gas
DPGR (Production)	•Production of electricity	•Extraction of natural gas from the ground • Processing natural gas into pipeline quality gas
Non-DPGR (Transmission or Distribution)	•Transmission of electricity from generating facility to point of local distribution • Distribution of electricity to final customers	•Transmission of pipeline quality gas from natural gas field or processing plant to local distribution company's city gate (or to another customer) • Purchase and distribution from city gate to local customers

Proposed Legislation Affecting §199 for Energy Industry

- There is pending legislation for the repeal of §199 for oil and gas companies
  - Excludes from DPGR gross receipts derived from the production, refining, transportation, or distribution of oil, natural gas, or any primary product
  - Removes special rules for taxpayers with oil related QPAI
- Legislative efforts to modify and repeal §199 have been ongoing since at least 2007
- Obama's FY2014 Budget targeted repeal of §199 for, among others, oil and natural gas companies

DEFENDING §199 DEDUCTION IN AUDIT AND APPEALS

Defending §199 Deduction

- Administrative guidance and pending court decisions create substantial uncertainty under §199 for many taxpayers
- Possible ways of obtaining certainty before filing of tax return:
  - Pursue a Pre-Filing Agreement ("PFA")
  - Participate in Compliance Assurance Process ("CAP")
- Key actions to prepare for when defending §199:
  - Perform detailed analysis of current operations
  - Implement necessary systems to track qualifying receipts and expenses at proper level of granularity
  - Document testimony of operational witnesses
- The Exam Team could issue an Information Document Request ("IDR"), request interviews and summon third-party witnesses

IDR Best Practices

- Document analysis undertaken to conclude that §199 deduction was appropriate
  - Complete documentation before the tax return is filed
- If receive opinion from in-house or outside advisors:
  - Consider qualifications of counsel and their role in transaction
  - Review legal and factual assumptions
  - Assess reasonableness of legal analysis
  - Document and retain this review
- Review and update analysis and opinions in future tax years, particularly if there are new developments in the tax law
- Consider the extent to which the *IRS* could rely on press releases or SEC filings in raising alternative arguments that contradict analysis and opinions

Establishing and Maintaining Privilege

- Recognize that privilege may be waived; exercise care in documenting analysis and opinions and in determining what documents are provided to the Exam Team
  - Attorney-Client Privilege: Strongest, but waiver to any "third party" (even an auditor) waives privilege on subject
  - §7525: Good until you reach the court room
  - *Kovel*: Extends A/C privilege and §7525 to others who have been engaged by attorney/accountant to assist
  - Work Product Doctrine: Relatively strong, but waived for specific documents shown to adversary

Establishing and Maintaining Privilege (cont'd)

- Segregate protected documents
- Label protected communications and information
  - Failing to label protected information may cause unintended distribution of documents and waiver of the protection
  - Labeling non-privileged information as "privileged" may effect a subject matter waiver if the information is subsequently disclosed to third parties
  - Labeling information as "work product" may trigger document retention obligations by the company
  - Consider whether a label is necessary for non-public corporate information

Strategies for Managing Interview Requests

- Understand what the Exam Team is trying to accomplish
- Be part of the discussion of who is selected
- Negotiate the place and timing
- Set reasonable limits on the number of interviews and length
- Consider informal versus formal interviews

Strategies for Preparing Employees for IRS Interviews

- Advise employees to respond based on actual knowledge, not speculation
- Advise employees not to disclose the contents of communications with attorneys; even disclosing the gist of communications can waive privilege
- Avoid showing the employees privileged or sensitive documents
  - In litigation, FRE 612 requires documents shown to refresh a witness's recollection to be produced, notwithstanding assertions of privilege/work product, where:
    - The witness uses a writing to refresh memory for the purpose of testifying, either while testifying or before testifying, and
    - The court in its discretion determines that production is necessary in the interests of justice
- Avoid discussing strategy or sharing work product with fact witnesses
- Consider implications of joint preparation of employees
- Caution employees that they should not discuss the interview with others

Impact of §199 Audit in Administrative Appeals

- §199 issue that is not raised or that is resolved at audit generally cannot be addressed in Appeals based on new IRS Appeals guidance issued in July 2013
  - New guidance relates to implementation of the Appeals Judicial Approach and Culture (AJAC) Project
  - AJAC Project returns Appeals to quasi-judicial approach in handling cases
- New guidance relating to new issues/reopening issues (IRM 1.2.17.1.2, Policy Statement 8-2; IRM 8.6.1.6)
  - Now prohibits new issues raised by the Government from being raised in Appeals and agreed issues from being reopened in Appeals
  - Exception: §7121 – "showing of fraud or malfeasance, or misrepresentation of a material fact"
  - BUT, in a docketed case, Appeals will consider new issues the Government raises in its pleadings (IRM 8.4.1.15.3)

Impact of §199 Audit in Administrative Appeals (cont'd)

- "New issues" are:
  - Issues identified by Appeals in non-docketed cases
  - A matter not raised during Compliance's consideration
- A "new issue" is NOT:
  - A new theory or alternative argument
  - A change in computation
  - Discussion of new or additional authorities that support a theory or argument previously presented
  - Newness of §199 has led Appeals to request IRS National Office guidance on applying §199
    - CCA 201313020 (March 29, 2013): Appeals asked National Office to determine whether book publisher's activities (without regard to activities of the contract manufacturer) constitute production under §199

CURRENT CONTROVERSY ISSUES UNDER §199

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SUPPORT FOR COMPUTING THE BENEFIT

Does the Benefit Apply?

- Would the IRS agree that the benefit applies in the first place?
  - There are examples of the IRS exercising narrow discretion to limit application of §199. For instance:
    - CCA 201313020: By deliberately limiting the issues to be addressed, taxpayer's activities relating to the production of an electronic version of a book (that it provides to the contract manufacturer for mass production) is not QPP
    - CCA 201246030: Denied §199 deduction by disregarding unique functional value of combined components where taxpayer made and sold "blister packs" that contained third-party pills and information about the medication
- Would the courts agree with the IRS?
  - *United States v. Dean*, No. 11-01977 (C.D. Cal. 2013): §199 deduction allowed for taxpayer's arrangement of individual items into gift baskets
  - How to reconcile *Dean* and CCA 201246030?

Does the Benefit Apply?

- An additional, favorable Tax Court case
  - *Gibson & Associates Inc. v. Comm'r*, 136 T.C. 195 (Feb. 2011)—§199 deduction allowed for engineering and construction projects because the work performed substantially renovated real property by (1) renovating a major component or substantial structural part of real property and (2) materially increasing the value of the real property, substantially prolonging the life of the real property, and/or adapting the real property to a different or new use

Support for Computing the Benefit

- Burden is on taxpayer to support the deduction
- §199 effectively requires taxpayer to create a new set of books
- Existing accounting system and conventions may need to be adjusted to track §199 information
- Accounting firms are making the best of available options
- Keep robust documentation to defend §199 computations in audit and Appeals
- IRS is training agents to look for tracking problems as a way of denying the deduction
  - §199 IDRs have been both broad and specific

Sample §199 IDRs

IDR 1

- Describe the Taxpayer's activities giving rise to the income which you claim are eligible for inclusion in the calculation of the §199 deduction
- Provide receipts for the income which you claim are eligible for inclusion in the calculation of the §199 deduction
- Explain your computation for the §199 deduction including any allocations, §861 apportionment and wage and taxable income limitations that was applied

IDR 2

- Provide a detailed explanation and computation for the §199 deduction for the year under examination. This explanation should include the supporting documentation for the amounts reported on Form 8903.

IDR 3

- Given that Taxpayer is an international company with global operations, how did you determine that all U.S. revenues per the §199 calculation spreadsheet were derived from software MPGE *in whole or in significant part in the United States*? For example, was any of the software MPGE in locations outside the United States?

Sample §199 IDRs (cont'd)

IDR 4

- Provide the workpapers, calculations, tax authority and other relevant information used to determine the qualifying vs. nonqualifying revenues for each of your revenue segments
- Provide the "Profitability Report" used to determine expenses by revenue segment

IDR 5

- Provide a copy of the engagement letter with Accounting Firm regarding §199 deduction studies
- Provide a copy of Accounting Firm's report on §199 deduction study

Sample §199 IDRs (cont'd)

- Why is the IRS asking these particular questions?
  - Looking for a lack of documentation and filtering of non-qualifying items
  - Looking for signs of prepackaged study by accounting firm vs. vetting by company
  - Same questions asked to all taxpayers at the direction of National Office
- How to best respond?
  - Make extra effort to assemble/organize an unassailable package of documentation and analysis of qualifications
  - Include company-branded documentation and analysis
  - Stand out from the crowd as hyper-organized and diligent

CONTRACT MANUFACTURING

Contract Manufacturing

- Many companies today in a variety of industries use CMs to manufacture goods to their specifications
- So who gets the §199 deduction – the taxpayer or the CM?
- §199 says:
  - Only one party gets it – the party with the benefits and burdens of ownership ("BBO") during the period in which the MPGE activity occurs is treated as engaging in the MPGE activity
  - There are two examples in the regulations, but they provide little guidance on how to apply the BBO test
  - Apply federal tax principles to determine which party has the BBO

Federal Income Tax Principles Are Favorable

- There is a nearly identical "benefits and burdens" test for determining whether a taxpayer is a "producer" of property for capitalization requirements under §263A
  - *Suzy's Zoo v. Comm'r*, 114 T.C. 1 (2000), *aff'd*, 273 F.3d 875 (9th Cir. 2001) (taxpayer designed greeting cards, selected printers, and controlled production process; printers had no right to sell products to third parties; taxpayer is producer)
- Similar considerations were controlling for a former federal manufacturing excise tax applied using principles of tax ownership in the contract manufacturing context
  - *Polaroid Corp. v. United States*, 235 F.2d 276 (1st Cir. 1956) (application of manufacturing excise tax depends on whether during manufacturing taxpayer possessed a "proprietary interest" – incidents of ownership in manufactured articles, including right to sell any finished goods to third parties)

IRS Approach to Contract Manufacturing – July 2013 Directive

- In July 2013, the IRS issued a Directive requiring examiners to obtain certification statements from a taxpayer as to who has the BBO under a contract manufacturing arrangement
  - Examiners should not challenge if forms are provided
  - The forms must typically be received within 30 days of the date of an IRS information document request regarding the §199 deduction
- If the taxpayer does not provide the certification statements, the IRS should not presume that the taxpayer does not have the BBO
  - Examiners should apply regular audit procedures
  - Query if this means the factors described in the superseded February 2012 Directive will still be applied?

IRS Approach to Contract Manufacturing – Superseded February 2012 Directive

- In February 2012, the IRS issued a Directive to examiners to use in determining who has the BBO for purposes of §199
  - Three-part test focusing on: (1) contract terms, (2) production activities, and (3) economic risks
  - Each part asks three questions
  - If taxpayer satisfies two of the three questions in two of the three parts, then taxpayer has BBO. Otherwise, consider all relevant facts and circumstances.

BBO Is Being Litigated in Tax Court

- IRS’s position has resulted in litigation by several companies
- If the typical CM relationship does not enable the manufacturing principal to claim the §199 deduction, then few, if any, companies employing CMs will be able to benefit from §199’s incentive to manufacture in the United States

BBO Cases in Tax Court

- *Limited Brands, Inc. and Subs. v. Commissioner*, Docket No. 17903-10 (Tax Ct. filed Aug. 10, 2010)
  - Taxpayer manufactures and sells Bath & Body Works and Victoria's Secret products
  - Taxpayer uses CMs that provide printing, machining, molding, mixing and filling services
  - Taxpayer's employees participate in and control the design, development, manufacturing, and testing of the products
  - Taxpayer believed it had the BBO under the facts and circumstances and claimed a §199 deduction

BBO Cases in Tax Court (cont'd)

- *ADVO, Inc. v. Commissioner*, Docket No. 17247-10 (Tax Ct. filed Aug. 2, 2010)
  - Taxpayer sells printed advertising products
  - Uses CMs that provide printing services
  - Maintains direct supervision and control over CMs through certain contractual rights and controls the printed product specifications, production schedules, and quality requirements
  - Taxpayer believed it had the BBO under the facts and circumstances and claimed a §199 deduction

Sample §199 IDRs:
Contract Manufacturing Cases

IDR 1

1. Who owns the equipment and plant used to produce the QPP?
2. Who employs the contract manufacturer’s employees (who is liable for any worker’s compensation claims)?
3. Who has direct control over the contract manufacturer’s equipment, plant and employees?
4. Who controls the physical production of the materials?
5. Which party conducts quality control (determined by which party conducts the most tests or samples)?
6. Who maintains control over inventory during production?
7. Who reviews inventory?
8. Who controls the production schedule?
9. How are modifications handled with respect to production?
10. Who directly pays for new technology and production methods?
11. Who pays for and/or own the dies, molds, etc. used in the production process?
12. Who provides the majority of the raw materials or components, determined by the relative cost of such raw materials (selection or pre-approved vendors does not meet factors)?
13. Who has the expertise and the know-how over the manufacturing process?

Sample §199 IDRs –
Contract Manufacturing Cases (cont'd)

IDR 2

1. Who is responsible for over consumption by the CM? This is defined as the CM "messing" up and using more than allowed raw material?
2. If a batch does not pass muster because the CM messed up the formula, who is responsible for the materials?
3. Does the CM still get paid for a "bad" batch caused by the CM?
4. What specific equipment is provided by Taxpayer to CM? Please provide the specifics of the equipment.
5. How many Taxpayer personnel at CM? How often? At what stage of production?
6. What specific quality control steps are take by Taxpayer?
7. How does Taxpayer approve the production steps or "batches"?
8. Please provide explanation and support to the statement that Taxpayer "direct" the manufacturing line.
9. How often does Taxpayer audit the CMs? Please provide support such as timesheets, schedules, etc?
10. Taxpayer stated "at the end they sometimes pay for the materials delivered to the CMs." How often this is done? How much are Taxpayer talking about?

Sample §199 IDRs – Contract Manufacturing Cases (cont'd)

- Why is the IRS asking these particular questions?
  - To portray typical CM terms as non-BBO
  - To pose unrealistic fact patterns designed to show that CM is not a pure cost-plus service provider
- How to best respond?
  - Understand contractual terms, rights, and responsibilities
  - Understand pricing and who bears risks/rewards
  - Talk with operations folks
  - Focus on development and production of new products where company involvement is likely greater
  - Document company involvement in manufacturing process (*e.g.*, SOPs, production schedules, QC, travel receipts, etc.)

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SOFTWARE VS. SERVICES

Determining DPGR from Software Transactions

- DPGR includes gross receipts from software developed by taxpayer in whole or in significant part within the U.S.
  - "Computer software" is broadly defined
  - Includes software provided by disk and by download
- DPGR does not include gross receipts derived from services
  - Customer and technical support
  - Telephone and other telecommunication services
  - Online services (Internet access services, online banking services, providing access to online electronic books, newspapers, and journals)
  - Other similar services
- Therefore, "online software" (software accessed through an Internet browser) generally does not generate DPGR

Two Exceptions for Online Software as DPGR

- Congress pushed Treasury to create online software exception
- Revenue from online software can qualify as DPGR if:

    1. The ***Taxpayer***, on a regular and ongoing basis derives gross receipts from the sale of same software (with ***only minor or immaterial differences*** from online software) that is provided to customers either affixed to tangible medium or via Internet download
    2. An **unrelated person**, on a regular and ongoing basis, derives gross receipts from ***substantially identical*** software that is provided to customers either affixed to tangible medium or via Internet download

        "Substantially identical" means such software (1) "from a customer's perspective, has the same functional result" and (2) "has a significant overlap of features or purpose" with the taxpayer's online software

CCA 201226025 (June 2012)

- Taxpayer represented that, in the aggregate, certain 3rd-party computer software products were equivalent to taxpayer's online software
- ***Holding*—**If unable to find a single offline program with all the same features as online program, cannot aggregate multiple offline programs to satisfy 3rd-party comparable exception
- ***But***, can break online software program into its components
  - Can favorably use "shrink back rule" to qualify the gross receipts from features of its online software program for which it could identify "substantially identical" offline programs
  - Each feature needs to satisfy the general §199 requirements
  - No guidance on how the taxpayer should allocate gross receipts to qualifying and nonqualifying features (if any)

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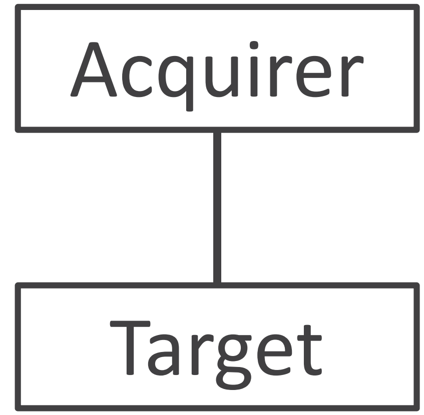
Other Software vs. Services Issues

- While online software is a clear target of the IRS, the IRS can make a services argument in other contexts as well
- Hypothetical:
  - Taxpayer develops, markets, and licenses software to institutions for royalties based on use
  - Institutions use software to provide services to end users
- ***Query*****—**Can IRS deny §199 deduction to Taxpayer under a joint "services" theory?
  - Acknowledge license, but attribute zero revenue to it
  - Misconstrue contractual provisions designed to protect IP of Taxpayer
  - Conflate marketing of software with marketing of services

ACQUISITIONS

Acquisitions



Hypothetical:

- Target is a calendar year taxpayer
- As a result of an acquisition by Acquirer on 10-31-12, the taxable year of Target ends

Query**—**What is Target's §199 deduction for its short taxable year ending 10-31-12?

