Volume XXIX, Issue 3 Fall 2003

Michigan Tax Lawyer

TABLE OF CONTENTS

The *Michigan Tax Lawyer* is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. The *Michigan Tax Lawyer* is published three times each year — October (Fall), February (Winter) and July (Summer). Features include concise reports in a uniform format from the Section's committees, practitioner articles with the "how to" approach, news of events and of other Section members, and "Short Subjects" providing helpful practice information.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact Jay A. Kennedy, 300 River Place, Suite 3000, Detroit, MI 48207-4225.

Subscription Information

The *Michigan Tax Lawyer* (ISSN 0899-2460) is published three times a year by the Taxation Section, State Bar of Michigan, 917 N. Gainsborough, Royal Oak, Michigan 48067. Subscription fee of $5.00 is included in the $30.00 annual Taxation Section membership fee. Standard mail postage paid at Royal Oak, Michigan. POSTMASTER: Send address changes to *Michigan Tax Lawyer*, Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend, Lansing, Michigan 48904.

Change of Address

Individual subscribers should send notification in writing to: *Michigan Tax Lawyer*, Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend, Lansing, Michigan 48904.

Citation Form

The *Michigan Tax Lawyer* may be cited as follows: (Vol.)(Issue) MI Tax L. (Page)(Yr.).

Disclaimer

TAXATION SECTION

STATE BAR OF MICHIGAN

PROGRAM FACILITATOR
JAN M. BAGGETT
2290 FIRST NATIONAL BUILDING
660 WOODWARD AVENUE
DETROIT, MI 48226-3506
(313) 465-8212
JBaggett@honigman.com

October 6, 2003

Dear Taxation Section Members:

It is a pleasure and an honor to serve as Chairperson of the Taxation Section for 2003-2004. I look forward to meeting as many of you as possible during the coming year at one of the Taxation Section activities. Meanwhile, please join me in welcoming new Council members Aaron H. Sherbin, Jeffrey A. Devree, and Joan R. Dindoffer, as well as new Committee Chairpersons Eric T. Carver (Business Entities), Warren J. Widmayer (Employee Benefits) and James F. Mauro (Practice and Procedure).

The Section's other new officers for 2003-4 are Eric M. Nemeth, Vice-Chairperson, Charles M. Lax, Treasurer, and Aaron H. Sherbin, Secretary. The entire Taxation Section Council, together with our Program Facilitator, Jan M. Baggett, is committed to making this year's Section activities interesting, informative, and accessible to you. These include:

The Michigan Tax Lawyer. Publication is scheduled at approximately four month intervals, with Jay Kennedy taking over as editor from David B. Deutsch. Please call Jay at (313) 566-2500 if you are interested in submitting an article for a future issue of ***The Michigan Tax Lawyer***.

After Hours Tax Law Series. Shirley A. Kaigler has scheduled a series of four late afternoon programs presented in conjunction with ICLE: October 28, 2003, Hot Topics in Estate and Gift Tax; November 18, 2003, Tax Aspects of Buying and Selling a Business; January 13, 2004, Tax Aspects of Business Succession Planning; and February 17, 2004, Estate Planning for Retirement Benefits. Trevor T. Wetherington has already started work on next year's series. Please contact Trevor at (313) 628-7439 if you are interested in being a future program speaker.

Summer Tax Conference. The Section's Annual Summer Tax Conference will be moving to the Soaring Eagle Resort in Mt. Pleasant, Michigan, June 25-26, 2004. Henry P. Lee is putting together an outstanding program at this new conference venue. Our theme for this year's conference

will be: Back to Basics. Conference information and registration forms should be in your mailbox soon.

Tax Court Luncheon. When the Tax Court is in Detroit, our Section schedules a luncheon for the presiding Tax Court judge and IRS District Counsel members. Ronald T. Charlebois will be responsible for arranging the luncheon(s) this year. He may be reached at (248) 643-6500.

Committee Meetings. Each of the Taxation Section's five Committees conducts informative meetings to address issues relating to each Committee's area of law. Taxation Section members can be placed on a Committee's mailing and/or e-mail list by contacting the appropriate Committee Chairperson. If you are interested in learning more about a Committee, please contact the appropriate Committee Chairperson:

Business Entities - Eric T. Carver	(313) 568-6587
Employee Benefits - Warren J. Widmayer	(734) 662-0222
Estates and Trust - George H. Runstadler III	(248) 645-9680
Practice and Procedure - James F. Mauro	(517) 371-1730 Ext. 4701
State and Local - John M. Neberle	(248) 357-3010

Internet. The Taxation Section's website can be accessed either through the State Bar website at www.michbar.org or directly at www.michigantax.org. Jeff Devree will be working hard this year to upgrade all aspects of the website. If you have ideas for website content or improvements, please contact Jeff at (616) 459-3200.

As I begin my year as Chairperson, my sincere thanks goes to my predecessor, Ed Deron, for his dedicated leadership of the Section this past year and for his many years of service to the Taxation Section. At the same time I look forward to working with the new officers, and the new and continuing Council members and Committee Chairpersons. All of us look forward to meeting you soon.

Sherill Siebert

Chairperson

Report of the Business Entities Committee

Eric Thomas Carver, Chairperson
Dykema Gossett PLLC
400 Renaissance Center
Detroit, Michigan 48243
(313) 568-6587 Office
(313) 568-6735 Fax
ecarver@Dykema.com

Upcoming Activities
The Business Entities Committee is planning two conferences for the beginning of next year. The first, to be held in early February, will speak to the area of split dollar insurance and the impact of the recently issued final regulations. The second, scheduled for late May, 2004, will feature a discussion on recent developments involving both business and discount valuations. As always, I welcome any suggestions for topics to be discussed and debated for future meetings.

The Business Entities Committee is planning two conferences for the beginning of next year.

Report of the Employee Benefits Committee

Warren J. Widmayer, Chairperson
Ferguson & Widmayer, P.C.
538 North Division
Ann Arbor, Michigan 48104
(734) 662-0222 Office
(734) 662-8884 Fax
warren@fw-pc.com

Recent Activities
Daniel S. Gardner, the 403(b)/457 Plan Educational Outreach Coordinator for the Great Lakes Area of TE/GE Division of the IRS, spoke September 8, 2003 on current 403(b) and 457 issues at the Detroit office of Honigman Miller Schwarz and Cohn. His presentation included insight into the IRS specialist study groups formed around specific issues and the debates arising during the process of finalizing the 457 regulations and proposed unpublished changes to the 403(b) audit guidelines.