- The §199 deduction is capped by 50% × allocable W-2 wages.
- The term W-2 wages means, with respect to any person for any taxable year of such person, the sum of the certain amounts described in §§6051(a)(3) & (8) paid by such person with respect to employment of employees by such person <u>during the calendar year ending during such taxable year</u>. §199(b)(2) & §1.199-3(e)

FINAL THOUGHTS

Final Thoughts

- §199 provides a valuable benefit but comes with a high compliance cost and uncertainty
- The IRS is using a variety of theories that purport to disallow the §199 deduction in its entirety
- For certainty, taxpayers may consider seeking a PFA with the IRS
  - Can result in a statutory closing agreement to resolve the issue for a taxpayer’s current tax year and up to 4 years into the future
  - To date, successful completion of at least 7 PFAs on §199
- In the absence of a PFA, taxpayers should consider how they will defend their §199 claim and whether any financial reserves are appropriate
- Approach §199 as though it were the R&E Credit 2.0

QUESTIONS & ANSWERS

Circular 230 Disclaimer

- This presentation may not be used to avoid tax penalties under U.S. law.
- This presentation does not render tax advice, which can be given only after considering all relevant facts about a specific transaction. Consult a professional tax adviser for tax advice.

QUALIFYING YOUR CLIENT'S PROPERTY FOR PROPERTY TAX EXEMPTION IN TEXAS

BY

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State Bar of Texas
NONPROFIT ORGANIZATIONS COURSE
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John Brusniak, Jr. is a nationally recognized property tax attorney. His ground-breaking appellate successes over the past 30 years and his active involvement with the legislature have significantly influenced Texas property tax law. He is a frequently sought speaker and publisher of property tax articles and texts. John has been recognized by his peers with election to the positions of chair of the American Bar Association's Property Tax Committee, chair of the State Bar of Texas Property Tax Committee, and chair of the entire State Bar of Texas Section of Taxation. He has repeatedly been selected as one of Texas' Super Lawyers and one of The Best Lawyers in America. John is a partner of the property tax specialty law firm of Ryan Law Firm, LLP and is President of the National Association of Property Tax Attorneys, an elite organization of the top property taxpayer attorneys in the United States.

I. Standards.

A. Constitutional Basis. Texas views exemptions of property from taxation restrictively. To qualify for exemption, specific authorization must be found in Article VIII of the Texas Constitution. If an authorization is found in the Constitution, the taxpayer must also meet the qualification requirements established by the Legislature. *North Alamo Water Supply Co. v. Willacy County Appraisal District, 804 S.W.2d 894 (Tex. 1991); First Baptist/Amarillo Foundation v. Potter County Appraisal District, 813 S.W.2d 192 (Tex. App.-Amarillo 1991, no writ); Op. Tex. Att'y Gen. No. JM-682 (1987).*

B. Rules of Construction.

1. Burden of Proof. The burden of proving a property qualifies for exemption is on the taxpayer. *River Oaks Garden Club v. City of Houston, 370 S.W.2d 851 (Tex. 1963).*

2. Doubts as to Qualification. All doubts as to the exempt status of a property are resolved against the taxpayer. *Trinity Methodist Episcopal Church v. City of San Antonio, 259 S.W. 296 (Tex. Comm'n App. 1924, opinion adopted).*

3. Standards of Construction. All constitutional provisions are construed in light of the conditions that existed at the time of the adoption of the constitutional provision. The Legislature does not have the power to alter constitutional provisions. *Swearingen v. City of Texarkana, 596 S.W.2d 157 (Tex. Civ. App.-Texarkana 1979, writ ref'd n.r.e.).*

4. Presumption of Constitutionality. All statutes are presumed to be constitutional, and they will not be held unconstitutional unless it is absolutely necessary to do so. *McCreless v. City of San Antonio, 464 S.W.2d 346 (Tex. 1971).*

5. Ownership. With limited exceptions, a person seeking an exemption must be the owner of the property. Leasing property to an exempt organization does not qualify a property for exemption; however, leases that are financing mechanisms, may qualify a property for exemption if under the lease the exempt organization is the equitable owner of the property. *Texas Department of Corrections v. Anderson County Appraisal District, 834 S.W.2d 130 (Tex. App.-Tyler 1992, writ denied).* Real property leased by charitable organizations to institutions of higher education qualify for exemption. TEXAS PROPERTY TAX CODE § 11.18(p).

6. Partial Ownership. If a qualified person is not the sole owner of a qualified property, then the exemption is prorated based upon the percentage of ownership by the qualifying person. TEXAS PROPERTY TAX CODE § 11.41; *Martinez v. Dallas Central Appraisal District, No. 05-09-00858-CV (Tex. App.–Dallas, March 22, 2011, no pet. h.). (to be published).*

II. Public Property. Property owned by the United States, the State of Texas, a county, a city, a school district (or any other governmental unit) is exempt from taxation provided that it is used for a governmental function. *Texas Department of Corrections v. Anderson County Appraisal District, 834 S.W.2d 130 (Tex. App.-Tyler 1992, writ denied).* Public property used for a private purpose or leased to private taxpayers is taxable; *Gables Realty Limited Partnership v. Travis Central Appraisal District, 81 S.W. 869 (Tex. App.–Austin 2002, pet. denied); Grand Prairie Hospital Authority v. Dallas Central Appraisal District, 730 S.W.2d 849 (Tex. App. - Dallas 1987, writ ref'd n.r.e.);* however, residential housing used in connection with the operation of a cancer treatment facility is exempt. *Op. Tex. Att'y Gen. No. DM-272 (1993).*

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III. Federal Exemptions. Property that is exempt from taxation by virtue of federal law cannot be taxed. TEXAS PROPERTY TAX CODE § 11.12. For example, property that is in the stream of foreign or interstate commerce (and that has not acquired a tax situs in Texas) is exempt from taxation. *See Midland Central Appraisal District v. BP America Production Co., 282 S.W.3d 215 (Tex. App. –Eastland 2009, pet. denied) cert. denied 131 S. Ct. 2097 (2011); Harrison Central Appraisal District v. The Peoples Gas, Light and Coke Co., 270 S.W.3d 208 (Tex. App.–Texarkana 2008, pet. denied) cert. denied 131 S. Ct. 2097 (2011); Diamond Shamrock Ref. & Mktg. Co. v. Nueces County Appraisal District, 876 S.W.2d 298 (Tex. 1994), cert. denied 115 S.Ct. 500 (1994); Harris County Appraisal District v. Virginia Indonesia Co., 871 S.W.2d 864 (Tex. App.-Houston [14th Dist.] 1994, writ granted); Harris County Appraisal District v. Transamerica Container Leasing, Inc., 821 S.W.2d 637 (Tex. App.-Houston [1st Dist.] 1991, writ denied).*

IV. Homestead and Farming Exemptions.

A. Mandatory Homestead Exemptions. Counties are required to grant a $3,000 residential homestead exemption, and school districts are required to grant a $15,000 residential homestead exemption. TEXAS PROPERTY TAX CODE §§ 11.13(a) and (b).

B. Discretionary Homestead Exemptions. Additionally, taxing units, with the approval of their voters, are allowed to exempt up to an additional 20% of value of a residential homestead. If they do, in no event may they exempt less than an additional $5,000. TEXAS PROPERTY TAX CODE § 11.13(n). The existence of these exemptions must be verified directly with each taxing entity. Some appraisal districts maintain comprehensive lists of exemptions and post them on line.

C. Mandatory Exemptions for the Elderly and Disabled. School districts are required to grant an additional $10,000 homestead exemption to property owners who are over the age of 65 or who are disabled. TEXAS PROPERTY TAX CODE § 11.13(c).

D. Discretionary Exemptions for the Elderly and Disabled. Governmental unit (or their voters through petitioned election) may exempt additional amounts on residential homestead properties owned by the elderly and the disabled. TEXAS PROPERTY TAX CODE §§ 11.13 (c)-(g). As with regular homestead exemptions, the existence of these additional homestead exemptions must be verified directly with each taxing entity.

E. Tax "Freezes" for Elderly and Disabled. Unless a disabled individual or an individual over the age of 65 makes bona-fide improvements to his or her residence, a school district may not assess any taxes over the amount that were assessed when the individual reached 65 years of age or became disabled. TEXAS PROPERTY TAX CODE § 11.26. These tax limitations are commonly referred to as "tax freezes." Other taxing units, in their discretion, may offer a tax freeze as well.

F. Valuation Limitations. The taxable value of a residential homestead after its initial valuation may not be increased by more than ten percent in any subsequent tax year. The value of any improvements made to the property may be added to the valuation. The limitation expires on January 1 of the tax year after the property ceases to qualify as the residential homestead of the owner. TEXAS PROPERTY TAX CODE §23.23.

G. Portability of Tax Freeze. A qualified person who sells a residential homestead that has a tax freeze may carry the freeze over to a new homestead property on a pro-rata basis. TEXAS PROPERTY TAX CODE § 11.26 (g).

H. Tax Deferrals. Persons over 65 and disabled individuals may defer the payment of their residential homestead taxes until 180 days after the property ceases to be their residential homestead by filing an affidavit with the chief appraiser stating the request. The affidavit stops all collection processes and all subsequent taxes accrue interest at the rate of eight percent per annum, but no penalties. TEXAS PROPERTY TAX CODE §33.06.

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I. Household Furniture, Cars, Planes and Boats. Tangible personal property not producing income (e.g., household furniture, cars, planes and boats) is exempted from taxation unless a governing body of a taxing unit specifically acts to make such property taxable. TEXAS PROPERTY TAX CODE § 11.14.

J. Farm Products, Farm Supplies and Implements of Farming. Farm products, farm supplies and implements of farming that are used for the production of farming income are exempt from taxation. TEXAS PROPERTY TAX CODE §§ 11.15, 11.16 and 11.161. Improvements to farms and ranches do not constitute "implements of husbandry" and are taxable. *Hawkins v. Van Zandt County Appraisal District, 834 S.W.2d 619 (Tex. App.- Eastland 1992, writ denied).* Temporary nursery stock weather protection is considered an exempt implement of husbandry. TEXAS AGRICULTURAL CODE § 71.041(5).

K. Cemetery Plots. Property that is owned, and used exclusively for human burial, is exempt from taxation provided that it is not held for profit. TEXAS PROPERTY TAX CODE § 11.17. *Laurel Land Memorial Park, Inc. v. Dallas Central Appraisal District, 911 S.W.2d 783 (Tex. App.--Dallas 1995 writ denied).*

L. Application Deadlines. Homestead exemption applications are required to be filed with the Chief Appraiser of an Appraisal District prior to May 1 of the year for which exemption is being sought. However, homestead applications may be filed, without penalty, as late as one year after the date on which the taxes on the home would have become became delinquent. TEXAS PROPERTY TAX CODE §§ 11.43(d) and 11.431. Additional homestead exemptions for the elderly become available on the individual's 65th birthday and apply for the entire year. TEXAS PROPERTY TAX CODE § 26.112. The individual has one year after the date they turn 65 to apply for this additional exemption. TEXAS PROPERTY TAX CODE § 11.43(k). Exemption application forms request the date of birth of applicants, and exemptions are granted on an automatic basis by appraisal districts that have sufficient information to determine when persons turn 65.

V. Youth, Spiritual, Mental and Physical Development Associations.

Property that is owned by a qualified organization and that is used for the three-fold purpose of spiritual, mental and physical development of boys, girls, young men and young women is exempt from taxation. TEXAS PROPERTY TAX CODE § 11.19. The organization must be principally dedicated to this purpose. If an organization is principally dedicated to another purpose (e.g., religious) or if it is dedicated principally to only one of the three purposes, the property does not qualify for exemption. *Texas Conference of Association of Seventh Day Adventists v. Leander Independent School District, 669 S.W.2d 353 (Tex. App. - Austin 1984) affirmed 679 S.W.2d 487 (Tex. 1984).*

VI. Disabled Veterans.

A veteran who is less than 100% disabled is entitled to a partial exemption on a residential homestead owned by the veteran. The exemption ranges from $5,000 to $12,000 based on the extent of the disability. TEXAS PROPERTY TAX CODE § 11.22.

A disabled veteran who receives 100% disability compensation due to a service-related disability and has a rating of 100% disabled or of individual unemployability is entitled to a total exemption of the appraised value of the veteran's residential homestead. TEXAS PROPERTY TAX CODE § 11.131.

Subject to the approval of a constitutional amendment by the voters on November 5, 2013, a disabled veteran, with a disability rating of less than 100%, who has been donated a home by a charitable organization, is entitled to a tax exemption at the same level as the disability rating. TEXAS PROPERTY TAX CODE § 11.132.

The latter two exemptions may be retained by a surviving spouse of a deceased veteran; provided that the surviving spouse does not remarry. If the surviving spouse acquires a new homestead, the spouse may carry over the dollar equivalent of the exemption to the new homestead. TEXAS PROPERTY TAX CODE §§ 11.131 and 11.132.

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Subject to the approval of a constitutional amendment by the voters on November 5, 2013, the surviving spouse of a member of the armed services killed in action is entitled to a total exemption of a homestead owned at the time of death and may retain the exemption for as long as the surviving spouse does not remarry. If the surviving spouse acquires a subsequent homestead, the surviving spouse is entitled to transfer the dollar equivalent of the original exemption to the new homestead. TEXAS PROPERTY TAX CODE § 11.132.

VII. Historic Sites.

A. Property that is designated as a recorded Texas Historical Landmark by the Texas Historical Commission and by the governing body of a taxing unit or which is designated by a taxing unit as a historically significant site in need of tax relief to encourage its preservation may be exempted from taxation. TEXAS PROPERTY TAX CODE § 11.24(a).

B. Unlike all other exemptions in the Texas Property Tax Code, this exemption is administered, not by the Appraisal District, but by the individual taxing units. Taxpayers interested in obtaining this type of exemption must make separate application with each taxing unit. TEXAS PROPERTY TAX CODE § 11.24(b).

VIII. Religious Organizations.

A. Property owned by religious organizations may be exempted from taxation if it is used as a regular place of religious worship and is reasonably necessary for engaging in religious worship. TEXAS PROPERTY TAX CODE § 11.20(a)(1).

B. Real property owned by a religious organization and used as a residence for clergy and that does not produce revenue may also be exempted. A residence may not exceed one acre in size. TEXAS PROPERTY TAX CODE § 11.20(a)(3).

C. To qualify as a religious organization, the organization must be organized and operated primarily for the purpose of engaging in religious worship or promoting the spiritual development or well-being of individuals. TEXAS PROPERTY TAX CODE § 11.20(c)(1).

D. The religious organization must be operated in a way that does not produce distributable profit or private gain. It must not pay excessive salaries. TEXAS PROPERTY TAX CODE § 11.20(c)(2).

E. The articles, bylaws or regulations of the organization must pledge the property for use in performing the organization's religious functions and on dissolution the assets of the organization must flow to another exempt entity. TEXAS PROPERTY TAX CODE § 11.20(c)(3).

F. "Religious worship" is broadly construed as including individual or group ceremony or meditation, education, and fellowship, the purpose of which is to develop reverence, homage and commitment in behalf of a religious faith. TEXAS PROPERTY TAX CODE § 11.20(e).

G. Buildings other than "churches and synagogues" may be exempted. For example, a building used by a minister to prepare religious radio programs was granted an exemption. *Highland Church of Christ v. Powell, 644 S.W.2d 177 (Tex. App. - Eastland 1983, writ ref'd n.r.e.).* Religious retreat properties may also be exempted, but only to the extent they are actively used for purposes of religious worship. *Kerrville Independent School District v. Southwest Texas Encampment Association, 673 S.W.2d 256 (Tex. App. - San Antonio 1984, writ ref'd n.r.e.).* Church parking lots also may be exempted from taxation even if they are leased out during the week. *See First Baptist Church of San Antonio v. Bexar County Appraisal District, 833 S.W.2d 108 (Tex. 1992)* and *City of Austin v. University Christian Church, 768 S.W.2d 718 (Tex. 1988).*

H. If a religious organization is denied an exemption by the Appraisal District due to a technical deficiency in its organizational or governing documents, the Appraisal District must grant an extension to the

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religious organization to the later of June 1 or 60 days after the denial of an exemption application to correct the technical deficiency. TEXAS PROPERTY TAX CODE § 11.421.

I. Religious property under active construction may be exempted for up to three years before the property is placed in actual operation. TEXAS PROPERTY TAX CODE § 11.20(f). Vacant land, owned by a qualified religious organization, that is contiguous to exempt property being used by the organization for religious worship may be exempted for up to six years if the taxpayer intends to expand its facilities onto that location. TEXAS PROPERTY TAX CODE § 11.20 (j).

J. Refunds of tax payments upon the granting of an exemption (after lawsuit) bear interest at the 90 day Treasury Bill rate, not to exceed ten percent (10%). TEXAS PROPERTY TAX CODE § 42.43(b).

IX. Schools.

A. Property owned by a person operating a school and used exclusively for school purposes may be exempted from taxation to the extent that the property is reasonably necessary for school purposes. TEXAS PROPERTY TAX CODE § 11.21(a).

B. To qualify as a school, the entity must have a regular faculty and curriculum and also have a regularly organized body of students in attendance. TEXAS PROPERTY TAX CODE § 11.21(d)(1).

C. The organization by charter, bylaw or regulation must pledge the use of its assets for school purposes and must pledge that upon dissolution its assets will be transferred to another exempt entity. TEXAS PROPERTY TAX CODE § 11.21(d)(3).

D. If a school is denied an exemption by the Appraisal District due to a technical deficiency in its organizational or governing documents, the Appraisal District must give the school to the later of June 1 or 60 days after the denial of the exemption application to correct the technical deficiency. TEXAS PROPERTY TAX CODE § 11.422.