A joint dinner meeting with the Michigan Employee Benefits Conference was held on November 20, 2003 at the Red Run Golf Club in Royal Oak. Paul Shultz, Director of Employee Plans Rulings and Examinations, TE/GE spoke on a number of current topics in the employee benefits area, including changes to the determination letter program that are currently under consideration within the IRS.

Larry Burleson and Michael Hayden also presented an update from the Examination function of the Detroit TE/GE office, assisted by Debi Lohning.

Upcoming Activities
The committee is planning a meeting addressing recent tax law developments, including the new health savings accounts, tentatively scheduled for Thursday, February 19, 2004. Time, speakers and location to be announced.

The committee will co-sponsor the IRS/ASPA Great Lakes Employee Benefits Conference, which is scheduled to be held Thursday and Friday, April 29 and 30, 2004 at the Hyatt Regency McCormick Place, 2233 S. Martin Luther King Drive, Chicago, IL 60616 (Phone: (312) 567-1234, Fax: (312) 528-4000). Members will receive further information and are encouraged to attend.

Report of the Estates and Trusts Committee

George H. Runstadler, Chairperson
Berry Moorman, P.C.
255 E. Brown Street, Suite 320
Birmingham, MI 48009
(248) 645-9680
(248) 645-1233 (Fax)
grunstadler@berrymoorman.com

The Committee has not had a recent meeting. Several will be scheduled for the Year 2004. The *New York Times* proposed in a recent article that several Republican Senators known to be strong proponents of the Estate and Gift Tax repeal are informally softening their position in light of the significant budget deficit being experienced. These unnamed Senators have refused public comment and denied the rumors. This NYT article could be taken to be a trial balloon, intending to test the public's reaction to repeal of the repeal.

Report of the Practice and Procedure Committee

James F. Mauro, Chairperson
Dickinson Wright PLLC
215 S. Washington Square, Suite 200
Lansing, MI 48933
(517) 487-4701 Office
(517) 487-4700 Fax
jmauro@dickinsonwright.com

On September 17, 2003, during the Annual Meeting of the State Bar, I was elected Chairperson of the Tax Section's Practice and Procedures Committee. This two-year term will conclude in September of 2005.

Given my lack of experience with the State Bar Committees, it will be a learning process. I have many ideas, with the challenge of turning them into reality. I will measure my success, in part, by the level of participation in the future section meetings. Therefore, I invite each of you to provide suggestions, comments, or assistance in creating section meetings that are held in a location accessible to you and involve a topic that is of interest to you. Please call, write, or e-mail me at any time.

My first official act as Chairperson was on October 14, 2003, when I attended the Tax Council meeting in Novi. At that time, the Summer Tax Conference for 2004 was announced. It will be held on June 25 and 26 at the Soaring Eagle Resort in Mount Pleasant, Michigan. Also announced was the Annual Tax Section meeting date of September 9, 2004. Please mark your calendars accordingly.

Plans are currently in process for four Practice and Procedure Committee meetings during 2004. Suggested topics include: 1) Dealing with the IRS in the Audit and Appeals process; 2) Dealing with the Michigan Department of Treasury on collection matters; and 3) Property tax appeals before the Michigan Tax Tribunal. To the extent that these are crossover topics into other practice section areas, joint meetings with those other sections will be considered.

At this time, I have had discussions with Eric Carver, Chair of the Business Entities Tax Section. We are making plans for a joint meeting in March dealing with the topic "Protecting Individuals from the Tax Liabilities of a Business Entity." We hope to secure a guest speaker from the Internal Revenue Service to address Trust Fund liability. The location is tentatively set for the Dykema Gossett Law Firm, 39577 Woodward Avenue, Suite 300, Bloomfield Hills, Michigan. Announcements with details will be released after all plans have been finalized.

While I welcome comments from all of you, I am particularly interested in hearing from out-state practitioners to see if there is a demand for meetings to be brought to you, either in person or via video link. Thank you for your support.

I welcome comments from all of you, I am particularly interested in hearing from out-state practitioners ...

Report of the State and Local Tax Committee

John M. Neberle, Chairperson
Raymond & Prokop, P.C.
26300 Northwestern Highway, 4th Floor
Southfield, MI 48086-5058
(248) 357-3010

The Chairman indicated that the MTT wants to avoid even the appearance of partiality.

Recent Activities.
The State and Local Tax Committee held a meeting on October 14, 2003 at the offices of Raymond & Prokop, P.C., Southfield, Michigan. The guest speaker was Michigan Tax Tribunal Chairperson the Honorable Jack Van Coevering.

After the self-introductions of those attending and participating by phone the Chairman advised the group of the appointment of Patricia Helm to the position of a Michigan Tax Tribunal ("MTT") judge, subject to Michigan Senate confirmation. For more information concerning the MTT judges and their backgrounds, see its web site.

The Chairman indicated that the MTT wants to avoid even the appearance of partiality. He stressed. those that practice before the MTT should request a judge to recuse if there are any concerns about partiality. In addition to the "professional rules of conduct" the MTT also has a procedure that prohibits judges from being involved in cases where their former employer (within two years) are parties.

Ideas for Improving MTT Procedures.
Ideas were collected from attorneys that practice before the MTT, listed and furnished to the MTT Chairman. That unedited list is as follows:

Motion Practice Hearings: Parties should be able to obtain a hearing on pending motions by filing a motion requesting a hearing. Such motions should be routinely granted administratively with the hearing set for the next available motion day.

The tribunal should designate a day of the week as "Motion Day," with motion hearings to be held on that day.

Assignment of Cases: Assign cases to Judges as the cases are filed. Assignments should be random within areas of expertise

Amend the Tribunal Act to Remove Requirement that Tribunal be self-funding and seek more financial support

Increase salaries: Consider parity of Tribunal judges with District Court Judges and parity of the Chief Judge with circuit court judges.

Discovery: Request for Admissions and Request for Production of Documents should be permitted as a matter of right.

Depositions under MCR/ Subpoenas for Depositions should be routinely supplied by the Clerk.

Simultaneous Exchange. Is this necessary? A hardship can occur when taxpayers submit appraisals seeking greater reductions in value than the Respondent had notice of from the petition. Consider limiting relief to the amount of the petition or non-simultaneous exchange of appraisals.

Publish Credentials of all members in MTT Reporter. Also list the category each judge was appointed to fill.

Limit representation in Tax Tribunal to those admitted to Bar or to those who by training and experience otherwise qualify. This is analogous to the tax court procedure.

Assign an Attorney/Judge/ Hearing Officer to full Tribunal trials

Stipulations/Consent Judgments: Should be routinely and promptly entered.

Timeliness of Decisions: – Four months should be the maxi-

mum time from the submission of post trial briefs for a decision to be entered.

Rehearing: Conform rules to the Act – 20 days.

Counsel Conferences: Change the date for conferences and summary to a date X days after the answer is filed.

Establish a procedure to allow a party to move for a counsel conference in state tax cases at which the decision makers with authority to settle the case must be present.

Specifically permit conferences to be held by telephone.

Costs: Allow attorneys' fees to be awarded as costs, with the concurrence of the chair or by two members appointed by the chair.

Fees. Allow multiple fees to be paid with one check

Motion Practice: Clarify page limit on motions, and permit replies unless oral argument is permitted.

Dispositive Motions: Require affidavits for Dispositive motions.

Official Record: Permit certified court reporters to make a record if a party so requests, and provide, subject to the court rules concerning corrections, that the reporter's record is the record of the tribunal.

Hearings: Amendment to the Act and Rules to clarify applicable rules of evidence.

Hearings: Provide that if Petitioner calls Respondent's expert witnesses, Petitioner may be required to pay a portion of the expert's fees in certain circumstances.

Qualifications. Amend the statute to provide that the chair must be an attorney with state or local tax experience and to remove limit on the number of attorney that can be appointed to the tribunal.

FOIA and OMA: Amend FOIA/OMA to permit confidential treatment of information used in Tribunal appeals.

Subpoenas: Issue Subpoenas Duces Tecum for Depositions and Hearing.

Interrogatories: Not to be filed with the Tribunal unless otherwise ordered.

Discovery: Adopt the MCR.

Clerk: Clerk to be appointed every four years by the chair with approval of majority of members.

Clerk's role to be limited to filing and procedural matters – not deciding motions, cases, etc.

Must be an attorney.

MTT Employees: No dual capacity by any MTT employee.

Ex Parte Communications: No Ex Parte communication by any practitioner (lawyers and non-lawyers) with MTT's judges/hearing officers, parties or state officials.

Cannons of Judicial Ethics to apply to MTT Judges.

Prehearing Call. Provide counsel with independent notice of their cases, which are on a given Prehearing Call.

Delay on Refunds. Amend the Act so that governmental units pay much higher interest when refunds are delayed more than 35 days.

Defaults. Change procedures so that the Tribunal does not put both parties in default when one party has acted properly and a deadline is missed (such as a Stipulation of Counsel Conference) because of the action/inaction of the other party.

Give parties 35 days to cure defaults or respond to defect letters.

Joinder of Claims/Petitioners. Allow Petitioners with identical or related claims to file together in one case.

Tax Administration & Legislative Update.

The Michigan Department of Treasury has issued a Revenue Administrative Bulletin, i.e., RAB 2003-B, Pass Through Entity Withholding Requirements related to Non-Resident Members.

... governmental units pay much higher interest when refunds are delayed more than 35 days.

Treasury (www.Michigan.gov/treasury) is currently issuing a notice called Legal Policy Determination ("LPD") on its web site. Treasury describes the LPD as follows:

> "The Department of Treasury is re-evaluating the form and substance of informational materials and guidance given to taxpayers. As a first step in that process it has been determined that the Legal Policy Determination memos (LPD) will be made available on the Department of Treasury web site as they are developed and issued."

Failure to comply would result in a penalty of $50 ...

The LPDs that have been issued are as follows:

2003-1 GENERAL SALES AND USE TAX ACTS: INTERSTATE COMMERCE REQUIREMENT OF THE ROLLING STOCK EXEMPTION.

2003-2 GENERAL SALES AND USE TAX ACTS: STATE CHARTERED CREDIT UNIONS.

2003-3 GENERAL SALES AND USE TAX ACTS: FOOD SERVICE ESTABLISHMENT EMPLOYEE MEALS.

2003-4 SINGLE BUSINESS TAX INVESTMENT TAX CREDIT RECAPTURE IN A YEAR THAT A GROSS RECEIPTS REDUCTION IS TAKEN.

The Michigan Legislature has passed SB 770 that requires persons to file a copy of the federal Form 1099 with the Michigan Department of Treasury and with local units of government in Michigan that levy an income tax. Failure to comply would result in a penalty of $50 for each federal Form 1099 that the taxpayer failed to file.

Future Meetings.
The next meeting of the State and Local Tax Committee will be held at the call of the Chairperson in February 2004 at a location to be determined.

Joint meetings with the Practice and Procedures Committee are in the planning stages on the topics of (i) Dealing with the Michigan Department of Treasury on collection matters and (ii) Property tax appeals before the Michigan Tax Tribunal. If members have suggestions for future meeting topics, please let me know.

Working Within the Final Split-Dollar Life Insurance Regulations

By: Robert M. Hartley

Equity split-dollar life insurance arrangements have been utilized by employers for nearly 40 years to provide current life insurance protection and tax-favored deferred compensation to key employees. In the wake of the much-anticipated final regulations governing split-dollar life insurance arrangements issued on September 12, 2003,[1] most equity split-dollar arrangements will not fully achieve the tax benefits they were originally designed to achieve and employers must act prior to December 31, 2003 to save a portion of these originally intended benefits. This article examines (i) the traditional taxation of split-dollar arrangements in the employer-employee context, (ii) the taxation of split-dollar arrangements under the final regulations, (iii) the treatment of existing split-dollar arrangements under the grandfather and safe harbor provisions of Notice 2002-8,[2] and (iv) steps employers should take with respect to existing split-dollar arrangements.

I. Traditional Taxation of Split-Dollar Arrangements

In the employer-employee context, equity split-dollar life insurance arrangements are a method to finance the cost of current life insurance protection and provide deferred compensation to an employee in the form of the built-up cash value in excess of the employer's premium payments with little or no tax cost to the employee. There are two types of split-dollar arrangements utilized by employers: (i) collateral assignment split-dollar; and (ii) endorsement method split-dollar.

In collateral assignment arrangements, (i) the employee owns the insurance policy, (ii) the employer pays all or most of the premiums, and (iii) the employee assigns the policy to the employer as collateral for repayment of the premiums paid by the employer. Collateral assignment arrangements are almost always equity arrangements, meaning the employee has a right to the built-up cash value of the policy in excess of the employer's premium payments. Practitioners generally believed that the employee was not subject to income tax on the built-up cash value of the policy in equity split-dollar arrangements until the employee cancelled the policy or withdrew cash value in excess of the employee's basis in the policy, thereby offering a deferred compensation arrangement at no tax cost. The employee only recognized the cost of current term life insurance protection (i.e., the P.S. 58 cost[3]) as taxable income each year.