E. Residences for administrators or faculty members are not exempt from taxation even if a significant number of educational activities take place on the property and the individual is required to reside in the residence by the terms of his or her employment contract. *Bexar Appraisal District v. Incarnate Word College, 822 S.W.2d 295 (Tex. App. - San Antonio 1992, writ denied).* Institutions whose primary purpose is to provide day care do not qualify for exemption. *Circle C Child Development Center, Inc. v. Travis Cent. Appraisal Dist., 981 S.W.2d 483 (Tex. App.-Austin 1998, no pet.).*

F. School property under active construction may be exempted for up to three years before the property is placed in actual operation. TEXAS PROPERTY TAX CODE § 11.21(g).

X. Freeport (Goods Transported Outside the State).

A. A taxpayer who acquires goods or materials and transports them out of the State of Texas within 175 days is entitled to an exemption for that portion of the taxpayer's personal property. TEXAS CONSTITUTION art. VIII, § 1-j(a)(2); TEXAS PROPERTY TAX CODE § 11.251(a). A manufacturer who sells components to another in-state manufacturer who adds the components to units and ultimately ships those products out-of-state within the 175 day period is entitled to claim a Freeport exemption. *Op. Tex. Att'y Gen. DM-463 (1997).* This exemption is granted on a local option basis by individual taxing units.

B. To qualify for exemption, a taxpayer must detain property in the State of Texas for purposes of assembling, storing manufacturing, processing or fabricating the property. TEXAS CONSTITUTION art. VIII, § 1-j(a)(2). Airplane parts and repair specifically qualify for exemption. Oil, gas, and other petroleum products do not qualify for exemption. TEXAS CONSTITUTION art. VIII, § 1-j(c)(1).

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C. To qualify for exemption, a taxpayer must file an exemption application specifying the percentage of the taxpayer's property which in the preceding year was not detained in the State for more than 175 days. If a chief appraiser requests that the taxpayer provide additional information to support its application, and the taxpayer fails to provide such information within 30 days of the request, the taxpayer forfeits the exemption. TEXAS PROPERTY TAX CODE § 11.251(h); *Motorola, Inc. v. Tarrant County Appraisal District, 980 S.W.29 899 (Tex. App. - Fort Worth 1998, no pet.)*. A taxpayer may file a late application for exemption (and may respond belatedly to a request for additional information) up to the date on which the appraisal review board certifies the appraisal records (typically, mid-July). TEXAS PROPERTY TAX CODE § 11.439(a). The late application is subject to a 10% penalty. TEXAS PROPERTY TAX CODE § 11.439(b). No further filing extensions are available.

D. Cotton stored in a warehouse destined for export from the state within 175 days is entitled to exemption. The owner of a warehouse in which cotton is being stored may apply for the exemption on behalf of the owner of the cotton. TEXAS PROPERTY TAX CODE § 11.436.

E. Subject to the approval of a constitutional amendment by the voters on November 5, 2013, on a location option basis the 175 day period may be extended to 730 days for aircraft parts to be transported outside the state. TEXAS PROPERTY TAX CODE § 11.251(l).

XI. Freeport (Goods Transported Inside or Outside the State).

A. A taxpayer who acquires goods or materials and transports them either inside or outside of the State of Texas within 175 days is entitled to an exemption for that portion of the taxpayer's personal property, provided that the property is not stored within a facility owned by the owner of the inventory. TEXAS CONSTITUTION art. VIII, § 1-n; TEXAS PROPERTY TAX CODE §§ 11.253(a) and (b). This exemption is also granted on a local option basis by individual taxing units.

B. To qualify for exemption, a taxpayer must detain the property in the State of Texas for purposes of assembling, storing manufacturing, processing or fabricating the property. TEXAS PROPERTY TAX CODE § 11.253(a)(1)(B).

C. To qualify for this exemption, the taxpayer must file an exemption application specifying the percentage of the taxpayer's property which in the preceding year was not detained in the location for more than 175 days. If a chief appraiser requests that a taxpayer provide additional information to support its application, and the taxpayer fails to provide such information within 30 days of the request, the taxpayer forfeits the exemption. TAX PROP. TAX CODE Section 11.253(h);

XII. Institutions Engaged Primarily In Public Charitable Functions.

A. The following organizations may have their property exempted from taxation:

1. Hospitals and medical organizations which provide medical care without regard to the beneficiaries' ability to pay; TEXAS PROPERTY TAX CODE § 11.18(d)(1). Only those portions of an entire complex which are performing charitable work qualify for exemption. All "for-profit" functions are fully taxable even if the dominant function of the organization is the performance of charitable work. *Baptist Memorials Geriatric Center v. Tom Green County Appraisal District, 851 S.W.2d 938 (Tex. App.-Austin 1993, writ denied);*

2. Organizations providing support or relief to orphans, delinquent, dependent or handicapped children, battered spouses and battered children, the impoverished and victims of natural disasters; provided that these services are provided without regard to the beneficiaries' ability to pay; TEXAS PROPERTY TAX CODE § 11.18(d)(2);

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3. Organizations providing support to the elderly or handicapped without regard to the beneficiaries' ability to pay; TEXAS PROPERTY TAX CODE § 11.18(d)(3);

4. Organizations preserving historical landmarks or sites; TEXAS PROPERTY TAX CODE § 11.18(d)(4); *San Antonio Conservation Society, Inc. v. City of San Antonio, 455 S.W.2d 743 (Tex. 1970);*

5. Organizations promoting or operating a museum, zoo, library, theater of the dramatic arts, symphony orchestra or choir; TEXAS PROPERTY TAX CODE § 11.18(d)(5). Property owned by a nonprofit symphony organization is entitled to exemption. *Dallas Symphony Association, Inc. v. Dallas County Appraisal District, 695 S.W.2d 595 (Tex. App. - Dallas 1985, writ ref'd n.r.e.);*

6. Organizations providing for the humane treatment of animals; TEXAS PROPERTY TAX CODE § 11.18(d)(6);

7. Organizations providing public water supplies, and non-profit water supply and waste water companies; TEXAS PROPERTY TAX CODE §§ 11.18(d)(7) and 11.30;

8. Volunteer Fire Departments; TEXAS PROPERTY TAX CODE § 11.18(d)(8);

9. Organizations promoting the athletic development of youth; TEXAS PROPERTY TAX CODE § 11.18(d)(9);

10. Organizations preserving or conserving wildlife; TEXAS PROPERTY TAX CODE § 11.18(d)(10);

11. Organizations which provide educational loans or scholarships; TEXAS PROPERTY TAX CODE § 11.18(d)(11);

12. Halfway houses; TEXAS PROPERTY TAX CODE § 11.18(d)(12);

13. Nursing homes which provide their services without regard to the beneficiaries' ability to pay; TEXAS PROPERTY TAX CODE § 11.18(d)(13); Property may qualify for exemption even if more than half of the patients pay completely for their services if the organization provides substantial free care to indigent patients. *Dallas County Appraisal District v. The Leaves, Inc., 742 S.W.2d 426 (Tex. App.-Dallas 1988, writ denied);*

14. Organizations which promote or operate an art gallery, museum or collection that is open to the public; TEXAS PROPERTY TAX CODE § 11.18(d)(14);

15. "United Way" type organizations; TEXAS PROPERTY TAX CODE § 11.18(d)(15);

16. Organizations conducting biomedical or scientific research for the benefit of the public; TEXAS PROPERTY TAX CODE § 11.18(d)(16);

17. Public television stations; TEXAS PROPERTY TAX CODE § 11.18(d)(17);

18. Organizations providing housing for low and moderate income families or for elderly or handicapped individuals; TEXAS PROPERTY TAX CODE § 11.18(d)(18);

19. Organizations providing housing and related services in a retirement community; TEXAS PROPERTY TAX CODE § 11.18(d)(19);

20. Organizations providing cooperative student housing at an institution of higher education; TEXAS PROPERTY TAX CODE § 11.18(d)(20);

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21. Urban land banks; TEXAS PROPERTY TAX CODE §§ 11.18(d)(21) and (22);

22. Organizations that provide handicapped individuals with training and employment in the production of commodities or under federal set aside programs for the blind or disabled. TEXAS PROPERTY TAX CODE § 11.18(d)(2);

23. Organizations that operate radio stations broadcasting educational, cultural or other public interest programming that have in the prior five years received one or more grants from the Corporation for Public Broadcasting. TEXAS PROPERTY TAX CODE § 11.18(d)(17) and (23); and

24. Homeless shelters; TEXAS PROPERTY TAX CODE §11.23(d)(23).

B. Charter Requirements. The organization by charter, bylaw or regulation must pledge the use of its assets for its charitable purposes and must pledge that upon dissolution that its assets will be transferred to another exempt entity. TEXAS PROPERTY TAX CODE § 11.18(f).

C. Use. Taxpayers seeking exemption as purely charities must use their property *exclusively* in the performance of their charitable work. TEXAS PROPERTY TAX CODE § 11.18(a)(2). Incidental use by other charitable organizations and performance of incidental non-charitable functions will not void the exemption. TEXAS PROPERTY TAX CODE §§ 11.18(b) and (h). *Hilltop Village, Inc. v. Kerrville Independent School District, 426 S.W.2d 943 (Tex. 1968).*

D. Fraternal Organizations and Social Clubs. Fraternal organization, affiliated with a qualified statewide organization may be exempted in five year increments. To obtain an exemption, they must apply with the Comptroller of Public Accounts and obtain proof of qualification. They must submit the letter of approval from the Comptroller to the Appraisal District along with their application. The letter constitutes conclusive proof of the qualification of the entity for exemption. Qualified entities holding property for fraternal organizations may also similarly qualify for exemption. TEXAS PROPERTY TAX CODE § 11.184. Property owned by organizations that are predominantly social in nature do not qualify for exemption.

E. Charitable organization property under active construction may be exempted for up to three years before the property is placed in actual operation. TEXAS PROPERTY TAX CODE § 11.18(m).

XIII. Miscellaneous Exemptions.

The following organizations are entitled to have their property exempted from taxation:

1. Veteran's organizations; TEXAS PROPERTY TAX CODE § 11.23(a);

2. Texas Federation of Women's Clubs; TEXAS PROPERTY TAX CODE § 11.23(b);

3. The Nature Conservancy of Texas; TEXAS PROPERTY TAX CODE § 11.23(c);

4. The Texas Congress of Parents and Teachers; TEXAS PROPERTY TAX CODE § 11.23(d);

5. Nonprofit organizations which teach private enterprise principles to youth; TEXAS PROPERTY TAX CODE § 11.23(e);

6. Organizations owning buffalo and cattalo that are breeding them to improve the strain or which are keeping them to preserve the species; TEXAS PROPERTY TAX CODE § 11.23(f);

7. Nonprofit theater schools; TEXAS PROPERTY TAX CODE § 11.23(g);

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8. Community service clubs; TEXAS PROPERTY TAX CODE § 11.23(I);

9. Nonprofit medical centers which have donated land to a state medical, nursing, or dental school; TEXAS PROPERTY TAX CODE § 11.23(j);

10. Nonprofit scientific research corporations which benefit colleges and universities; TEXAS PROPERTY TAX CODE § 11.23(k);

11. Property owned by the Federal government used to provide temporary shelter to homeless individuals; TEXAS PROPERTY TAX CODE § 11.111;

12. Property owned by charitable organizations which rehabilitate and construct low-income housing; TEXAS PROPERTY TAX CODE § 11.181(a); This exemption may not be claimed for more than three years. TEXAS PROPERTY TAX CODE § 11.181(b);

13. Solar and wind-powered energy devices designed for on-site use; TEXAS PROPERTY TAX CODE § 11.27;

14. Offshore oil and gas drilling equipment being stored in a county adjacent to the Gulf of Mexico or which is in the process of being repaired or which is not in the process of drilling a well at its current location is exempt from taxation. TEXAS PROPERTY TAX CODE § 11.271;

15. Property subject to a tax abatement or economic incentive agreement; TEXAS PROPERTY TAX CODE Ch. 312 and Section 11.28: TEXAS LOCAL GOVERNMENT CODE CHAPTERS 380 and 381;

16. Land that is being used as a disposal site for materials dredged from the intercoastal waterway. TEXAS PROPERTY TAX CODE § 11.29; The Attorney General has ruled that this section is unconstitutional because it is not grounded in article VIII, section 2 of the Constitution. *Op. Tex. Att'y Gen. No. DM-301 (1994);*

17. Pollution control property which was acquired after January 1, 1994 and which has been approved for exemption by the Texas Commission on Environmental Quality. TEXAS PROPERTY TAX CODE § 11.31. NOTE: After the exemption is granted by the Texas Commission on Environmental Quality, the taxpayer must apply for the exemption with the Chief Appraiser;

18. Property owned by organizations providing affordable housing may qualify for a partial exemption. TEXAS PROPERTY TAX CODE § 11.1825;

19. Marine cargo containers used exclusively in international commerce are exempt from extension. TEXAS PROPERTY TAX CODE § 11.25;

20. One motor vehicle or light truck used for both business and personal use. The vehicle may not be used to transport passengers for a fee. TEXAS PROPERTY TAX CODE §11.252;

21. Equipment owned or leased by companies who are solely in the business of containing offshore spill responses. TEXAS PROPERTY TAX CODE § 11.271;

22. Through December 31, 2015, property used to collect landfill methane and covert it into usable natural gas. TEXAS PROPERTY TAX CODE § 11. 311; and

23. Energy storage systems that are located in a city adjacent to Houston, Texas with a population in excess of 100,000 that has agreed to grant this exemption. TEXAS PROPERTY TAX CODE § 11.315.

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XIV. Qualification for Exemption.

A. Automatic Exemptions. No exemption application is necessary for public property, federal exemptions, homestead personal property, family supplies, farm supplies and implements, farm products and marine cargo containers used exclusively in international commerce. TEXAS PROPERTY TAX CODE § 11.43 (a).

B. April 30 Deadline. All other taxpayers must apply for their exemptions between January 1 and May 1. A 60 day extension may be obtained from the Chief Appraiser upon a showing of good cause. TEXAS PROPERTY TAX CODE § 11.43(d).

C. Incidental Use of Property. Generally, incidental use of the exempt property does not cause loss of the exemption; however, each statute should be specifically consulted.

D. Back Assessments. If the Chief Appraiser discovers that a property has been erroneously granted an exemption, the Chief Appraiser may back assess the property for taxes for a period of five years. TEXAS PROPERTY TAX CODE § 11.43(I).

E. Continuing and annual exemptions. The Texas Property Tax Code requires certain exemptions be claimed annually: (1) Freeport exemptions, (2) public property used to provide transitional housing for indigent persons, (3) tax abatements, (4) Colonia model subdivision program, (5) vehicles leased for personal use, (6) Veteran's Organizations, (7) Texas Federation of Women's Clubs, (8) Nature Conservancy of Texas, (9) Texas Congress of Parents and Teachers, (10) private enterprise demonstration associations, (11) bison, buffalo and cattalo, (12) theater schools, (13) community service clubs, (14) scientific research corporations, (15) solar and wind-powered energy devices, (16) offshore drilling equipment not in use; (17) charitable organizations improving property for low-income housing, and (18) organizations constructing or rehabilitating low-income housing. Certain other exemptions need not be claimed annually once granted. They are: (1) residence homesteads, (2) additional homestead exemptions for disabled or elderly individuals, (3) cemeteries, (4) charitable organizations, (5) associations providing assistance to ambulatory health care centers, (6) organizations engaged primarily in performing charitable functions, (7) youth spiritual, mental, and physical development associations, (8) religious organizations, (9) schools, (10) county fair associations, (11) medical center developments, (12) intracoastal waterway dredge disposal sites, (13) nonprofit water supply or wastewater service corporation, and (14) pollution control property. Finally, other exemptions are granted automatically without the need for application. These are: (1) governmental exemptions, (2) marine containers, (3) tangible personal property not producing income or income-producing property or mineral interests having a value of less than $500, (4) family supplies, (5) farm products, and (6) implements of husbandry. Exemptions for certain water conservation initiatives and for historic sites are not sought through the appraisal district, but must be claimed through the individual taxing units. Once granted, these continue until revoked.

F. Required Reapplications and Cancellations of Exemptions. The Chief Appraiser has the right to require a taxpayer to reapply for an exemption if the Chief Appraiser has any concern about its propriety. TEXAS PROPERTY TAX CODE § 11.43(c). Alternatively, the Chief Appraiser may simply cancel the exemption on five days written notice if the Chief Appraiser discovers that the exempt use has ceased. TEXAS PROPERTY TAX CODE § 11.43(h). Failure to deliver clear unequivocal notice of the cancellation of the exemption voids any subsequent assessment. *Inwood Dad's Club, Inc. v. Aldine Independent School District, 882 S.W.2d 532 (Tex. App.-Houston [1st Dist.] 1994, no writ); Fina Oil and Chemical Co. V. Port Neches I.S.D., 861 S.W.2d 3 (Tex. App.-Beaumont 1993, writ denied.).*

G. Pro-ration of Exemption Upon Transfer of Property. All exemptions continue for an entire tax year if a property qualified as of January 1, except for the following which terminate upon the transfer of the property to a new owner or upon a change in the person's qualification for exemption.: (1) cemeteries, (2) charitable organizations, (3) associations providing assistance to ambulatory health care centers, (4) youth spiritual, mental, and physical development associations, (5) religious organizations, (6) schools, (7) disabled veterans, (8) county fair associations, (9) medical center developments, (10) intracoastal waterway dredge disposal sites, (11) nonprofit water

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supply or wastewater service corporation, and (12) pollution control property. When these exemptions terminate during a tax year, the tax due against the property is calculated as follows:

> Total tax due for an entire year x number of days nonexempt / 365

If an exemption on a residential homestead for an individual over 65 or for a disabled individual terminates during the year as a result of that person's qualifying a different property for one of these exemptions, the tax proration for the exemption is determined as follows:

> (Taxes that would have been imposed without the over 65 or disability exemption - taxes with the over 65 or disability exemption) x (days not qualified / 365).