... the employee has a right to the built-up cash value of the policy in excess of the employer's premium payments.

In endorsement arrangements, the employer (i) owns the policy, (ii) pays the premiums on the policy, and (iii) endorses a portion of the death benefit to the employee. The employee generally has no interest in the policy other than the ability to designate a beneficiary. As a result, endorsement split-dollar arrangements are typically non-equity, meaning that the employer is entitled to receive all of the cash value of the policy if the arrangement is terminated during the employee's lifetime or upon the employee's death. As with collateral assignment arrangements, the employee only included the cost of current term life insurance protection as income each year.

Generally, both types of arrangements are designed to terminate upon the earlier of the employee's termination of employment or death. Upon termination of employment, a collateral assignment arrangement

is usually "rolled-out" by (i) the employee taking a loan against the policy to repay the employer for premiums paid and the employer releasing its security interest in the policy, or (ii) the employer releasing its security interest in the policy without repayment. The employee is only subject to income tax to the extent the employer released its security interest without repayment. In contrast, an endorsement arrangement is usually terminated upon an employee's termination of employment by the employer either (i) retaining control of the policy as sole owner and beneficiary and using the cash value and death benefit to provide the employee monthly income pursuant to a separate nonqualified deferred compensation plan, or (ii) transferring the policy to the employee and subjecting the employee to income tax on the cash value in excess of the employee's basis. In both types of arrangements, upon the employee's death, the employer is repaid from the death benefit the amount of its premium payments (in equity arrangements) or the entire cash value (in non-equity arrangements) and the remainder is paid to the employee's designated beneficiary income tax-free.

... the only economic benefit provided to the employee is current life insurance protection ...

II. Taxation of Split-Dollar Arrangement Under the Final Regulations

The final regulations provide that split-dollar arrangements entered into after September 17, 2003 will generally be taxed under two mutually exclusive regimes: (i) an "economic benefit" regime; and (ii) a "loan" regime. Which regime applies depends solely on whether the employer or the employee owns the policy.[4] The economic benefit regime applies to endorsement arrangements where the employer owns the policy. The loan regime applies to collateral assignment arrangements where the employee owns the policy. Generally, the owner named on the insurance policy will be considered the owner for split-dollar purposes.[5] The only exception is that the employer is treated as the policy owner if, at all times, the only economic benefit provided to the employee is current life insurance protection (i.e., non-equity split-dollar arrangements).[6]

A. Economic Benefit Regime

If the employer owns the policy (or in any non-equity arrangement), the arrangement will be taxed under the economic benefit regime. Non-equity endorsement arrangements will continue to be taxed in a manner similar to before—the employee will be taxed each year only on the cost of current term life insurance protection.[7] Split-dollar arrangements entered into before January 28, 2002 may continue to value the current life insurance protection using either the P.S. 58 rates set forth in Revenue Ruling 55-747 or the insurer's lower published one-year term insurance rates. Split-dollar arrangements entered into after January 28, 2002, but on or before September 17, 2003, may use the insurer's lower published rates through December 31, 2003. Thereafter, the value of current life insurance protection may be based on the insurer's rates only if the insurer regularly sells term insurance at such rates to individuals applying for term insurance through the insurer's normal distribution channels. Otherwise, the rates originally published in Notice 2001-10 as Table 2001 must be used.[8]

In the less common equity endorsement arrangement, in addition to taxation of the cost of current term life insurance protection, the employee will also be subject to tax each year

on (i) any increased amount of cash value to which the employee has "current access" and (ii) the value of any other economic benefits provided to the employee during the year (i.e., policy dividends, withdrawals, or policy loans[9]), reduced by any amount contributed by the employee.[10] An employee is considered to have current access to any portion of a policy's cash value that he or she has a current or future right to and that is currently directly or indirectly accessible to the employee, inaccessible to the employer, or inaccessible to the employer's general creditors.[11]

In addition, under the economic benefit regime, since the employer is treated as the owner of the entire policy, the employee has no investment in the policy.[12] As a result, the employee does not obtain basis in the policy for either (i) any premium actually paid by the employee, or (ii) the cost of current life insurance protection included in the employee's income. Any premium paid by the employee is income to the employer,[13] but the employer cannot deduct (i) any premium payment made by either the employer or the employee or (ii) the cost of current life insurance protection included in the employee's income.[14]

Under the economic benefit regime, all economic benefits provided by the employer to the employee are fully taxed each year. Going forward, no equity can be transferred to an employee without immediate taxation using an endorsement arrangement. As a result, very few equity split-dollar arrangements will be structured as endorsement arrangements in the future. Endorsement arrangements will only be useful as a planning tool if an employer's sole objective is to provide current life insurance protection to an employee and perhaps fund a separate nonqualified deferred compensation plan at retirement through the insurance investment.

B. Loan Regime

If the employee owns the policy, the arrangement will be taxed under the loan regime.[15] Most split-dollar arrangements in the employer-employee context use the collateral assignment method and, as such, will fall within the loan regime. Under the loan regime, each premium payment by the employer is treated as a separate loan from the employer to the employee. Each loan is subject to Section 7872 if below-market interest rates are used, and the original issue discount rules of Sections 1271–1275 if the loan is a term loan. Since the policy is purchased by the employee via a loan, the employee is not subject to tax on the cost of current life insurance protection.

For purposes of determining whether a split-dollar loan provides adequate interest, the loan is characterized as either (i) a demand loan, (ii) a term loan, or (iii) a hybrid term/demand loan. A split-dollar demand loan is any split-dollar loan that is payable in full at any time on the demand of the employer.[16] Most existing collateral assignment arrangements will be considered demand loans unless modified, since employers generally reserve the right to terminate a split-dollar arrangement. A demand loan is tested each calendar year for adequate interest by comparing the interest rate on the loan to the blended applicable federal rate ("AFR")

... all economic benefits provided by the employer to the employee are fully taxed each year.

published in July of each year.[17] If the interest rate is less than the AFR, the loan is a below-market loan subject to Section 7872. The employer is deemed to have paid the foregone interest to the employee as compensation on the last day of the calendar year and the employee is treated as having paid the interest to the employer.[18] The employer can deduct the imputed interest paid to the employee, but must recognize income on any interest actually or deemed paid by the employee. Because the indebtedness is personal in nature, the employee cannot deduct any interest that is actually or deemed paid.[19]

Because the indebtedness is personal in nature, the employee cannot deduct any interest ...

The advantage of a demand loan is that it is easy to determine whether it provides sufficient interest. The disadvantage is that the determination is subject to changes in the annual blended AFR.

Split-dollar term loans are tested for adequate interest on the day the loan is made by comparing the present value of the repayment amount using the appropriate AFR for the term of the loan to the amount of the initial loan.[20] If the present value of all repayments is less than the amount of the initial loan, the loan is a below-market loan subject to Section 7872 and the present value of the entire foregone interest is imputed to the employee as compensation income in the year the loan is entered into—all up-front.[21] There is no offsetting interest expense available to the employee. The employer is generally able to deduct the imputed interest as compensation expense in the year the loan is made. The original issue discount rules then require the employer to include deemed interest payments in the employer's income over the term of the loan arrangement.[22] For these reasons, a split-dollar arrangement should not be structured as a term loan unless it provides for adequate interest.

The final regulations also provide hybrid term/demand loan treatment in the employer-employee context for (i) term loans conditioned on the performance of substantial future services, (ii) loans payable at an employee's death, or (iii) loans payable at the earlier of an employee's death or a stated term.[23] Hybrid loans are term loans for purposes of testing for adequate interest (using the AFR related to the term of the loan and tested on the date on which the arrangement is entered into).[24] However, if the loan does not provide sufficient interest when the loan is made, foregone interest is determined and taxed annually similar to a demand loan, except that the appropriate AFR for the term of the loan as of the date of the loan is used to determine the amount of forgone interest each year.[25] The term of a loan payable on the death of an employee is based on the employee's life expectancy calculated under the appropriate table in Treasury Regulation Section 1.72-9 on the date the loan is made.[26] The term of a loan conditioned on the performance of substantial future services is presumed to be seven years unless the loan states a maturity date.[27] In either case, the loan is treated as retired and reissued as a split-dollar demand loan if the loan remains outstanding longer than the term.[28]

Under the loan regime, the employee receives basis for all premiums paid by the employer

since each premium payment is deemed to be loaned to the employee and used by the employee to purchase the policy.[29] This compares favorably to the economic benefit regime where, as discussed above, the employee can obtain no basis in the policy.

Finally, if a split-dollar loan is non-recourse, the final regulations treat the loan as providing for "contingent" payments, which will result in the imposition of unfavorable assumptions when testing the loan for adequate stated interest.[30] The typical collateral assignment arrangement is non-recourse to the employee since repayment is only made from the insurance policy and the employee is generally not personally obligated to repay the employer. To avoid contingent payment treatment, the employer and employee must represent in writing that a "reasonable person" would expect that all payments under the loan will be made.[31] The written statement must be attached to the income tax returns of both the employer and the employee for each year the loan is outstanding.[32]

The end result of the loan regime is that, going forward, equity can only be transferred to an employee using a collateral assignment arrangement if the insurance investment yields a higher return than the interest rate charged on the loan. Under this regime, higher premiums will generate higher interest, which must be paid by the employee or imputed as income. In addition, the amount of interest will increase each year as the cumulative premiums paid by the employer increases. In order for an arrangement under the loan regime to emulate old equity split-dollar arrangements, the policy must minimize premiums and yet build enough equity to maintain the death benefit following roll-out and repayment of the employer's premiums. Premium efficiency will be critical.

III. The Grandfather and Safe Harbor Provisions

The final regulations apply only to split-dollar arrangements "entered into"[33] or "materially modified"[34] after September 17, 2003. Split-dollar arrangements entered into on or before September 17, 2003 (and not materially modified thereafter) will be governed by the grandfather and safe harbor provisions of Notice 2002-8 issued on January 3, 2002.

A. Grandfathering

Split-dollar arrangements entered into on or before September 17, 2003 (and not materially modified thereafter) are "grandfathered" pursuant to Notice 2002-8. Under the grandfather provision, an employee's built-up equity in the cash value of a policy in excess of the employee's basis will not be taxed to the employee until the split-dollar arrangement is rolled-out if the parties to the arrangement continue to report the value of current life insurance protection as an economic benefit provided to the employee.[35]

Under this grandfather provision, an employer may continue an existing equity split-dollar arrangement after January 1, 2004 without subjecting the employee to income tax each year on the built-up equity in the cash value. However, when the arrangement is later rolled-out upon an employee's termination of employment, the entire built-up cash value beyond the employee's basis in the policy will be taxable to the employee,

... the entire built-up cash value beyond the employee's basis in the policy will be taxable to the employee ...

whether or not the employee continues the policy. As discussed above, practitioners previously believed that an employee was not subject to income tax on the built-up cash value in excess of the employee's basis upon roll-out of the arrangement. Thus, even under the grandfather provision, equity split-dollar arrangements will not achieve the tax benefits they were originally designed to achieve.

... the employer can release its security interest in the cash value without repayment.

B. Safe Harbor Options

Notice 2002-8 also offers two safe harbor options for split-dollar arrangements entered into before January 28, 2002, each of which allow an employer to roll-out a split-dollar arrangement without the employee being subject to tax on the built-up equity in the cash value.

First, an employer may roll-out a split-dollar arrangement prior to January 1, 2004. Rolling-out a split-dollar arrangement involves ending the relationship between the employer and the employee with respect to the policy. Two steps are required to roll-out an arrangement and qualify for this first safe harbor: (i) the employee repays the employer for all premiums previously paid by the employer (usually by taking a loan against the policy cash value); and (ii) the employer releases its security interest in the cash value of the policy. Alternatively, the employer can release its security interest in the cash value without repayment. This method of roll-out will subject the employee to income tax on the amount released by the employer.

Following roll-out of the arrangement, the employee remains the owner of the policy and the employer has no rights in the policy and no obligation to pay future premiums. So long as the policy remains in effect after the arrangement is rolled-out, the employee is not taxed on the built-up equity in the cash value. Going forward, the employee can either pay premiums out-of-pocket or, if the policy has sufficient equity, the premiums can be charged against the cash value as loans. Interest will be charged by the insurance company on any loans taken against the policy by the employee.

The second safe harbor option requires the parties to treat an arrangement as a split-dollar loan for all periods beginning on or after January 1, 2004 and subjecting it to tax under the loan regime.[36] To comply with this safe harbor option, all past premiums paid by the employer from the inception of the arrangement must be treated as a loan made on January 1, 2004. If the arrangement is treated as a loan, the employee will not be subject to income tax on the built-up equity in the cash value when the arrangement is subsequently roll-out upon the employee's termination from employment.