This result is added to the taxes which would have been due if the property had qualified for the exemption for the entire year. Exempt property that is under a contract of sale on January 1 to a non-exempt purchaser is to be carried in the name of the non-exempt purchaser on the appraisal roll for the ensuing year. TEXAS PROPERTY TAX CODE § 25.13.

H. Proration of Exemption Upon Acquisition of Property. Property tax determinations and qualifications for exemptions are typically made based on the status of the property and taxpayer as of January 1 of the tax year. Changes in circumstances or ownership after that date do not affect taxability or exemption of a property. *State v. Republic Natural Gas Co., 181 S.W.2d 592 (Tex. Civ. App. –San Antonio 1943, writ ref'd w.o.m.).* The Texas legislature has carved out exceptions to this rule for acquisitions by the federal government, the state government, political subdivisions of the state, charitable organizations improving property for low income housing, Community Housing Development Organizations, certain charitable organizations identified in Section 11.18 of the Texas Tax Code, homesteads of individuals 65 years of age or older, homesteads of disabled individuals, cemeteries, Youth, Spiritual, Mental and Physical Development Associations, religious organizations, private schools, nonprofit water supply or wastewater organizations and certain miscellaneous entities identified in Section 11.23 of the Texas Tax Code. These entities or individuals are entitled to receive a prorated exemption for the portion of the tax year after acquisition.

I. Calculation of Prorated Exemption and Application. With the exception of homesteads of individuals 65 years of age or older and homesteads of disabled persons, the prorated calculation is made as follows:

Tax for Entire Year X Calendar Days Prior to Acquisition/365.

If an acquisition is made by the federal government, the state government or a political subdivision of the state and the taxes for the current year have not been determined, the prorated tax bill is to be calculated based on the prior year's tax assessment. If a party to the transfer tenders this amount to the tax assessor, the assessor is required to accept the tender and all further liability for the taxes for that tax year are absolved. If the taxes for that year have been determined, then the actual tax amount is to be utilized.

This option is not available to the other exempt entities which are allowed proration. Their final tax bill is determined in the ordinary course of the appraisal process for that tax year. Individuals 65 years of age and older and disabled persons acquiring homestead property are entitled to receive the additional homestead exemptions, should they be offered by their taxing entities, retroactively for the entire year of acquisition.

J. Qualification for the prorated exemptions is not automatic. A taxpayer wishing to avail itself of the benefits of these provisions must file an exemption application with the chief appraiser. The deadline for filing the application for prorated exemption is the one year anniversary of the acquisition of the property. Upon a written request and showing of good cause, a chief appraiser may extend the application deadline for up to 60 days.

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K. Attorneys Fees. With the exception of exemptions for cemeteries, disabled veterans, miscellaneous exemptions listed in Section 11.23 of the Texas Tax Code, nonprofit community business organizations and historic sites, no attorneys' fees may be awarded in successful challenges of the denial of an exemption. TEXAS PROPERTY TAX CODE § 42.29(a); *Bexar County Appraisal Review Board v. First Baptist Church, 846 S.W.2d 554 (Tex. App.--San Antonio 1993, writ denied).* Fees for these entities is limited to the greater of $15,000 or 20% of the tax amount in dispute, but in no event may the amount exceed $100,000; nor may it exceed the amount of tax in controversy should that amount be less than $15,000. TEXAS PROPERTY TAX CODE § 42.29(a).

L. Late Exemption Applications. Certain organizations may file belated exemption applications, up to five years in arrears. *See* TEXAS PROPERTY TAX CODE § 11.433 (Religious organizations), TEXAS PROPERTY TAX CODE § 11.434 (Schools), TEXAS PROPERTY TAX CODE § 11.438 (Veteran's Organizations), and TEXAS PROPERTY TAX CODE § 11.435 (Charitable organizations). To qualify, these organization may not have paid their taxes. Other late exemptions are also allowed: TEXAS PROPERTY TAX CODE § 11.436 (Certain Property Used for Low-Income Housing–30 days after acquisition), TEXAS PROPERTY TAX CODE § 11.439 (Disabled Veteran's Homestead-one year after delinquency date after qualification), TEXAS PROPERTY TAX CODE § 11.4391 (Freeport–prior to approval of appraisal records by appraisal review board).

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Federal Tax Practice Ethics and Circular 230

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I. INTRODUCTION AND FIRM-WIDE CONSIDERATIONS

A. This presentation focuses on administrative practice before the Internal Revenue Service. Hence, it addresses Federal statutes and regulations that govern or relate to practice before the IRS, especially 31 C.F.R. Subtitle A, Part 10, which is known as Circular 230. Circular 230 states that it governs the practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and registered tax return preparers before the IRS. However, keep in mind that lawyers are also subject to ethical rules of the states in which they practice, as well as to ethical rules that are adopted by courts in which they practice (typically either the ethical rules of a particular state or the ABA Model Rules). Moreover, the ABA has from time to time issued Ethics Opinions with respect to issues relating to practice before the IRS. Due to the recent spate of law changes in this area, many of the older opinions are obsolete. The author has not endeavored to set out any such opinions here, but if a practitioner is confronted with a difficult question it would be advisable to determine whether the ABA has issued an opinion on the topic.

B. Practice in the area of Federal taxation must be conducted within the framework of the Federal civil and criminal penalty provisions that apply to Federal taxation, the Federal statutes and regulations that apply to tax return preparers, as well as the Federal regulations (Circular 230) that govern practice before the Internal Revenue Service. Failure to observe the norms of these statutes and regulations can result in the imposition of penalties and other sanctions upon individual practitioners and a firm and can jeopardize a firm's continued ability to engage in this practice area.

C. Because of these considerations and the highly specialized nature of a Federal tax practice, our firm has policies and procedures regarding the opening and handling of engagements with respect to Federal tax matters. Our firm's Tax department is organized into "Areas of Practice." Our firm policy requires that matters relating to the appropriate Area of Practice be referred to and handled by, or directly supervised by, an attorney in the appropriate Area of Practice. Moreover, any engagement relating to such matters may only be accepted by a partner in the Area of Practice to which the matter must be referred.

II. IN GENERAL – ASPIRATIONAL STANDARDS (UNDER CIRCULAR 230)

A. **Best Practices**. Pursuant to Circular 230 § 10.33, tax advisors "should" strive to provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In

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addition to complying with the standards of practice elsewhere in Circular 230, section 10.33(a) provides that best practices include the following:

1. Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

2. Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.

3. Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.

4. Acting fairly and with integrity in practice before the Internal Revenue Service.

B. Circular 230 § 10.33(b) provides that persons with responsibility for overseeing a firm's Federal tax practice "should" take reasonable steps to ensure the firm's procedures are consistent with these best practices.

C. The standards in section 10.33(a) are directory rather than mandatory, but in the event a firm's Federal tax practice comes under IRS scrutiny, the IRS is more likely to be lenient on a firm and the head of its tax practice for violations by individual practitioners if the firm has adopted policies encouraging best practices. Our firm has adopted these best practices as a part of its firm policies.

III. IN GENERAL – MANDATORY STANDARDS

A. **Knowledge of client's noncompliance, error, or omission**. Circular 230 § 10.21 provides that a practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, learns that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission, and must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission. Circular 230 §

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10.36(b) requires that a firm have adequate procedures for purposes of complying with Circular 230 in preparing tax returns, claims for refund, or other documents for submission to the IRS. Consequently, our firm's policies and procedures incorporate section 10.21 and provide that advice rendered in order to comply with section 10.21 should be promptly documented in the firm's files.

B. **Diligence as to accuracy.** Circular 230 § 10.22 provides that practitioners are required to exercise due diligence.

1. in preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

2. in determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

3. in determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

A practitioner may rely on the work product of another person if the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person. Our firm's policies and procedures provide that the practitioner should document the exercise of that due diligence in the firm's files.

C. **Time Entries**. Time entries for advice on Federal tax matters relating to prospective transactions should reflect that the advice related to a prospective or proposed transaction or occurrence. This is because IRS regulations that provide the definitions of tax return preparers make a distinction between advice regarding prospective transactions (which is usually not viewed as tax return preparation) and advice regarding completed transactions (which can be viewed as tax return preparation). See Treas. Reg. §§ 301.7701-15(b)(2), 1.6694-1(b)(6). Moreover, IRS regulations provide that time spent on advice given after events have occurred which represents less than 5% of the aggregate time incurred by an individual with respect to a tax return position is disregarded in determining whether the individual is a non-signing tax return preparer. See Treas. Reg. § 301.7701-15(b)(2)(i). There are ramifications to this. If the advice constitutes tax return preparation, the advisor must have a Preparer Tax Identification Number ("PTIN") and the advice can be subject to penalties under I.R.C. sections 6694 and 6695, which are further discussed below.

D. **Tax Compliance by Practitioners**. Circular 230 § 10.51(a)(6) makes it a violation of Circular 230 to willfully fail to make a Federal tax return in violation of

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Federal tax laws, or to willfully evade, attempt to evade, or participate in any way in evading or attempting to evade assessment or payment of any Federal tax. There are various ways that firms can ensure that this requirement is met. They can require each member of their tax practice to certify periodically that he or she is in compliance with his or her personal Federal tax return filing and payment requirements. They can require that each practitioner have his or her tax returns prepared by a specified provider and/or submit proof of filing. They can require each practitioner to execute a Form 8821 Tax Information Authorization, allowing the head of the tax practice to check on the member's compliance. Or they can require each practitioner to obtain a PTIN, because the IRS checks compliance as part of granting or renewing a PTIN. Our firm requires each attorney (as well as any other employee, such as a paralegal, involved in tax return preparation) in its Tax department to obtain a PTIN.

E. **Taxpayer Checks**. Circular 230 § 10.31 prohibits a practitioner who prepares tax returns from endorsing or negotiating any check issued to a client by the government in respect of a Federal tax liability. Consequently, our firm has a policy prohibiting any attorney or employee of the firm from endorsing or negotiating any check issued to a third party by the government in respect of a Federal tax liability.

F. **Contingent Fees**. Circular 230 § 10.27 prohibits a practitioner from charging an unconscionable fee in connection with any matter before the Internal Revenue Service. Additionally, Circular 230 § 10.27 prohibits a practitioner from charging a contingent fee (as broadly defined in subsection 10.27(c)(1)), except as follows:

1. For services rendered in connection with the Service's examination of, or challenge to —

    a. An original tax return; or

    b. An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return.

2. For services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.

3. For services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

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Consequently, our firm has a policy that any arrangement regarding a contingent fee in connection with any Federal tax matter requires the approval of the head of our Tax department.

G. **Training**. It is prudent for a firm to have a policy providing for periodic training and to circulate materials relating to the requirements of Circular 230, as well as other Code sections, regulations, and ethical requirements that apply to a federal tax practice) to its federal tax practitioners and staff who need to know of these requirements. Our firm has such a policy, and that policy provides that the written training materials from such training will be transmitted to the head of the Tax department, together with a list of attendees, for filing in the firm's records of such matters.

H. **Disclosure and Periodic Reviews**. It is also prudent for a firm to have procedures to allow for review or "audit" of its files to help insure that practitioners are complying with Circular 230 and other statutory and regulatory requirements. Any such reviews must be done in accordance with I.R.C. §§ 6713 and 7216, and particularly Treas. Reg. § 301.7216-2T(p)(1), regarding the disclosure or use of information obtained in connection with tax return preparation. Our firm has a policy that the head of the Tax department may direct that periodic reviews of the firm's files be undertaken to evaluate, monitor, and improve the quality and accuracy of the firm's tax-related services to clients and to monitor compliance with the firm's policies and procedures, and that any such review be performed in compliance with section 7216 and the regulations thereunder.

IV. STANDARDS FOR WRITTEN TAX ADVICE

A. **Minimum standards for written tax advice**. Circular 230 § 10.37 provides that certain minimum standards must be met for any practitioner to issue written tax advice in any form (letter, memorandum, email, text message, fax, etc.). No practitioner may issue written tax advice:

1. that is based on unreasonable factual or legal assumptions (including assumptions as to future events);

2. that unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person;

3. that does not consider all relevant facts that the attorney knows or should know; or

4. that takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

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Our firm incorporates these requirements into its policies and procedures.

B. **Covered opinions**. Pursuant to Circular 230 § 10.35, "covered opinions" are subject to heightened standards. As currently defined in Circular 230 § 10.35(b), with certain exceptions specified therein (summarized below), a "covered opinion" is written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues arising from –

1. A transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the Internal Revenue Service has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction under 26 CFR 1.6011-4(b)(2);

2. Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose (i.e., a purpose that exceeds any other purpose) of which is the "avoidance or evasion" of any tax imposed by the Internal Revenue Code; or

3. Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the "avoidance or evasion" of any tax imposed by the Internal Revenue Code if the written advice –

    a. Is a *reliance opinion* – i.e., if the advice concludes at a greater than 50 percent likelihood that one or more significant Federal tax issues (i.e., issues for which the IRS has a reasonable basis for a successful challenge and which could have a significant impact on the overall federal tax treatment of the transaction) will be resolved in the taxpayer's favor;

    b. Is a *marketed opinion* – i.e., if the practitioner knows or has reason to know that the advice will be used or referred to by another person to promote, market or recommend a partnership or other entity, investment plan or arrangement to one or more taxpayers;

    c. Is subject to certain *conditions of confidentiality* that a practitioner imposes on one or more recipients of the advice (as spelled out in section 10.35(b)(6)); or

    d. Is subject to *contractual protection* – i.e., if the taxpayer is given the right to a full or partial refund of fees in the event all or part of the intended tax consequences are not sustained, or if fees are contingent on the realization of tax benefits.

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C. "**Avoidance or evasion**." Use of the word "avoidance" within the term "avoidance or evasion" above may be construed to give the term broad effect.

1. The Internal Revenue Manual broadly defines what constitutes "avoidance" of tax, and emphasizes that "avoidance" can involve a perfectly legitimate transaction:

> Avoidance of tax is not a criminal offense. Taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means. One who avoids tax does not conceal or misrepresent, but shapes and preplans events to reduce or eliminate tax liability within the perimeters of the law.

Internal Revenue Manual § 25.1.1.2.4 (12-16-2011).

2. Courts have also broadly defined what constitutes "avoidance or evasion" of tax. For example, in Valero Energy Corp. v. United States, 569 F.3d 626 (7th Cir. 2009), the court considered whether a transaction was a "tax shelter" which had a significant purpose of tax "avoidance or evasion." The court concluded that the term was broadly defined, was not limited to "cookie-cutter products peddled by shady practitioners [as distinguished from] individualized tax advice," and could "include some legitimate attempts by a company to reduce its tax burden."

D. **Exceptions to "covered opinions**." Circular 230 § 10.35(b)(2)(ii) sets out certain exceptions from the definition of a covered opinion for certain preliminary written advice, certain advice concerning the qualification of a qualified plan, a "state or local bond opinion," advice included in documents filed with the SEC, certain advice provided after a return has been filed, advice provided by in-house practitioners to their employers, and certain negative written advice.

E. **Requirements for covered opinions**. Circular 230 § 10.35(c) sets out detailed requirements for covered opinions (including, by cross-reference to sections 10.35(b) and 10.35(e), certain required disclosures), summarized as follows:

1. **Factual matters.**

   a. The practitioner must use reasonable efforts to identify and ascertain relevant facts, and the opinion must identify and consider all facts that the practitioner determines to be relevant.

   b. The practitioner must not base the opinion on any unreasonable factual assumptions.

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c. The practitioner must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person.

2. **Relate law to facts.**

a. The opinion must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.

b. The practitioner must not assume the favorable resolution of any significant Federal tax issue (except for certain limited scope opinions and reliance on certain opinions of other practitioners) or otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions.

c. The opinion must not contain internally inconsistent legal analyses or conclusions.

3. **Evaluation of significant Federal tax issues.**

a. The opinion must consider all significant Federal tax issues (except for certain limited scope opinions and reliance on certain opinions of other practitioners).

b. The opinion must provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant Federal tax issue considered in the opinion, or, if the practitioner is unable to reach a conclusion with respect to one or more of those issues, the opinion must so state. The opinion must also describe the reasons for the conclusions, including the facts and analyses supporting the conclusions.

c. If the practitioner fails to reach a more-likely-than-not conclusion with respect to one or more significant Federal tax issues, the opinion must prominently disclose that (i) it does not reach a conclusion of more likely than not with respect to one or more significant Federal tax issues and (ii) with respect to those issues the opinion cannot be used for penalty protection.

d. The practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement.

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e. In the case of a marketed opinion, the opinion must conclude that the taxpayer will more-likely-than-not prevail. If the practitioner is unable to reach that conclusion, then the practitioner must not provide the marketed opinion, but instead may provide written advice that includes disclosures that (i) the advice cannot be used for penalty protection, (ii) the advice was written to support the promotion or marketing of the transaction, and (iii) the taxpayer should seek independent advice based on the taxpayer's particular circumstances.

4. **Limited scope opinions.** A practitioner may provide an opinion that considers less than all of the significant Federal tax issues if:

a. Both the practitioner and the taxpayer agree that the scope of the opinion and the taxpayer's reliance on it are limited to the Federal tax issues addressed;

b. The opinion does not concern a listed transaction or a "principal purpose" transaction and is not a "marketed opinion";

c. The opinion discloses that it is limited to the one or more Federal tax issues addressed, that additional issues may exist that could affect the federal tax treatment of the transaction and the opinion does not consider or provide a conclusion with respect to any additional issues, and that, with respect to significant Federal tax issues outside the scope of the opinion, the opinion cannot be used as penalty protection; and

d. The opinion identifies in a separate section all issues for which the practitioner assumed a favorable resolution.