Treating an arrangement as a split-dollar loan for purposes of this safe harbor option does not require the parties to modify the existing arrangement prior to January 1, 2004. Instead, the parties only need to report the arrangement in a manner consistent with the loan regime, including the below-market interest rate and original issue discount rules. However, because these rules are so complicated, an employee should execute a promissory note effective January 1, 2004 providing adequate interest to (i) avoid the below-market interest rate and

original issue discount rules, and (ii) structure the loan in a manner most advantageous to the parties (i.e., as a demand loan, term loan, or hybrid term/demand loan and with interest being paid annually or accrued and paid when the principal becomes due). Nonetheless, if the parties fail to roll-out an arrangement prior to January 1, 2004 under the first safe harbor, the parties can still roll-out the arrangement after January 1, 2004 without subjecting the employee to income tax on the built-up equity under the second safe harbor if the employer and the employee report the arrangement as a split-dollar loan for the period beginning January 1, 2004 through the date of subsequent roll-out. This should help alleviate the negative tax consequences in situations where parties desire to roll-out now, but fail to do so prior to the end of the year.

Some commentators have suggested that Notice 2002-8 permits a third safe harbor option described as "switch-dollar." The idea is that an arrangement entered into before January 28, 2002 may continue to be taxed only on the cost of current life insurance protection pursuant to the grandfather provision and later switch to the loan regime in some future tax year when the cost of current life insurance protection equals or exceeds the interest cost. However, attempting this switch-dollar approach seems very risky, since Notice 2002-8 states that the loan regime safe harbor is only available where the arrangement is treated as a loan "for all periods beginning on or after January 1, 2004." As a result, it seems that an employee will be subject to tax on the built-up equity in the cash value once the arrangement is later rolled-out.

IV. Steps Employers Should Take With Respect to Existing Policies

Policies with substantial built-up equity in the cash value should generally be rolled-out prior to January 1, 2004. If the policy equity is sufficient, the policy can maintain itself without the payment of future premiums by the employee and the employee will not be taxed on the built-up equity unless and until the employee either cancels the policy or withdraws cash value in excess of the employee's tax basis in the policy.

Policies with some built-up equity but still requiring the payment of additional premiums to sustain them should generally be treated as loan arrangements during the first period beginning on or after January 1, 2004. Otherwise, the employee will be required to pay future premiums out-of-pocket (if the arrangement is rolled-out prior to January 1, 2004) or subject to tax on the built-up equity upon subsequent roll-out. Once the built-up equity is sufficient to sustain the policy, it can be rolled-out at any time and the employee will not be subject to tax on the built-up equity. In the current low interest rate environment, the best course of action in many circumstances may be to convert the arrangement to a term loan that states adequate interest unless roll-out is likely to occur in the near future, in which case the arrangement should be converted to a demand loan to take advantage of the lower annual blended AFR.

This should help alleviate the negative tax consequences ...

ROBERT M. HARTLEY is an associate with Foster, Swift, Collins & Smith, P.C., and is based in the Lansing office. Mr. Hartley received his J.D. cum laude from the University of Michigan and practices the areas of trusts and estates, business planning, and employee benefits.

ENDNOTES

1. Treas. Reg. Sects. 1.61-2(d)(2)(ii)(A), 1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(q) and 1.7872-15 (2003).
2. I.R.S. Notice 2002-8, 2002-1 C.B. 398.
3. Rev. Rul. 55-747, 1955-2 C.B. 228.
4. Treas. Reg. Sec. 1.61-22(b)(3)(ii)(A).
5. Treas. Reg. Sec. 1.61-22(c)(1)(i).
6. Treas. Reg. Sec. 1.61-22(c)(1)(ii)(A)(1). In such non-equity split-dollar arrangements, the employer will be deemed the policy owner even if the employee is named as the owner on the policy.
7. Treas. Reg. Sec. 1.62-22(d)(2).
8. I.R.S. Notice 2002-8, 2001-1 C.B. 398.
9. A policy loan provided to an employee is treated as a loan taken by the employer against the policy and paid to the employee as compensation. *See* Treas. Reg. Sec. 1.61-22(e)(1).
10. Treas. Reg. Sec. 1.61-22(d)(2).
11. Treas. Reg. Sec. 1.61-22(d)(4)(ii). The explanation to the final regulations states that "access" is to be construed broadly and discusses in greater detail when these conditions are met. The right to withdraw from a policy, borrow against a policy, or affect a total or partial surrender of a policy is considered access.
12. Treas. Reg. Sec. 1.61-22(f)(2)(i).
13. Treas. Reg. Sec. 1,61-22(f)(2)(ii). The theory for subjecting the employer to tax on premiums paid by the employee is that the employee is renting the death benefit from the employer.
14. *Id.*
15. The one exception is that if the employer and employee enter into a separate agreement providing that the employer will make a transfer to the employee in an amount sufficient to repay the purported split-dollar loan, the employee will be subject to income tax on each premium payment to the extent that the employee's rights in the policy are substantially vested. *See* Treas. Reg. Sects. 1.61-2(d)(2)(ii)(A) and 1.61-22(b)(5).
16. Treas. Reg. Sec. 1.7872-15(b)(2).
17. Treas. Reg. Sec. 1.7872-15(e)(3)(ii).
18. Treas. Reg. Sec. 1.7872-15(e)(3)(iii)(B).
19. Treas. Reg. Sec. 1.7872-15(c).
20. Treas. Reg. Sec. 1.7872-15(e)(4(ii).
21. Treas. Reg. Sec. 1.7872-15(e)(4)(iv).
22. Treas. Reg. Sec. 1.1272-1 (as amended in 1996).
23. Treas. Reg. Sec. 1.7872-15(e)(5)(i).
24. *Id.*
25. *Id.*
26. Treas. Reg. Sec. 1.7872-15(e)(5)(ii)(C).
27. Treas. Reg. Sec. 1.7872-15(e)(5)(iii)(C).
28. Treas. Reg. Sects. 1.7872-15(e)(5)(ii)(D) and 1.7872-15(e)(5)(iii)(D).
29. Treas. Reg. Sec. 1.61-22(f)(2)(ii).
30. Treas. Reg. Sec. 1.7872(d).
31. Treas. Reg. Sec. 1.7872-15(d)(2)(i).
32. Treas. Reg. Sec. 1.7872-15(d)(2)(ii).
33. A split-dollar arrangement is entered into on the later of the date that (i) the policy is issued, (ii) the policy is effective, (iii) the first premium is paid, (iv) the parties enter into an agreement with respect to the policy, or (v) the arrangement satisfies the definition of a split-dollar life insurance arrangement. *See* Treas. Reg. Sec. 1.61-11(j)(1)(ii).
34. The final regulations provide a non-exclusive list of non-material modifications. For the most part, the list contains only changes that are clearly not material, such as a change in the mode of premium payments, a change of the designated beneficiary, or a change of address. *See* Treas. Reg. Sec. 1.61-22(j)(2)(ii). As a result, any proposed modification to a policy or split-dollar arrangement should be closely reviewed before implementation.
35. I.R.S. Notice 2002-8, 2002-1 C.B. 398.
36. The explanation to the final regulations provides that arrangements modified to comply with the loan regime will not be considered materially modified.

IRS Treats Obligation to Deliver Securities (and/or Cash) Under Variable Prepaid Forward Contract as Partnership Liability – But Proceed with Caution!

By: James H. Combs and
Alexander G. Domenicucci

The Internal Revenue Service ("***IRS***") recently released Technical Advice Memorandum ("***TAM***") 200341005 (October 10, 2003), which addresses the federal income taxation of a prepaid forward sale of a variable amount of stock. Earlier in 2003, the IRS had published a revenue ruling, Revenue Ruling 2003-7,[1] that concluded that execution of one type of "variable prepaid forward contract" ("***VPFC***"), an "over-the-counter" VPFC, did not result in a current IRC § 1001 sale or exchange of the underlying stock. TAM 200341005 applies the reasoning of Revenue Ruling 2003-7 to an alternative structure for a VPFC transaction, a "trust structure" VPFC, and reaches the same conclusion on the common law sale issue.

TAM 200341005 also analyzes the potential interaction of certain partnership taxation rules, in particular the disguised sale rules of IRC § 707, with the taxation of VPFC transactions. The disguised sale rules potentially can play a significant role in VPFC transactions where the taxpayer holds stock through a family limited partnership. In this area, the TAM appears to break new ground, concluding that an obligation to deliver securities and/or cash under a VPFC is a "liability" under IRC § 752. This taxpayer-friendly result is significant because the Depart-ment of Treasury recently proposed regulations (which are to be effective as of June 24, 2003, if finalized) that administratively reach the same result as TAM 200341005. TAM 200341005 addresses a taxable year prior to the publication (and potential effective date) of the proposed regulations, suggesting that the TAM represents the IRS' settled view on the state of the law prior to June 24, 2003. However, the IRS' analysis of the liability issue in the TAM is incomplete and somewhat misleading, which raises questions about the position taken in the TAM and the proposed regulations. This article first reviews the facts of the TAM and the IRS' analysis of whether entry into the transaction resulted in a common law sale, and then looks at the IRS' analysis of the partnership taxation issues raised by the structure of the transaction.

However, the IRS' analysis of the liability issue in the TAM is incomplete and somewhat misleading ...

Facts of TAM 200341005

In TAM 200341005, an individual owned 100% of an entity ("***Shareholder***") that held shares of Corporation A. For accounting reasons, the Shareholder desired to reduce the percentage ownership of Corporation A shares that it held directly. In order to achieve this goal, the Shareholder undertook the following steps:

- The Shareholder contributed shares of Corporation A stock to a partnership ("***Partnership***") in exchange for a non-managing membership interest and distributions of cash. The contributions occurred on two dates: the "Execution Date" and the "Option Date."
- The Partnership established a trust comprised of two sub-trusts: Series A Sub Trust and Financial Instruments Sub Trust.
- In exchange for interests in Series A Sub Trust, the Partnership contributed shares of Corporation A stock. The

The Financial Instruments entitled the holders to a beneficial interest in the Trust Obligation and in the Treasury securities.

interests in the Series A Sub Trust provided the Partnership a beneficial interest in the Corporation A shares, including the power to vote the shares through the trust, to receive ordinary dividends on the shares and to receive the proceeds of a sale, exchange or liquidation of the shares.

- The Series A Sub Trust and the Financial Instruments Sub Trust entered into an agreement (the "***Trust Obligation***") whereby the Series A Sub Trust agreed to deliver to Financial Instruments Sub Trust, on a date in the future, shares of Corporation A stock, cash or a combination thereof.
- The Trust Obligation required the Series A Sub Trust to deliver to investors (described below) in Financial Instruments Sub Trust a number of shares (or equivalent value of cash or cash and shares) determined under the "Exchange Formula." The Exchange Formula provided that the amount of stock (or cash or combination of stock and cash) to be delivered to settle the contract would depend on the trading price of the shares at settlement.
- The Financial Instruments Sub Trust sold "Financial Instruments" at a discount to an underwriting syndicate made up of several brokers who acted as initial purchasers of the Financial Instruments. These sales occurred on each of the Execution Date and the Option Date.
- The underwriting syndicate sold the Financial Instruments to third party investors for their "full value." The Financial Instruments Sub Trust applied the proceeds to purchase Treasury securities, compensate a trustee and to pay the Series A Sub Trust under the Trust Obligation. The Financial Instruments entitled the holders to a beneficial interest in the Trust Obligation and in the Treasury securities. The Treasury securities had staggered maturities that funded quarterly distributions to the holders of the Financial Instruments.
- The Trust's ability to exercise the cash settlement option was controlled by the Shareholder through the Partnership, which held the Series A Sub Trust interest. As of the Execution Date, the Shareholder was restricted in its ability to exercise the cash settlement option to the extent that such exercise and the subsequent liquidation of the Partnership would result in the Shareholder owning more than a specified percentage of Corporation A.
- The Trust Obligation contained various other features relating to price adjustments upon certain events and to distributions including stock splits or stock dividends, and permitting the early settlement or partial liquidation of the Financial Instruments under limited circumstances.
- On the Execution Date and the Option Date, the Series A Sub Trust distributed the funds that it received to the Partnership, which used a portion of the funds to acquire Treasury securities and the balance to distribute to the Shareholder.