5. **Additional required disclosures.** In addition to the disclosures described above, the following disclosures are also required under Circular 230 § 10.35(e):

a. A covered opinion must prominently disclose any compensation or referral arrangement between the practitioner and a promoter.

b. A marketed opinion must prominently disclose that (i) the opinion was written to support the promotion or marketing of the transaction, and (2) the taxpayer should seek independent advice based on the taxpayer's particular circumstances.

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6. **Overall conclusion.** The opinion must provide the practitioner's overall conclusion as to the likelihood that the federal tax treatment of the transaction is the proper treatment and must provide the reasons for that conclusion. If the practitioner cannot reach an overall conclusion, the opinion must so state and describe the reasons. If the opinion is a "marketed opinion," the practitioner must conclude that the treatment is more likely than not proper.

F. **Use of legends/disclaimers**. The various disclosure requirements with respect to covered opinions and to keep written advice from being treated as certain kinds of covered opinions, as described above, has led most professional firms to attach broad disclaimers/legends to electronic mail and other informal written communications in order to minimize the chances that such communications will be treated as covered opinions. Professional firms have generally each developed their own disclosure legends, but the language is usually similar. Our firm's email system automatically adds the following legend to all emails sent by attorneys in the Tax department and in certain other departments that may become involved in tax matters:

> "To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to any party any transaction or tax-related matter[s]."

Additionally, our firm policies and procedures provide that attorneys should:

1. Avoid sending work-related messages from their personal computers, phones, or PDAs, unless they have been properly synchronized with the firm network pursuant to approved procedures, or unless the attorney has remotely accessed the firm network pursuant to approved procedures.

2. Consider adding the legend to firm letters, memoranda, or other written communications, where appropriate under the facts and circumstances.

G. **Review procedures**. Circular 230 § 10.36(a) requires the head of a firm's Federal tax practice to take reasonable steps to ensure the firm has adequate procedures in effect to comply with section 10.35, which provides standards for covered opinions and, by cross-reference to section 10.37, for written advice other than covered opinions. Consequently, it is prudent for a firm to develop

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policies and procedures regarding the review of covered opinions and written advice other than covered opinions. Our firm has such policies and procedures.

1. **Formal legal opinions.** Our firm policies and procedures provide that all formal legal opinions of the firm with regard to a tax matter or issue must be issued in writing, must be signed by or on behalf of a partner in the appropriate Area of Practice, and must conform to the requirements of Circular 230 and applicable Rules or Codes of Professional Conduct. Our firm policies and procedures require "cold partner" review:

    a. For a "covered opinion": by the head of the Tax department or another partner he or she may designate from the appropriate Area of Practice.

    b. For an opinion that is not a "covered opinion": by another partner from the appropriate Area of Practice.

V. STANDARDS FOR TAX RETURNS AND REFUND CLAIMS, AND FOR DOCUMENTS, AFFIDAVITS, AND OTHER PAPERS

A. **Preparer tax identification numbers**. Regulations under I.R.C. § 6109 and Circular 230 § 10.8(a) require an individual who for compensation prepares or assists with the preparation of all or substantially all of a Federal tax return or claim for refund to have a preparer tax identification number ("PTIN"). Under Circular 230 § 10.51(a)(17), a practitioner is subject to discipline for willfully preparing all or substantially all of, or signing, a return/claim if the practitioner does not have PTIN. A firm may also be subject to a monetary penalty (under Circular 230 § 10.50(c)(1)(ii)) if the firm knew or reasonably should have known of such conduct. Consequently, it is prudent for a firm to require all of its Federal tax practitioners to have a PTIN. Our firm has a policy requiring every attorney in the Tax department (as well as any other attorney or employee who prepares or assists with the preparation of all or substantially all of a Federal tax return or claim for refund) to have a PTIN.

B. **Tax Return Preparers**. Practitioners should be aware of the broad definition of "tax return preparer" under Circular 230, I.R.C. § 7701(a)(36)(A) and Treas. Reg. § 301.7701-15 (which is even broader than the definition set forth in the preceding paragraph for purposes of requiring a PTIN). Treas. Reg. section 301.7701-15 specifically defines a tax return preparer as any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any Federal tax return or claim for refund. This can include advising with respect to a position on a return or claim for refund. Persons who are tax return preparers with respect to any one or more positions on a tax return or claim for refund, or with respect to the entire tax

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return or claim for refund ("position/return/claim") are subject to the requirements of Circular 230, as well as other applicable requirements under the Code and the regulations thereunder, such as I.R.C. §§ 6694, 6695, 6011, 6713, and 7216, which are briefly discussed below.

C. **Penalties with respect to positions on returns/claims for refund.**

1. I.R.C. § 6694(a) and the regulations thereunder provide a penalty for a tax return preparer who prepares a tax return or claim for refund that takes an "unreasonable position" that results in an understatement of tax. The penalty is the greater of $1,000 or 50 percent of the income derived by the tax return preparer with respect to the position. A position is unreasonable unless:

   a. there was substantial authority for the position, or

   b. the position was properly disclosed (pursuant to I.R.C. § 6662(d)(2)(B)(ii)(I) and the regulations thereunder) and there is a reasonable basis for the position, or

   c. in the case of a tax shelter or reportable transaction, it is reasonable to believe that the position would more likely than not be sustained.

2. I.R.C. § 6694(b) and the regulations thereunder provide a penalty for any understatement of tax on a return or claim for refund that results from (a) a willful attempt to understate liability or (b) reckless or intentional disregard of rules or regulations. The penalty is the greater of $5,000 or 50 percent of the income derived by the tax return preparer with respect to the position.

3. The standards under section 6694 are reiterated in Circular 230 § 10.34(a).

D. **Other penalties with respect to preparation of returns/claims for refund**. I.R.C. § 6695 provides for various other penalties with respect to preparation of a return or claim for refund, for such things as failing to furnish a copy of the return to the taxpayer, failing to sign the return when required by regulations to do so, failing to furnish an identifying number (i.e., PTIN), and failing to retain copies of prepared returns/claims or lists of such returns/claims.

E. **E-Filing**. I.R.C. § 6011(e)(3) and the regulations and rules thereunder impose electronic filing requirements on tax return preparers with respect to "individual income tax returns" (which are defined as Federal income tax returns for

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individuals, estates and trusts), unless the preparer's firm reasonably expects to file 10 or fewer of such returns during a calendar year. Currently, amended individual income tax returns and certain other returns are not accepted electronically by the IRS, and so are not counted. See Treas. Reg. § 301. 6011-7(c)(2), (d)(1); Notice 2011-26, 2011-17 I.R.B. (3/28/2011). Additionally, if the tax return preparer obtains a hand-signed and dated statement from the taxpayer that the taxpayer chooses to file the return in paper format and that the taxpayer (and not the preparer) will submit the paper return to the IRS, then the return will not be counted. See Treas. Reg. § 301.6011-7(a)(4)(ii), (d)(1); Rev. Proc. 2011-25, 2011-17 I.R.B. (3/28/2011). Circular 230 § 10.51(a)(16) makes it a violation of Circular 230 to willfully fail to file on magnetic or other electronic media a return prepared by a practitioner when the practitioner is required to do so, unless the failure is due to reasonable cause and not willful neglect. Consequently, our firm has instituted procedures requiring every practitioner who files such individual income tax returns to take all necessary steps to comply with electronic filing requirements.

F. **Restrictions on Disclosure or Use of Tax Return Information.** I.R.C. §§ 6713 and 7216 are civil and criminal penalty statutes that prohibit the disclosure or use of information obtained in connection with tax return preparation except in certain circumstances, including as permitted by the IRS in regulations. In addition to penalties under those statutes, Circular 230 § 10.51(a)(15) makes it a violation of Circular 230 to willfully disclose a tax return or tax return information in a manner not authorized by the Internal Revenue Code. Consequently, our firm has incorporated these requirements into its policies and procedures. Permissible disclosures and uses are set out in section 7216(b) and the regulations thereunder. They include (leaving out a few that are more esoteric), **in summary** (see the regulations for particulars):

1. use of such information to prepare a taxpayer's state, local or foreign tax returns (but see below regarding disclosure);

2. use and disclosure of such information in connection with the preparation of returns of certain related taxpayers;

3. disclosure pursuant to a court order, a subpoena issued by a grand jury or by Congress, or a summons or subpoena issued by a government agency;

4. disclosure to the IRS;

5. disclosure to other members of the tax return preparer's firm located within the United States for purposes of tax return preparation (disclosure to other members located outside of the United States requires written

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consent of the client, unless the taxpayer's initial disclosure was to a tax return preparer located outside of the United States);

6. disclosure to other tax return preparers located within the United States for purposes of tax return preparation (so long as the recipient makes no substantive determinations or advice);

7. disclosure to contractors for purposes of tax return preparation (with a written notice about sections 6713 and 7216 required to be provided to such contractors);

8. disclosure to an attorney for purposes of securing legal advice;

9. for law and accounting firms, use of or disclosure to other members of the firm for purposes of providing other legal or accounting services (but not to related or affiliated firms unless the taxpayer provides written consent), as well as disclosure to third parties in the normal course of rendering legal or accounting services to the taxpayer;

10. disclosure to the taxpayer's fiduciary in certain circumstances;

11. maintaining a list of the tax return preparer's customers for purposes of providing educational information to them or soliciting additional tax return preparation business from them;

12. to produce certain kinds of statistical compilations of data that are anonymous as to particular taxpayers, but only for purposes of internal management and support of the tax return preparation business (which can include marketing in support of the tax return preparation business but not other lines of business) or for bona fide research or public policy discussions concerning state or federal taxation;

13. for quality, peer or conflict reviews;

14. pursuant to written consent of the taxpayer in the manner set out in Treas. Reg. § 301.7216-

    a. a tax return preparer may not request a taxpayer's consent to disclose or use tax return information for purposes of solicitation of business unrelated to tax return preparation after the tax return preparer provides a completed tax return to the taxpayer for signature,

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b. if a taxpayer has declined a request for consent to the disclosure or use of tax return information for purposes of solicitation of business unrelated to tax return preparation, the tax return preparer may not solicit another consent,

c. unless otherwise specified, a consent is only valid for one year

G. **Definitions of Tax Return and Tax Return Information.** The definitions of tax return and tax return information for purposes of sections 6713 and 7216 are set out in Treas. Reg. § 301.7216-1(b), summarized as follows:

1. Tax return – An original or amended income tax return (consequently, employment tax, estate tax, gift tax, and various kinds of excise tax returns are not implicated);

2. Tax return preparer – Any person who: (a) is engaged in the business of preparing or assisting in preparing tax returns, (b) is engaged in the business of providing auxiliary services in connection with the preparation of tax returns, (c) is compensated for preparing or assisting in preparing a tax return for any other person, or (d) employees of any such foregoing person who assist in the preparation of, or provide auxiliary services in connection with, the preparation of a tax return.

3. Tax return information – This means any information (including, but not limited to, a taxpayer's name, address, or identifying number) which is furnished in any form or manner for, or in connection with, the preparation of a tax return of the taxpayer. This includes information furnished to the tax return preparer by the taxpayer or a third party. It also includes information derived or generated by the tax return preparer from such information in connection with the preparation of the tax return. It also includes information received by the tax return preparer from the IRS in connection with the processing of the return, including an acknowledgment of acceptance or notice of rejection of an electronically filed return. The term does not include information identical to any tax return information furnished to the tax return preparer if the identical information was obtained otherwise than in connection with the preparation of a tax return.

H. **Standards for documents, affidavits, and other papers.** Circular 230 § 10.34(b) provides that:

1. A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.

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2. A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service—

    a. The purpose of which is to delay or impede the administration of the Federal tax laws;

    b. That is frivolous; or

    c. That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

Under Circular 230 § 10.36(b), a practitioner who has principal authority for overseeing a firm's practice of preparing returns, claims, or other documents for submission to the IRS must take reasonable steps to ensure that the firm has adequate procedures in place for purposes of complying with Circular 230. Consequently, the above requirements have been incorporated into our firm's policies and procedures.

I. **Advising clients concerning potential penalties and disclosure.** Circular 230 § 10.34(c) provides that:

1. A practitioner must inform a client if there are any penalties that are reasonably likely to apply to the client with respect to—

    a. A position taken on a tax return if the practitioner advised the client with respect to the position, or the practitioner prepared or signed the tax return.

    b. Any document, affidavit or other paper submitted to the Internal Revenue Service.

2. The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

Under Circular 230 § 10.36(b), a practitioner who has principal authority for overseeing a firm's practice of preparing returns, claims, or other documents for submission to the IRS must take reasonable steps to ensure that the firm has adequate procedures in place for purposes of complying with Circular 230. Consequently, our firm has adopted policies and procedures regarding the above requirements.

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J. **Relying on information furnished by clients**. Circular 230 § 10.34(d) provides that a practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

K. **Review of position/return/claim**. In accordance with Circular 230 § 10.36(b) and to help ensure and monitor compliance with the requirements applicable to tax returns, claims for refund, and positions on such documents, our firm has adopted policies and procedures requiring each tax return preparer with respect to a position/return/claim to complete a checklist, and to maintain a completed copy of the checklist in the firm's files. Our firm policies and procedures require review of a position/return/claim:

1. If the preparer is a "signing tax return preparer" within the meaning of Treas. Reg. § 301.7701-15(b): by the head of the Tax department or another partner he or she may designate from the appropriate Area of Practice (who may not be involved directly in the engagement).

2. If the preparer is a "nonsigning tax return preparer" within the meaning of Treas. Reg. § 301.7701-15(b): by a partner (other than the preparer) from the appropriate Area of Practice.

L. **Reporting requirement for signing tax return preparers**. I.R.C. § 6060 and the regulations thereunder require that a firm maintain a list of each of its practitioners who was a "signing tax return preparer" for each 12-month period ending June 30. Consequently, our firm policies and procedures require that, on or before June 30 of each year, each firm practitioner

1. who was a "signing tax return preparer" (within the meaning of Treas. Reg. § 301.7701-15(b)) over the preceding 12-month period starting July 1 and ending June 30, or

2. who will be, or expects to be, a "signing tax return preparer" (within the eaning of Treas. Reg. § 301.7701-15(b)) over the upcoming 12 month period commencing July 1,

report that information to the head of the Tax department (together with his or her PTIN and principal place of work).

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VI. MATERIAL ADVISORS

A. **Requirements.**

1. I.R.C. § 6111 requires that a person who is a material advisor with respect to a reportable transaction make a return identifying and describing the transaction and the potential tax benefits.

2. I.R.C. § 6112 requires that a person who is a material advisor with respect to a reportable transaction maintain a list of advisees.

B. **Material Advisor.** A material advisor is defined as a person who provides material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out a reportable transaction, and who derives gross income in excess of:

1. $50,000, if substantially all of the tax benefits are provided to natural persons, or

2. $250,000, in any other case.

C. **Reportable Transaction.** A reportable transaction is defined in the regulations under I.R.C. § 6011, specifically at Treas. Reg. § 1.6011-4. A reportable transaction includes:

1. Transactions identified by the IRS as listed transactions;

2. Transactions where confidentiality is imposed on the taxpayer client and the advisor receives a fee of at least:

   a. $250,000 if the taxpayer is a corporation or a partnership or trust all of the owners or beneficiaries of which are corporations;

   b. $50,000 for all other transactions;

3. Transactions with contractual protection—i.e., where the taxpayer is entitled to a full or partial refund of fees if the tax treatment of the transaction is not sustained or where the fees are contingent on the realization of tax benefits.

4. Loss transactions: A transaction that results in a taxpayer claiming a loss under I.R.C. § 165 of at least:

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a. $10 million in one taxable year or $20 million in a combination of taxable years for corporations or partnerships that only have corporations as partners;

b. $2 million in one taxable year or $4 million in a combination of taxable years for partnerships, individuals, S corporations, or trusts; or

c. $50,000 in one taxable year for individuals or trusts if the loss arises from a section 988 transaction.

5. Transactions identified by the IRS as transactions of interest.

D. **Penalties.**

1. I.R.C. § 6707 imposes a penalty on a material advisor for failure to file a return with respect to a reportable transaction. The penalty is $50,000, unless the transaction is a listed transaction, in which case the penalty is the greater of $200,000 or 50 percent of the income derived by such person (75 percent if the failure was intentional).

2. I.R.C. § 6708 imposes a penalty on a material advisor for failure to maintain a list of advisees with respect to a reportable transaction. If the IRS requests the list and does not receive it within 20 business days, the penalty is $10,000 for each subsequent day that passes.

E. **Ramifications for a Firm's Policies and Procedures.**

1. A first line of defense: A firm's first line of defense to avoid problems in this area would be policies and procedures regarding engagement letters, and head of department or partner responsibility for accepting engagements, and fee arrangements. My firm has historically not been involved in advising on transactions of this type because of policies and procedures that I have described to you elsewhere in this presentation.

2. A second line of defense: If there is any risk of a practitioner getting beyond a first line of defense, or if a firm is already involved in this type of practice, recently proposed regulations regarding penalties for failing to maintain a list of advisees suggest a second line of defense. Proposed regulations under section 6708 would allow a material advisor to show in support of a reasonable cause defense that it established and adhered to procedures reasonably designed and implemented to ensure compliance with list maintenance requirements under section 6112. This encourages firms to adopt policies and procedures requiring development and

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maintenance of lists of advisees (and likewise to develop policies and procedures regarding filing returns with respect to reportable transactions).

VII. RULES APPLICABLE TO IN-HOUSE PERSONNEL

A. **Limited Practice Under Circular 230**. Circular 203 § 10.7(c) lists various types of individuals who may represent their employer before the IRS, including officers and employees of a corporation.

B. **Applicable Ethical Rules Under Circular 230**. Circular 230 § 10.7(c) provides generally that such an individual who represents his or her employer "is subject, to the extent of his or her authority, to such rules of general applicability regarding standards of conduct and other matters as prescribed by the Internal Revenue Service." This seemingly invites a common-sense reading of Circular 230 to apply only those portions of Circular 230 that would apply to an in-house person, but it would be wise to err on the side of caution, because whether a provision would apply could depend heavily on the particular circumstances.

Provisions that normally would not apply to in-house persons include:

1. Section 10.8 requirements that a return preparer obtain a PTIN.
2. Section 10.27 provisions on unconscionable and contingent fees.
3. Section 10.28 provisions on return of a client's records.
4. Section 10.30 provisions regarding advertising and solicitation of business (except possibly solicitation of employment).

C. **Return Preparer Penalties**. The regulations at Treas. Reg. § 301.7701-15(f) provide that certain persons, including officers and employees of a taxpayer, are not considered tax return preparers. Consequently, tax return preparer penalties under I.R.C. §§ 6694 and 6695 are inapplicable to such persons.

VIII. LOOKING AHEAD – PROPOSED AMENDMENTS TO CIRCULAR 230 AND LOVING V. INTERNAL REVENUE SERVICE

A. **Proposed Amendments to Circular 230**. In September of 2012, the Treasury Department published proposed regulations that would amend Circular 230. The major features of the proposed regulations are:

1. **Single standard for written advice**. The proposed regulations would adopt a single, simplified set of standards for written advice in place of the

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two sets of standards that exist currently for (a) covered opinions and (b) written advice other than covered opinions. The proposed new standards are a somewhat beefed-up version of the current standards for written advice other than covered opinions.

2. **Elimination of disclaimers/legends**. The single, simplified standard would eliminate the need for disclosure legends/disclaimers that many professional firms currently append to email messages and other routine written communications in order to avoid treatment of such communications as covered opinions.

3. **Procedures to ensure compliance**. The proposed regulations would revise section 10.36 regarding a firm's procedures to ensure compliance. Current section 10.36 requires the head of a firm's Federal tax practice to take reasonable steps to ensure the firm has adequate procedures in effect for purposes of complying with standards for (a) written tax advice and (b) preparation of tax returns, claims for refund or other submissions to the IRS. The revised section 10.36 would require the head of a firm's Federal tax practice to take reasonable steps to ensure that a firm has adequate procedures in effect for purposes of complying with **all** of the provisions of Circular 230.

B. ***Caveats* about the proposed amendments to Circular 230.**

1. They are only proposed amendments and could well change after comments and hearings.

2. There has been a considerable delay since the amendments were proposed, possibly because of the Loving case, described below.

C. **Loving v. Internal Revenue Service**, ___ F. Supp. 2d ___, 111 A.F.T.R. 2d 589, 2013-1 U.S.T.C. ¶ 50,156 (D.D.C. 2013); ___ F. Supp. 2d ___, 111 A.F.T.R. 2d 702, 2013-1 U.S.T.C. ¶ 50,171 (D.D.C. 2013); 111 A.F.T.R. 2d 1384 (D.C. Cir. 2013).

1. **The ruling in Loving v. IRS**. In Loving, several tax return preparers who were not attorneys, CPAs, enrolled agents or enrolled actuaries sued for an injunction against the IRS in the federal district court for the District of Columbia on grounds that they were not practicing before the Internal Revenue Service and thus could not be regulated under Circular 230 (as "registered tax return preparers"). The district court sided with the plaintiff tax return preparers and granted the injunction. The district court also denied a stay of the injunction pending appeal and clarified that the IRS's PTIN program is not enjoined, and that only those provisions of Circular

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230 that purport to apply to return preparers who are not attorneys, CPAs, enrolled agents or enrolled actuaries are enjoined. The appellate court also denied a stay pending appeal.

2. **Ramifications**. The court's ruling in Loving does not appear to have a direct impact on law firms and accounting firms. The current rules under Circular 230 should continue to apply to them. However, the Loving case may be one reason there has been a delay in adopting the currently proposed amendments to Circular 230. If Treasury proceeds to adopt the currently proposed amendments before the Loving case is resolved, it may be faced with having to amend Circular 230 yet again in order to remove/revise provisions in Circular 230 regarding registered tax return preparers in the event the district court is ultimately affirmed on appeal.

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IRS Circular 230 Disclosure:

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to any party any transaction or tax-related matter[s].

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May 31, 2013

CC:PA:LPD:PR (REG-130507-11)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20044

Re: Comments of the State Bar of Texas, Tax Section on Proposed Regulations Regarding Net Investment Income Tax under Section 1411 of the Internal Revenue Code

Dear Ladies and Gentlemen:

On December 5, 2012, the Department of Treasury and the Internal Revenue Service published proposed Treasury regulations under section 1411 of the Internal Revenue Code and requested comments on the proposed rules. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments on the proposed procedures.

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

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

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OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Tina R. Green

Tina R. Green
Chair, Section of Taxation
The State Bar of Texas

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RESPONSE TO REQUEST FOR COMMENTS ON PROPOSED REGULATIONS ISSUED TO PROVIDE GUIDANCE UNDER SECTION 1411 OF THE INTERNAL REVENUE CODE (IRS REG-13057-11)

This response to the request for comments with respect to proposed Treasury regulations issued under section 1411 of the Internal Revenue Code is presented on behalf of the Section of Taxation of the State Bar of Texas.

This response is a joint project between the Corporate Tax Committee and the Partnership and Real Estate Tax Committee of the State Bar of Texas Section of Taxation. The Chairs of those committees are Jeffry Blair and Daniel Baucum, respectively. Principal responsibility for drafting the S corporation comments was exercised by Jeffry Blair, David Peck and Sam Merrill; and principal responsibility for drafting the partnership comments was exercised by Jack Howell, Bryan Jepson, Steve Phillips, Tara Aevermann Potts and Daniel Baucum. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. David Wheat, past Chair of the Section of Taxation of the State Bar of Texas, reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, the Chair of COGS, also reviewed the comments on behalf of COGS.

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

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Date: May 31, 2013

For tax years beginning January 1, 2013, section 1411[1] of the Internal Revenue Code imposes a 3.8% tax on certain income of individuals, estates, and trusts. The Department of Treasury (the *"Treasury"*) and the Internal Revenue Service (the *"Service"*) have recognized the need for guidance in the interpretation of this section and the calculation of the tax imposed thereby. The intention of these Comments is to address specifically certain issues under the proposed Treasury regulations with respect to (i) the limitation under section 1411(c)(4) on the amount of gain or loss included as net investment income upon the disposition of an interest in a partnership or an S corporation and (ii) the application of the proposed regulations regarding net investment income tax under section 1411 to self-charged rental income.

I. Limitation on the amount of gain or loss included as net investment income upon the disposition of an interest in a partnership or an S corporation under section 1411(c)(4)

A. Executive Summary

We respectfully recommend that section 1.1411-7 of the proposed regulations be modified to provide that upon a transferor's disposition of an interest in a partnership or S corporation:

[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the *"Code"*), unless otherwise indicated.

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- the transferor's net gain under section 1411(c)(1)(A)(iii) will equal the lesser of (1) the amount of gain recognized by the transferor upon the disposition of the interest or (2) the amount of net gain that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value; and

- the transferor's net loss under section 1411(c)(1)(A)(iii) will equal the lesser of (1) the amount of loss recognized by the transferor upon the disposition of the interest or (2) the amount of net loss that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value.

We believe that modifying section 1.1411-7 of the proposed regulations as described above is more consistent with the language and legislative history of section 1411(c)(4).

B. Background

In general, the term "net investment income" includes the net gain attributable to the disposition of property except for property held in an active trade or business (i.e., a trade or business other than a trade or business described in section 1411(c)(2)).[2] Section 1411(c)(4) provides that in the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account as net gain under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) states that a similar rule applies with respect to losses from dispositions.

Section 1.1411-7 of the proposed regulations provides that in calculating the amount of net gain, a transferor must include as net investment income upon the disposition of an interest in a partnership or S corporation the actual gain or loss recognized by the transferor as adjusted in accordance with the proposed regulations. This amount is determined under section 1.1411-7(c) of the proposed regulations as follows:

- First, the partnership or S corporation is deemed to dispose of all of its properties for fair market value in a fully taxable transaction.

- Second, the partnership or S corporation determines the amount of gain or loss attributable to each property.

- Third, the partnership or S corporation determines the amount of gain or loss allocable to the transferor's interest. For purposes of this calculation, the transferor of a partnership interest must take into account partnership allocations under sections 704(b) and 704(c), and basis adjustments under section 743. The transferor of stock in an S corporation, however, would not take into account any reduction in that shareholder's distributive share resulting from a deemed built-in gains tax under section 1374.

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[2] *See* Section 1411(c)(1)(A)(iii).

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- Finally, the partnership or S corporation determines the amount of net gain or loss allocable to the transferor that is attributable to a trade or business not described in section 1.1411-5(a) of the proposed regulations (hereinafter, an "Active Business") and makes a negative adjustment (if there is a net gain attributable to an Active Business) or a positive adjustment (if there is a net loss attributable to an Active Business) to the amount of the transferor's gain. The transferor's gain or loss, after such adjustment, is the amount of net gain for purposes of section 1411(c)(1)(A)(iii).

C. Recommendation

We recommend that section 1.1411-7 of the proposed regulations be modified to provide that upon a transferor's disposition of an interest in a partnership or S corporation:

- the transferor's net gain under section 1411(c)(1)(A)(iii) will equal the lesser of (1) the amount of gain recognized by the transferor upon the disposition of the interest or (2) the amount of net gain that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value; and

- the transferor's net loss under section 1411(c)(1)(A)(iii) will the lesser of (1) the amount of loss recognized by the transferor upon the disposition of the interest or (2) the amount of net loss that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value.

As so modified, we believe that the proposed regulations would be more consistent with the intent of section 1411(c)(4), as evidenced by the text and legislative history of the statute.

D. Analysis / Explanation

Section 1.1411-4(d)(3)(ii)(B)(1) of the proposed regulations states that a partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock generally is net gain for purposes of section 1411(c)(1)(A)(iii). Under the proposed regulations, the gain or loss is then adjusted, as described above, by the amount of net gain or net loss that is attributable to an Active Business. In effect, the method in section 1.1411-7 of the proposed regulations results in the entire gain or loss from the disposition of an interest in a partnership or S corporation being treated as net investment income, except to the extent such gain or loss is attributable to an Active Business.

We respectfully submit that the methodology of section 1.1411-7 is inconsistent with the intent of section 1411(c)(4), as evidenced by the statute's plain language and legislative history. Section 1411(c)(4) states that upon a sale of a partnership interest or S corporation stock, gain from such sale shall be taken into account as net gain under section 1411(c)(1)(A)(iii) "only to

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the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest." Similarly, the Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010" provides that "only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account."[3] In our view, the text and legislative history of section 1411(c)(4) do not support the supposition that the sale of a partnership interest or S corporation stock generally is treated as the sale of an asset that gives rise to net gain. Instead, the statute and legislative history clearly indicate that the transferor's net gain must be limited to the amount of net gain that would be allocated to the transferor upon a taxable sale of the assets of the partnership or S corporation. Thus, we respectively propose that upon the sale of an interest in a partnership or S corporation, the transferor's net gain should be calculated as the lesser of (1) the amount of gain or loss recognized by the transferor upon the disposition of the interest or (2) the amount of net gain that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value.

In most cases, the approach contained in the Proposed Regulations and the approach we recommend would result in the transferor recognizing the same amount of net gain upon the sale of an interest in a partnership or S corporation. In particular, we believe that in each of the examples provided in Section 1.1411-7(e) of the Proposed Regulations, other than Example 2 (noted below), the amount of net gain recognized by the transferor would be the same regardless of which method applies.

In two situations, however, the approach we recommend produces a different result than the method contained in the Proposed Regulations. The first such situation involves those instances where there is an inside-outside basis disparity. This scenario may arise where the taxpayer purchases an interest in an S corporation for a price that is greater than or less than the taxpayer's share of the S corporation's inside basis. This scenario may also arise where the taxpayer purchases an interest in a partnership for a price that is greater than or less than the taxpayer's share of the partnership's inside basis and the inside basis of the partnership assets are not adjusted as a result of a Section 754 election or otherwise.[4]

For example, suppose that A and B each own 50% of the stock of S, a Subchapter S corporation. A and B each initially contributed \$100 to S in exchange for stock, and S used the \$200 to acquire an asset used in S's trade or business. After the value of S has declined to \$100, A sells its 50% interest to Z in exchange for \$50. Thereafter, the value of S increases to \$200, and Z sells its 50% interest in S to Y for \$100. At the time of the sale, S's asset has an adjusted basis of \$200, and such asset is used in an Active Business with respect to Z.

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[3] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10) (March 21, 2010), at 135; *see also* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11) (March 24, 2011), at 364.

[4] With respect to the purchase of a partnership interest, such inside-outside basis disparity will not exist for a transferor if the partnership elects (or is required) to adjust the basis of its assets under Section 743.

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Z would recognize gain of $50 upon the sale of its stock in S. Under the Proposed Regulations, there can be no adjustment to Z's gain for purposes of calculating Z's net gain because there is no built-in gain or loss in S's asset. Accordingly, Z recognizes net gain of $50. The result reached by applying the Proposed Regulations is clearly inconsistent with Section 1411(c)(4)(A) because if S had sold all of its assets for fair market value, S would not have recognized any gain that could be allocated to Z. Moreover, all of S's assets are used in an Active Business with respect to Z. Thus, even if S recognized a gain upon a sale of its assets, none of that gain would constitute net gain for purposes of Section 1411(c)(1)(A)(iii).

The modification that we recommend would correct the problem illustrated by the above example. Under our recommended approach, Z's net gain would equal the lesser of (1) the gain recognized by Z upon the sale of its stock ($50) or (2) the amount of net gain that would have been allocable to Z if S had sold all of its assets in a taxable transaction for fair market value ($0). Thus, Z would not recognize any net gain upon the sale of its interest in S.[5] This result is appropriate because all of S's assets are attributable to an Active Business, and the sale of such assets was not intended to give rise to net investment income.[6]

A second scenario in which the method we recommend would differ from the Proposed Regulations is where a taxpayer sells a partnership interest or S corporation stock at a premium over asset value. For example, suppose that A owns a 50% interest in an S corporation (S) with an adjusted basis of $100. S owns a single asset with an adjusted basis and fair market value of $200, and S uses such asset in an Active Business with respect to A. A sells its stock in S for $150.

A would recognize gain of $50 upon the sale of its stock in S. Under the Proposed Regulations, there can be no adjustment to A's gain for purposes of calculating A's net gain because there is no built-in gain or loss in S's asset. Accordingly, A recognizes net gain of $50. The result reached by the Proposed Regulations is clearly inconsistent with Section 1411(c)(4)(A) because if S had sold all of its assets for fair market value, S would not have recognized any gain that could be allocated to A. Moreover, all of S's assets are used in an Active Business with respect to A. Thus, even if S recognized a gain upon a sale of its assets, none of that gain would constitute net gain for purposes of Section 1411(c)(1)(A)(iii).

The modification that we recommend would correct the problem illustrated by the example above. Under our recommended approach, A's net gain would equal the lesser of (1) the gain recognized by A upon the sale of its stock (i.e. a $50 gain) or (2) the amount of net gain that would have been allocable to A if S had sold all of its assets in a taxable transaction for fair market value (i.e. $0 gain). Thus, A would not recognize any net gain upon the sale of its interest in S. This result is appropriate because all of S's assets are attributable to an Active Business, and the sale of such assets was not intended to give rise to net investment income.[7]

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[5] Example 2 of Section 1.1411-7(e) of the Proposed Regulations contains a fact pattern similar to the example set forth above. We respectfully submit that the outcome in Example 2 should be that A has zero net gain with respect to the sale of stock for purposes of Proposed Regulation Section 1.1411-4(a)(1)(iii).

[6] *See* I.R.C. § 1411(c)(1)(A)(iii).
[7] *See* I.R.C. § 1411(c)(1)(A)(iii).

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We recommend modifying the Proposed Regulations as described above in order to ensure that the Proposed Regulations are consistent with Section 1411(c)(4). The text and legislative history of Section 1411(c)(4) demonstrate a clear Congressional intent that gain from the sale of an interest in a partnership or S corporation will be treated as net gain only to the extent of the net gain that would have been taken into account if the partnership or S corporation sold all of its assets for fair market value. We believe that our proposed methodology will eliminate those situations where taxpayers recognize net gain that is attributable to an Active Business of a partnership or S corporation while ensuring that gain attributable to a passive trade or business is treated as net gain.

II. New safe harbor under Section 1.1411-4(d)(3)(ii)(C) for active trades or businesses with no working capital gain.

A. Executive Summary

We respectfully recommend that a new section 1.1411-4(d)(3)(ii)(C) be added to the proposed regulations to include the following safe harbor:

> (C) Safe harbor. Net gain described in paragraph (a)(1)(iii) of this section shall not include any gain from the disposition of stock in an S corporation or of an interest in a partnership if, regarding the S corporation or the partnership, the transferor is engaged only in trades or businesses that are not described in § 1.1411–5(a)(1) and there is no gross income from or net gain attributable to an investment in working capital (within the meaning of Section 469(e)(1)(B)) held by the S corporation or the partnership.

B. Background

In certain situations when stock in an S corporation or a partnership interest is sold, there is no need to apply Code section 1411(c)(4). The preamble to the proposed regulations states that

> the exception in section 1411(c)(4) does not apply where (1) there is no trade or business, (2) the trade or business is a passive activity (within the meaning of proposed §1.1411-5(a)(1)) with respect to the transferor, or (3) where the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed §1.1411-5(a)(2)), because in these cases there would be no change in the amount of net gain determined under proposed §1.1411-4(a)(1)(iii) upon an asset sale under section 1411(c)(4).[8]

[8] Net Investment Income Tax, 77 Fed. Reg. 72626 (proposed Dec. 5, 2012) (to be codified at 26 C.F.R. pt. 1411) (citing Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS–2–11) (March 24, 2011), at 364, fn. 976 (and accompanying text)).

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Using the drafters' logic as outlined in the preamble, the proposed safe harbor exempts a transferor of S corporation stock or partnership interests from the provisions of section 1.1411-4(a)(1)(iii) if (i) the transferor of the S corporation stock or the partnership interest is engaged only in trades or businesses that are not described in section 1.1411-5(a)(1) and (ii) there is no gross income or net gain attributable to an investment in working capital.

C. Recommendation

We respectfully recommend that a new section 1.1411-4(d)(3)(ii)(C) be added to the proposed regulations:

> (C) Safe harbor. Net gain described in paragraph (a)(1)(iii) of this section shall not include any gain from the disposition of stock in an S corporation or of an interest in a partnership if, regarding the S corporation or the partnership, the transferor is engaged only in trades or businesses that are not described in § 1.1411–5(a)(1) and there is no gross income from or net gain attributable to an investment in working capital (within the meaning of Section 469(e)(1)(B)) held by the S corporation or the partnership.

We respectfully believe that the proposed safe harbor is consistent with congressional intent and would lessen the burden on taxpayers and the IRS.

D. Analysis / Explanation

Under the terms of the safe harbor, there would be no change in the character of any net gain determined to exist in a sale of stock in an S corporation or of an interest in a partnership. The reasoning behind the safe harbor tracks the reasoning underpinning proposed section 1.1411-4(a)(1)(iii). Under section 1.1411-4(a)(1)(iii) there is no change in the character of any net gain in a deemed asset sale under section 1411(c)(4) if the trade or business is a passive activity with respect to the transferor.[9] Consequently, it is consistent with the current provisions to have a presumption of no change in the character of net gain where (i) the transferor of the S corporation stock or the partnership interest is engaged only in trades or businesses that are not described in section 1.1411-5(a)(1) and (ii) there is no gross income or net gain attributable to an investment in working capital, just like the situations where (i) there is no trade or business, (ii) the trade or business is a passive activity (within the meaning of proposed section 1.1411-5(a)(1)) with respect to the transferor, or (iii) the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed section 1.1411-5(a)(2)).[10]

The proposed safe harbor eases the burden on both taxpayers and the IRS without reducing tax revenue. The proposed safe harbor will prevent taxpayers from having to make the computation provided in section 1.1411-7 in situations where that computation cannot change

[9] *See id.*
[10] *See id.*

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the character of the net gain recognized on the disposition of stock in an S corporation or of an interest in a partnership. However, the safe harbor will not reduce tax revenue under section 1411 since the applicable net gain is not currently subject to the section 1411 tax.

III. Potential application of the § 1411 tax to self-charged rental.

A. Executive Summary

We respectfully recommend that the proposed regulations be modified to provide that net rental income received by a taxpayer from a lessee that is engaged in a trade or business in which the taxpayer materially participates be excluded from the definition of net investment income. We believe that the proposed regulations unfairly target and subject to Section 1411 a common and sound structuring technique used by taxpayers otherwise involved in trades or businesses in which they actively participate.

B. Background

Section 1.1411-4(a) of the Proposed Regulations defines net investment income, in part, as the gross income from rents, over deductions allocable to such rental income. There is an exception for net rental income earned in a trade or business that is a non-passive activity.

Frequently taxpayers who own real estate that is used in the taxpayer's active trade or business hold the real estate in a separate pass-through entity and rent the property to the active entity. This leasing structure is put in place for many non-tax business reasons, including financing and asset protection purposes. The drafters of the passive activity regulations contemplated this leasing structure and provided specific rules to prevent a taxpayer from artificially creating passive income through related party rentals. Particularly, section 1.469-2(f)(6) of the Treasury Regulations treats the net rental income received by a taxpayer from a lessee which is a trade or business in which the taxpayer materially participates as non-passive.[11]

Similar to self-charged rental income, the passive activity rules recharacterize self-charged interest income. The rules specifically allow self-charged interest income to be recharacterized from portfolio income to passive activity income in order to allow the taxpayer to offset the interest expense arising from a passive activity against the interest income.[12] Similar to the matching of income and expenses addressed in section 1.469-2(f)(6), section 1.469-7 also ensures that the expenses and income are properly matched under the passive activity rules.

C. Recommendation

We respectfully recommend that the proposed regulations be modified to provide that net rental income received by a taxpayer from a lessee that is engaged in a trade or business in which the taxpayer materially participates be excluded from the definition of net investment income. As

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[11] Rental activities are per se passive activities under section 469, subject to certain rules that overcome this presumption in narrow circumstances.

[12] Treas. Reg. § 1.469-7.

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modified, the proposed regulations would be more consistent with the passive activity rules and would avoid unnecessary taxpayer restructuring efforts.

D. Analysis / Explanation

Under the proposed section 1411 regulations, the described self-rental structure will cause rental income received by a related party to be subject to the section 1411 tax. The section 1411 tax arises because the activities of the entity owning the real estate and leasing the property may not satisfy the material participation standard. If the real estate were owned by precisely the same entity as the lessee no rent would change hands for tax purposes and the taxpayer would be in exactly the same economic position, but without the effects of the section 1411 tax.

While we agree with the overall approach taken by the drafters of the proposed section 1411 regulations in paralleling the section 469 regulations, we believe that the self-charged rule should be applied to the definition of net investment income. That is, income determined to be non-passive pursuant to section 1.469-2(f)(6) of the Treasury Regulations should not be considered to be net investment income.

There are a number of ways to apply the self-charged rule in the proposed regulations. The definition of net investment income in section 1.1411-4(c)(1) could exclude income described in section 1.469-2(f)(6). Alternatively, the activity could be deemed to be a non-passive trade or business activity. Specifically, section 1.1411-5(b) could exclude from the definition of "passive activity" those activities referred to in section 1.469-2(f)(6). If the IRS believes it is bound by the trade or business requirement of Code section 1411(c)(2), then it may find a solution through application of the "properly allocable expense" precept found under section 1411. That is, the rental expense incurred by the related lessee entity can and should be deemed to be a properly allocable expense against the rental income earned by the related lessor entity – at least in those same circumstances where 1.469-2(f)(6) would apply.

Ultimately, if section 1411 is not modified and continues to target taxpayers who hold real estate in a related entity and lease the property to an active entity, it is likely that little to no additional tax would be collected because these taxpayers will either collapse the two entities into one or reduce the amount of rent paid between the entities.

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SECTION OF TAXATION
State Bar of Texas

May 31, 2013

Ms. Yvette Lawrence
Internal Revenue Service
Room 6129
1111 Constitution Avenue NW
Washington, DC 20224

Re: Comments of the State Bar of Texas, Tax Section on Form 706-GS(D)

Dear Ms. Lawrence:

On February 12, 2013, the Department of Treasury and the Internal Revenue Service requested comments concerning Form 706-GS(D). On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments concerning Form 706-GS(D).

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

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

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1414 Colorado Street, Austin, TX 78701
(512) 427-1463 or (800) 204-2222

We appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Tina R. Green

Tina R. Green
Chair, Section of Taxation
The State Bar of Texas

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RESPONSE TO REQUEST FOR COMMENTS CONCERNING FORM 706-GS(D)

This response to the request for comments with respect to Form 706-GS(D) is presented on behalf of the Section of Taxation of the State Bar of Texas.

Principal responsibility for drafting these comments was exercised by Celeste Lawton, Amanda Gyeszly, Melissa Willms, and Lora Davis. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Tina R. Green, Chair of the Section of Taxation of the State Bar of Texas, reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, the Chair of COGS, also reviewed the comments on behalf of COGS.

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

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Date: May 31, 2013

The Internal Revenue Service (the "IRS") has solicited comments concerning Form 706-GS(D). The intention of these Comments is to specifically address issues associated with the due date for filing Form 706-GS(D) and the related Form 706-GS(D-1) as ways to enhance the quality, utility, and clarity of the information to be collected.

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1. Timing of Filing Form 706-GS(D)

We respectfully recommend that the IRS consider changing the due date for filing Form 706-GS(D-1) so that it does not coincide with the due date for filing Form 706-GS(D).

Generally, a person who receives a taxable distribution from a trust (the "taxpayer") must file Form 706-GS(D) by April 15 of the year following the year in which the taxable distribution was made. Similarly, by the same date, the trustee of the trust must file Form 706-GS(D-1) to report the taxable distribution. The trustee, however, is not required to send the taxpayer a copy of Form 706-GS(D-1) prior to the due date for filing Form 706-GS(D). In order for the taxpayer to complete Form 706-GS(D), the taxpayer relies on information that he or she obtains from Form 706-GS(D-1). In some instances, a taxpayer may not realize that a trust distribution constitutes a taxable distribution that gives rise to the necessity of filing Form 706-GS(D) until the taxpayer receives the trustee's Form 706-GS(D-1).

Because the initial due date for filing Form 706-GS(D-1) is the same date as the due date for filing Form 706-GS(D), the taxpayer may not receive a copy of Form 706-GS(D-1) until after Form 706-GS(D) is due. For example, if the trustee sends the taxpayer a copy of Form 706-GS(D-1) by U.S. mail on the date Form 706-GS(D-1) is due, the taxpayer would not receive Form 706-GS(D-1) until *after* the due date for filing Form 706-GS(D). As a result, if the taxpayer is relying solely on the information in Form 706-GS(D-1), it would be impossible for the taxpayer to file Form 706-GS(D) on or before the due date. Furthermore, without the information provided on Form 706-GS(D-1), it may be impossible for the taxpayer to timely pay the tax that is due as a result of the taxable distribution. Therefore, there is a concern that the taxpayer may not have the information needed to adequately prepare and file Form 706-GS(D) by the due date and to timely pay any tax that is due, even if an extension of time to file Form 706-GS(D) is requested.

The instructions for Form 706-GS(D) contemplate that there may be instances when the trustee has not completed column e of Form 706-GS(D-1) (regarding the value of property distributed from the trust) or that the taxpayer may disagree with the amounts that the trustee entered in column e of Form 706-GS(D-1). The burden of determining the appropriate value of the property received by the taxpayer in a taxable distribution ultimately lies with the taxpayer, given that he or she is the one who must pay the tax associated with the taxable distribution. In some instances, such as when the trustee fails to report the correct value of the distributed property, in order for the taxpayer to properly value the distributed property, the taxpayer may need information from the trustee regarding the property or may need to engage a qualified appraiser to value the property. As shown in the Form 706-GS(D) instructions, the definition of fair market value mirrors the definition for Federal estate tax purposes. In the Federal estate tax context, the fiduciary has nine months (or fifteen months, if Form 706 is extended) to fully value the property, unlike the taxpayer filing Form 706-GS(D), who has a fraction of that time if he begins the valuation process upon receipt of Form 706-GS(D-1) from the trustee. As a result, if the taxpayer receives Form 706-GS(D-1) shortly before the due date for filing Form 706-GS(D), the taxpayer may not have an adequate amount of time to determine the value of the distributed property in order for him or her to timely file Form 706-GS(D) or to compute the tax due, in order to timely pay any tax that is due, even if an extension of time to file is requested.

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Pursuant to Section 2662 of the Internal Revenue Code, the Secretary shall prescribe by regulation the due date for filing Form 706-GS(D) and Form 706-GS(D-1), and as stated above, the due date for filing both Forms 706-GS(D) and 706-GS(D-1) is on or before April 15 of the year following the year in which a taxable distribution is made. Form 706-GS(D-1) is similar to a Form 1099 in that the form provides notice and information to a taxpayer to aid the taxpayer in properly paying tax. Form 1099, like other information returns, are required to be provided to taxpayers ("payees") by February 15th of the year following the year in which a payment is made. If the due date for Form 706-GS(D-1) is changed to a date prior to April 15 of the year following the year in which a taxable distribution is made, such as February 15, the taxpayer's ability to timely file his or her Form 706-GS(D) and pay any tax resulting from a taxable distribution may be improved. Because the defined due date for Form 706-GS(D-1) is set forth in Treasury Regulation Section 26.2662-1, this change would require a revision of that regulation, which may result in this recommendation being beyond the scope of the requested comments. Changing the due date of Form 706-GS(D-1) as suggested would enhance the quality, utility, and clarity of the information to be collected both in that form and in Form 706-GS(D). We recognize that such a change could be more burdensome for the trustee, but such a change would better enable the taxpayer to timely and accurately file Form 706-GS(D) and pay any applicable generation-skipping transfer taxes that may be due.

2. Request for Extension of Time to File Form 706-GS(D)

<u>We respectfully recommend that the IRS consider allowing for an automatic extension of Form 706-GS(D) if the taxpayer's individual income tax return is extended.</u>

Pursuant to the Instructions for Form 706-GS(D), a taxpayer may request an automatic 6-month extension of time to file Form 706-GS(D) by filing Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns. There is no alternative method to extend the due date for filing Form 706-GS(D). The IRS may wish to consider providing for an automatic extension of the time to file a taxpayer's Form 706-GS(D) if the taxpayer extends the due date for filing his or her federal income tax return. Such an automatic extension currently exists with respect to the taxpayer's Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return). The instructions for Form 709 provide that any extension of time granted for filing a taxpayer's federal income tax return will automatically extend the time for filing the taxpayer's Form 709. If the due date of a taxpayer's Form 706-GS(D) could be extended automatically in the same manner as a taxpayer's Form 709, the taxpayer's burden of filing Form 7004 could be alleviated in some instances. As noted in the prior comment, there may be circumstances where a taxpayer may not be aware of the need to file Form 706-GS(D) or the need to timely request an extension of time to file until after the due date for the form. The taxpayer would then face penalties for the failure to file the Form 706-GS(D) or the Form 7004. Therefore, an automatic extension would be of significant assistance to taxpayers.

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SECTION OF TAXATION

State Bar of Texas

September 19, 2013

Mr. Daniel Werfel
Principal Deputy Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20024

RE: Comments on Proposed Treasury Regulations Section 301.6708-1 Relating to Failure to Maintain List of Advisees with Respect to Reportable Transactions

Dear Principal Deputy Commissioner Werfel:

On March 8, 2013, the Internal Revenue Service (the "IRS" or "Service") and the Department of the Treasury ("Treasury") released REG-160873-04 regarding Proposed Treasury Regulations Section 301.6708-1 relating to the failure to maintain a list of advisees with respect to reportable transactions (the "Proposed Regulations"). In the Preamble to the Proposed Regulations, the Service and Treasury requested comments on the Proposed Regulations. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments on the Proposed Regulations.

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

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

BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Elizabeth Copeland

Elizabeth Copeland
Chair, Section of Taxation
The State Bar of Texas

cc: Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury

William J. Wilkins
Chief Counsel
Internal Revenue Service

Emily S. McMahon
Deputy Assistant Secretary (Tax Policy)
Department of the Treasury

COMMENTS ON PROPOSED TREASURY REGULATIONS SECTION 1.6708-1, AS PUBLISHED IN THE FEDERAL REGISTER ON MARCH 8, 2013

Principal responsibility for drafting these comments was exercised by David Colmenero, Robert D. Probasco, Shawn O'Brien and Brandon Bloom. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Mary A. McNulty reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, Co-Chair of COGS, also reviewed the comments on behalf of COGS.

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

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Date: September 19, 2013

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I. EXECUTIVE SUMMARY.

We commend the issuance of the Proposed Regulations and guidance provided relating to the failure to maintain a list of advisees with respect to reportable transactions. We respectfully offer for your consideration the following suggested changes:

- Exclude the language in Prop. Treas. Reg. § 301.6708-1(b)(3),[1] which permits the IRS to leave a written request for a Section 6112 list at the last and usual place of abode or usual place of business of the person required to maintain the list;

- Revise the language in subsection (b) of the Proposed Regulations to require that, in situations where the IRS mails a request for a Section 6112 list, the notice state the date of mailing and to provide that the 20-day period begins to run from the later of three days after the stated date of mailing by the IRS or the date of actual delivery by the U.S. Post Office if the recipient can establish that delivery occurred at a later date.

- Clarify that all issues pertaining to the applicability and amount of the penalty are subject to administrative review by an IRS Appeals office;

- Clarify how the Proposed Regulations apply to law firms, accounting firms and other entities comprised of individual advisors; and

- Clarify certain aspects of reasonable compliance procedures establishing reasonable cause.

II. BACKGROUND.

Section 6112 requires material advisors to maintain lists of advisees and other information with respect to reportable transactions and to make such list and information available to the IRS upon written request. Under Section 6708(a)(1), if a material advisor fails to comply with a written request for the Section 6112 list within 20 business days after the request is made, the material advisor is subject to a penalty in the amount of $10,000 for each day of the failure after the 20th business day. Pursuant to Section 6708(a)(2), the penalty will not be imposed on any day that the failure is due to reasonable cause.

III. COMMENTS.

A. Delivery of Written Request

We recommend that Prop. Treas. Reg. § 301.6708-1(b)(3), which authorizes the IRS to deliver the request for the Section 6112 list by leaving it at the last and usual place of abode or usual place of business, be deleted.

Prop. Treas. Reg. § 301.6708-1(b) states that the 20-business-day period begins to run from the earliest of the date that the IRS

(1) Mails a request for the list required to be maintained under Section 6112(a) by certified or registered mail to the person required to maintain the list;

[1] Unless otherwise specified, all references to "Section" are to the Internal Revenue Code of 1986, as amended (the "Code"), all references to "Treas. Reg. §" are to the Treasury Regulations promulgated thereunder, and all references to "Prop. Treas. Reg. §" are to the Proposed Regulations.

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(2) Hand delivers the written request to the person required to maintain the list; or

(3) Leaves the written request at the last and usual place of abode or usual place of business of the person required to maintain the list.

The third method of delivery (last and usual place of abode or usual place of business) did not appear in the interim guidance issued by the IRS under Section 6708 in IRS Notice 2004-80. *See* IRS Notice 2004-80, I.R.B. 2004-50 (Dec. 13, 2004). It appears for the first time in these Proposed Regulations.

By contrast, a notice of deficiency must be delivered only by certified or registered mail. Section 6212(a). The delivery methods authorized for a written request for the Section 6112 list are broader and similar to those for collection due process notices: notification of the filing of a notice of lien, Section 6320(a)(2), or notice of an intent to levy, Section 6330(a)(2). But unlike collection due process notices, a Section 6112 request requires affirmative action and imposes significant penalties if the recipient does not respond.

Further, a Section 6112 request has more in common with the notice of deficiency than with the collection due process notices and therefore should be subject to the same limited methods of delivery to assure delivery. First, the collection due process notices come into play only after the taxpayer's liability has been determined. Usually the taxpayer has already had an opportunity to challenge the liability. A notice of deficiency or Section 6112 request precedes the determination of liability or penalty; therefore, it is more important to ensure that the recipient received the notice or request. Second, realistically taxpayers in the Collections phase may be more difficult to contact through normal methods than taxpayers receiving a notice of deficiency or material advisors receiving a Section 6112 request. It may be reasonable to provide delivery options for collection due process notices, but the same logic does not apply to Section 6112 requests. Section 6112 requests have more in common with notices of deficiency, and the authorized delivery options should be similar.

We believe there are too many potential problems inherent in leaving a notice that carries such significant consequences at a person's place of abode or usual place of business. The Proposed Regulations place no restrictions or limitations on how or with whom the letter can be left. The IRS could apparently simply tape the letter to a door or window, or set it on a door step, making it susceptible to being swept away, washed away, or inadvertently destroyed in any number of different ways. Or the IRS could leave the letter with anyone at the location, including a child, staff or even an incompetent person, any one of whom may fail to deliver the letter to the intended recipient.

Moreover, the reasonable cause provisions in the Proposed Regulations do not provide adequate protection because the burden of proof is on the material advisor. *See* Preamble, Prop. Treas. Reg. 301.6708-1(b). Thus, the material advisor would be in a position of having to prove the negative (*i.e.*, that he or she did not receive the notice), which is inherently difficult. A material advisor may have nothing more than his or her word to establish that he or she did not receive the notice, which the IRS would likely consider inherently self-serving and therefore not sufficiently credible. The material advisor may not be able to offer corroboration, particularly if he or she has no idea of why he or she did not receive the notice.

The interim guidance in Notice 2004-80 wisely excluded this method of delivery from the list of methods that trigger running of the 20-day period. We believe the Proposed Regulations should likewise exclude it.

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B. Commencement of 20-Day Response Period

We recommend that the Proposed Regulations be revised to require that, in situations where the IRS mails a request for a Section 6112 list, the notice state the date of mailing and to provide that the 20-day period begins to run from the later of three days after the stated date of mailing by the IRS or the date of actual delivery by the U.S. Post Office if the recipient can establish that delivery occurred at a later date.

Prop. Treas. Reg. § 301.6708-1(b) states that the 20-business-day period begins on the first business day after the earliest of the date that the IRS –

(1) Mails a request for the list required to be maintained under Section 6112(a) by certified or registered mail to the person required to maintain the list;

(2) Hand delivers the written request to the person required to maintain the list; or

(3) Leaves the written request at the last and usual place of abode or usual place of business of the person required to maintain the list.

If the IRS hand delivers the request or leaves it at a person's last and usual place of abode or usual place of business, the 20-day period runs – at least theoretically – from the date the request is actually received. By contrast, where the IRS delivers the request by U.S. Mail, the 20-day period would run from the date of mailing, not from the date the taxpayer actually receives it. Thus, as the Proposed Regulations are currently drafted, the taxpayer's 20-day period for responding is necessarily shortened by the amount of time it takes the U.S. Post Office to deliver the mail as compared to the other methods of delivery. This difference is significant given that the $10,000 penalty applies on a per-day basis and begins to run on the 21st day. In addition, the taxpayer may have no way of determining when the IRS mailed the request.

We believe that a material advisor should in all instances be given a full 20 days from the date he or she actually receives the request to provide the list. Under Section 6708, Congress clearly intended to give a person 20 days to provide the list. Moreover, we believe that giving a person the full benefit of the 20-day period is not only required by statute, but also appropriate given the draconian nature of the penalty. Therefore, when the IRS mails the request, we suggest that the Proposed Regulations be revised to require that the notice state the date of mailing and to provide that the 20-day period begins to run from the later of three days after the stated date of mailing by the IRS or the date of actual delivery by the U.S. Post Office if the recipient can establish that delivery occurred at a later date.

C. Administrative Review

We recommend providing an administrative review process for all issues relating to imposition of the Section 6708 penalty, including for example whether reasonable cause exists and whether an extension request should have been granted.

The Proposed Regulations state that the failure of the IRS to grant the person's extension request in full or in part may not be reviewed in any judicial proceeding. However, we believe that issues pertaining to the applicability and amount of the Section 6708 penalty, including issues such as whether an extension should have been granted or whether reasonable cause exists, should be subject to some level of administrative review. This is particularly important because the Section 6708 penalty is an "assessable penalty" under subchapter B of chapter 68. With respect to other assessable penalties, the IRS has argued and the Tax Court has agreed that the penalty is not subject to deficiency procedures and pre-payment judicial review by the Tax Court. *See, e.g., Smith v. Commissioner*, 133 T.C. 424 (2009)

(Section 6707A penalty). The absence of administrative review therefore would allow the IRS to impose the penalty without independent review by Appeals or a court before payment is required. The material advisor would have no recourse other than to pay the penalty and file a refund claim.

We therefore recommend adding language in the Proposed Regulations clarifying that all issues pertaining to the applicability and amount of the penalty, including issues such as whether an extension should have been granted or whether reasonable cause exists, are subject to administrative review by the material advisor's local IRS Appeals office.

D. Application to Law Firms, Accounting Firms and Other Entities We recommend supplementing Prop. Treas. Reg. § 301.6708-1(g)(1) with language clarifying that a material advisor may still show reasonable cause even if one or more individual employees of such person would not have reasonable cause.

Section 6708 applies to "any person who is required to maintain a list under Section 6112(a)." Section 6112 requires such a list to be maintained by a "material advisor" (as defined in Section 6111 and Treas. Reg. § 301.6111-3(b)). Generally, Section 6111 defines a material advisor as any "person" who provides material aid, assistance or advice with respect to a reportable transaction and who derives gross income for such aid, assistance or advice in excess of certain threshold amounts ($50,000 in the case of a transaction benefitting natural persons and $250,000 in any other case). The term "person" is defined in Section 7701(a)(1) to include an individual, partnership or corporation, among others. Based on the above definitions, law firms, accounting firms, and other similar entities will often qualify as material advisors with respect to reportable transactions.

These entities often employ a number of individuals who could provide material aid, assistance or advice with respect to a reportable transaction. Treasury anticipated the particular effect Section 6112 and the related Sections of the Code would have on such entities when it finalized Treas. Reg. § 301.6111-3(b)(2)(iii)(A), which provides (in relevant part):

> A material advisor generally does not include a person who makes a tax statement solely in the person's capacity as an employee, shareholder, partner or agent of another person. Any tax statement made by that person will be attributed to that person's employer, corporation, partnership or principal.

Prop. Treas. Reg. § 301.6708-1(f)(1) defines a "material advisor" as "a person described in section 6111 and § 301.6111-3(b)." Therefore, any application of the Proposed Regulations would treat the entity (i.e., the law firm or accounting firm) as the material advisor, and not the individual lawyer or accountant. The actual application of Treas. Reg. § 301.6111-3(b)(2)(iii)(A) to the Proposed Regulations, particularly Prop. Treas. Reg. § 301.6708-1(g), may lead to unintended consequences to the firms. It is unclear under the Proposed Regulations if and to what extent the actions, inaction, efforts, etc. of an individual advisor employed by a firm will affect the firm's ability to show reasonable cause. Therefore, we respectfully suggest further clarification as set forth below.

Ordinary Business Care

We recommend supplementing Prop. Treas. Reg. § 301.6708-1(g)(3) with language clarifying that a person may still show ordinary business care and, therefore, reasonable cause even if individual employees of such person did not exercise ordinary business care, as long as the person had appropriate procedures in place, and generally adhered to such procedures.

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Prop. Treas. Reg. § 301.6708-1(g)(3) provides (in relevant part):

> The exercise of ordinary business care may constitute reasonable cause. To show ordinary business care, the person may, for example, show that it established, and adhered to, procedures reasonably designed and implemented to ensure compliance with the requirements of Section 6112.

It is possible that a firm has such procedures in place and generally adheres to them, but that an individual employee disregards certain of the procedures that results in a failure to comply with Section 6112. The example in Prop. Treas. Reg. § 301.6708-1(c)(4) suggests that such situations would qualify for an extension of the time within which to supply the list. This portion of the Proposed Regulations, however, does not directly address reasonable cause. We respectfully suggest adding a similar example or adding language at the end of Prop. Treas. Reg. § 301.6708-1(g)(3) similar to the following:

In circumstances in which an employee of a material advisor fails to follow the list maintenance procedures of his employer, the employer may still demonstrate reasonable cause if the failure represents an isolated incident and the employer acted promptly to correct the error upon learning of the employee's non-compliance.

Reliance on Opinion or Advice

We recommend supplementing Prop. Treas. Reg. § 301.6708-1(g)(5)(i) with language clarifying that reasonable reliance on the advice of an independent tax professional is evaluated based on the knowledge and good faith of the individual employee(s) primarily responsible for compliance procedures for the particular transaction at issue, rather than other employees at the firm.

Prop. Treas. Reg. § 301.6708-1(g)(5)(i) provides (in relevant part), "[a] person may rely on the advice of an independent tax professional to establish reasonable cause. The reliance, however, must be reasonable and in good faith, in light of all the other facts and circumstances." As a practical matter, the assessment of the independence of another tax professional cannot be a "committee decision"; the assessment must be made by the employee primarily responsible for the transaction, who requests the independent tax professional's advice. If the employee who is primarily responsible follows reasonable procedures in seeking such advice, the reasonableness of reliance should be based on that employee's knowledge and good faith. It would be inappropriate to impute the knowledge of all individuals at the firm in assessing the reasonableness of reliance. Therefore, we respectfully suggest supplementing Prop. Treas. Reg. § 301.6708-1(g)(5)(i) with language clarifying that reasonable reliance on the advice of an independent tax professional is evaluated based on the knowledge and good faith of the individual employee(s) primarily responsible for compliance procedures for the particular transaction at issue, rather than other employees at the firm.

E. Reasonable Cause

Section 6708(a)(2) provides a reasonable cause defense against the penalty for failure to make the required list available on demand by the Secretary. Prop. Treas. Reg. §§301.6708-1(g) and (h) elaborate on what constitutes reasonable cause. We commend the IRS for its efforts to provide guidance on the application of this defense, but we respectfully suggest the following clarifications concerning reasonable compliance procedures that would establish reasonable cause.

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Accept Ordinary Business Care As Reasonable Cause

Prop. Treas. Reg. §301.6708-1(g)(3) provides a general standard for determining reasonable cause for failure to comply:

> The exercise of ordinary business care *may* constitute reasonable cause. To show ordinary business care, the person *may*, for example, show that it established, and adhered to, procedures reasonably designed and implemented to ensure compliance with the requirements of section 6112....Notwithstanding the occurrence of an isolated and inadvertent failure, a person still *may* be able to demonstrate that the person exercised ordinary business care, considering all the relevant facts and circumstances, but only if the person had established and adhered to procedures reasonably designed and implemented to ensure compliance with the requirements of section 6112. [Emphasis added.]

We believe that, absent extraordinary circumstances, reasonable compliance procedures should always result in a finding of reasonable cause. We therefore respectfully suggest that Prop. Treas. Reg. § 301.6708-1(g)(3) be revised to provide:

> The exercise of ordinary business care *shall* constitute reasonable cause. For example, if the person shows that it established, and adhered to, procedures reasonably designed and implemented to ensure compliance with the requirements of section 6112, the person has shown ordinary business care....Notwithstanding the occurrence of an isolated and inadvertent failure, a person still *would* be able to demonstrate that the person exercised ordinary business care, considering all the relevant facts and circumstances, if the person had established and adhered to procedures reasonably designed and implemented to ensure compliance with the requirements of section 6112. [Emphasis added.]

Reasonable Cause For Omissions of Transactions or Advisees

We recommend that certain of the examples in the Proposed Regulations be replaced by or supplemented with one or more examples in which the advisor had reasonable cause for omitting a transaction or advisee from the list.

The rules concerning whether a transaction is a "reportable transaction," and whether an advisor is a "material advisor" with respect to a specific person, are complex and difficult to apply. We believe that most failures to comply with Section 6112 will result from failures to identify, whether inadvertently or through a mistaken application of the rules, a particular transaction or advisee as subject to these requirements.

The Proposed Regulations include twelve examples, but only three involve the omission of specific advisees from the required list. In two of the three examples,[2] the advisor demonstrates that it is not a material advisor with respect to those clients. Such examples are superfluous to guidance as to reasonable cause. Reasonable cause is not relevant because the original list was complete and the reasonable cause defense is not needed to avoid a penalty. The third example[3] concludes that there was no reasonable cause because the supervisor did not review the list prior to sending it to the IRS. (Pre-submission review is discussed further below.)

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[2] Section 301.6708-1(g)(6), Example 2, and Section 301.6708-1(h)(3), Example 2.

[3] Section 301.6708-1(h)(3), Example 3.

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In our experience, IRS personnel considering potential penalties may be less likely to find reasonable cause if the facts and circumstances do not fit neatly within any of the examples in the applicable regulations. We are concerned that the absence of an example in which the advisor failed to list a transaction or advisee but had reasonable cause for the omission might be interpreted as a presumption that the material advisor can never show reasonable cause for such omissions. We therefore respectfully suggest that the first two examples be replaced by or supplemented with one or more examples in which the advisor had reasonable cause for omitting a transaction or advisee from the list.

Pre-Submission Review

We recommend that the examples be modified or supplemented to eliminate the implication that a pre-submission review would reasonably be expected to detect the omission of a transaction or advisee from the list.

The Proposed Regulations include two examples that discuss a supervisor's review of the list before it is submitted to the IRS ("pre-submission review"). One example involves the omission of a particular document from the list.[4] Because the supervisor "carefully reviewed the list to verify that it was comprehensive and accurate," and promptly provided the necessary document after being notified of the omission, the advisor had reasonable cause. The other example involves the omission of 15 advisees.[5] The advisor did not maintain a list contemporaneously with the issuance of advice and a supervisor did not review the final list before sending it to the IRS. Because the advisor could not establish a good faith effort to comply, it did not have reasonable cause for the failure to furnish the complete list.

We concur that pre-submission review is appropriate but the inefficacy of pre-submission review in identifying certain types of omissions makes it an inappropriate factor in determining whether a material advisor had reasonable cause for failing to comply with the Section 6112. For example, if the relevant transactions and advisees were identified contemporaneously with the issuance of the material advisor's advice,[6] a pre-submission review would be expected to detect most omissions of specific documents associated with those transactions and advisees. However, if the relevant transactions or advisees were not contemporaneously identified, and are therefore omitted from the list, it is unlikely that an additional pre-submission review would detect such omissions.

Many advisors handle a large volume of transactions, and relatively few are reportable transactions. Within the 20-day period, neither a supervisor nor individuals with primary responsibility for specific client matters could conduct a thorough review of *all* client matters to identify any omissions of transactions or advisees from the list. If the material advisor is a company handling a large number of transactions, it is highly unlikely that even a "careful review" of the list conducted during this limited period could have identified the missing advisors.

For the above reasons, we respectfully suggest that these examples be modified or supplemented to specify that an advisor can demonstrate reasonable cause for the omission of a transaction or advisee from the list, even if a pre-submission review did not identify such omissions. Such a revision clarifies that a person can show reasonable cause when there was an omission of a transaction or advisee. It also appropriately emphasizes that the procedures designed to ensure contemporaneous identification are much more important, because they are more likely to be effective, than a pre-submission review.

[4] Prop. Treas. Reg. § 301.6708-1(h)(3), Example 1.
[5] Prop. Treas. Reg. § 301.6708-1(h)(3), Example 3.
[6] Prop. Treas. Reg. § 301.6708-1(h)(3), Example 1.

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Advice Of Independent Tax Professional

We recommend that the Proposed Regulations explicitly reject any presumption of a lack of ordinary business care from the failure to consult with an independent tax professional.

Prop. Treas. Reg. § 301.6708-1(g)(5) provides (in relevant part), that "[a] person may rely on the advice of an independent tax professional to establish reasonable cause." We agree that such reliance should qualify as reasonable cause. However, we are concerned about the possible implications of this provision. For other penalties with similar safe harbor defenses, as a practical matter the IRS and courts have often presumed that the taxpayer did not exercise reasonable care if it did not consult with an independent tax professional. Such a presumption may be appropriate for inexperienced taxpayers facing complex tax issues, but it would not be appropriate for most material advisors, who do have the necessary background and experience to evaluate their list maintenance obligations without seeking outside advice. Although the Proposed Regulations do not require consultation with an independent tax professional to establish reasonable cause, we respectfully recommend that the Proposed Regulations explicitly reject any presumption of a lack of ordinary business care from the failure to consult with an independent tax professional. This lack of a requirement is implied,[7] but due to past presumptions by the IRS and courts in other contexts, we believe an explicit rejection is warranted.

Respectfully submitted,

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[7] Prop. Treas. Reg. § 301.6708-1(g)(6), Example 7.