Common Law Sale Analysis

The first issue addressed in TAM 200341005 was whether the Shareholder's execution of the VPFC through the Partnership

and the trusts resulted in a common law sale of the Corporation A shares sold forward under IRC § 1001.[2] VPFCs resemble current sales of stock because the taxpayer relinquishes title to and possession of securities and receives a payment of cash in the transaction. However, the common law taxation of forward contracts and other authorities addressing the tax ownership of securities support holding a forward sale open until shares are actually delivered to the forward purchaser to settle the contract where the taxpayer retains certain rights in respect of the securities.[3]

There are two formats typically adopted for VPFC transactions: an over-the-counter derivative and the trust structure.[4] The over-the-counter VPFC is used for smaller positions in a stock and a financial institution acts as the forward purchaser under the contract. The financial institution hedges its risk under the VPFC by entering into offsetting trades (*e.g.*, short sales of the same security).[5] For larger positions in a stock, the financial institution may find it difficult to lay off its risk because there may not be sufficient shares available for the stock loans necessary for the financial institution to enter into offsetting short sales.[6] In this situation, the parties generally employ the "trust structure" VPFC described in TAM 200341005. In a trust structure VPFC, the financial institution acts as an underwriter (rather than as the counterparty) and locates investors willing to enter into the forward purchase side of the VPFC.[7] The trust structure VPFC is a more complicated form of a prepaid forward sale of a variable amount of stock than an over-the-counter VPFC transaction. In substance, however, the forward contract component of the two transactions is essentially the same.

The IRS has ruled that entry into an over-the-counter VPFC transaction does not result in a current sale of the underlying stock.[8] In Revenue Ruling 2003-7, the taxpayer, an individual, entered into an agreement to deliver a variable amount of stock in a publicly-traded corporation to an investment bank counterparty on a date three years in the future. In exchange for this future delivery obligation, the taxpayer received an up-front payment of cash.[9] The taxpayer secured his obligation by pledging the maximum number of shares potentially deliverable under the contract to a third party trust unrelated to the investment bank. Under the declaration of trust, the taxpayer retained the right to vote the shares and to receive dividends. The taxpayer also had the right to deliver the equivalent value of cash or other shares (or a combination of cash and other shares) at settlement. On the execution date of the VPFC, the taxpayer intended to deliver the pledged shares to settle the contract.

For larger positions in a stock, the financial institution may find it difficult to lay off its risk ...

Revenue Ruling 2003-7 held that entry into this over-the-counter VPFC does not cause a sale of the stock to the forward purchaser upon execution of the contract. This holding was based on cases involving the transfer of securities to brokerage firms pursuant to subordination agreements and cases involving short sales of securities. The IRS cited the subordination agreement cases as authority for the proposition that a taxpayer can transfer title and possession of securities to another party without relinquishing tax ownership, so long as the taxpayer retains the right to vote the shares, to receive dividends and to reacquire the shares (*e.g.*, by substituting other collateral).[10] The IRS cited the short sale cases for the proposition that the delivery of shares is the operative event that closes the sale for tax purposes; a taxpayer's intent to deliver particular shares does not control the completion of the sale if the taxpayer has the right to determine whether

particular shares will in fact be delivered.[11]

The IRS also distinguished the VPFC transaction in Revenue Ruling 2003-7 from the conveyance of securities in *Hope v. Commissioner*.[12] In the *Hope* case, the taxpayer argued that a sale of securities to an investment bank had not been completed because the taxpayer sought rescission of the sale contract. The court rejected this argument because the taxpayer had transferred the shares to the investment bank and received cash without any restrictions on use or disposition. Although the taxpayer in Revenue Ruling 2003-7 also transferred shares and received cash not subject to any restrictions, the IRS noted that the transfer was to a third party trust that was unrelated to the investment bank. While the revenue ruling may be read to suggest that a third party trust as collateral agent is a necessary element for avoiding a current sale, the IRS distinguished the *Hope* case on other grounds as well (the taxpayer's retention of voting rights and dividends) and it appears that the use of such a trust is not mandatory to avoid a sale.[13]

The IRS explicitly acknowledged the similarity between over-the-counter VPFCs and trust structure VPFCs ...

In addition to the principles derived from the cited cases, Revenue Ruling 2003-7 also introduced two considerations asserted by the IRS to be potentially relevant to the analysis of whether a sale occurs upon execution of a VPFC. These factors are whether the taxpayer is under an "economic compulsion" or is restricted by "any legal restraint or requirement" to settle the contract with the pledged shares rather than cash or other shares.[14] The IRS stated as an example that a restriction on the taxpayer's ability to own the pledged shares after the settlement date would be a "significant" factor in the determination of whether a sale had occurred.[15] The revenue ruling did not specify when a taxpayer is required to test for the presence of economic compulsion or the absence of an unrestricted legal right to deliver cash or shares other than the pledged shares.[16]

TAM 200341005 applies the reasoning of Revenue Ruling 2003-7 to a trust structure VPFC transaction. The IRS explicitly acknowledged the similarity between over-the-counter VPFCs and trust structure VPFCs in TAM 200341005, listing off the elements common to both transactions. The IRS did not attempt to draw any distinctions from Revenue Ruling 2003-7 based on the sale of the securities through the trust, and the bulk of the IRS' sale analysis in the TAM focused on the unrestricted legal rights factor introduced in Revenue Ruling 2003-7.[17]

The TAM devoted several paragraphs to the determination of whether the Shareholder had, through the Partnership, a right "unrestricted by agreement or economic circumstances" to deliver property other than the pledged shares. This issue arose because, as of the Execution Date, the Shareholder could not by agreement own more than a certain percentage of the shares of Corporation A on the settlement date. The IRS noted that this agreement limited the Shareholder's ability to cause the Partnership to exercise the cash settlement option and to reacquire the pledged shares. However, the IRS accorded little weight to this restriction because Corporation A sold additional stock on the day following the Execution Date, which diluted Shareholders' percentage ownership of Corporation A. This stock offering negated any limitation on the Shareholder's ability to cause the Partnership to cash settle the VPFC. According to the IRS, the Shareholder, through the Partnership, did "effectively" have an unrestricted legal right to cash settle the contract.[18] The focus of the TAM on the existence or absence of an unrestricted legal right as of the

Execution Date thus appears to establish that the proper time to test for this factor is on the date the taxpayer enters into the contract.

Based on the similarity of the facts of TAM 200341005 to Revenue Ruling 2003-7 and the "effective" unrestricted legal right to reacquire the pledged shares, the IRS concluded that (i) the Shareholder's transfer of Corporation A shares to the trust, through the Partnership, did not constitute a taxable sale or exchange of the shares from the Shareholder to the Financial Instrument investors and (ii) the investors' acquisition of the Financial Instruments also did not constitute a taxable sale or exchange of the Corporation A shares. Therefore, TAM 200341005 confirms that the interposition of a trust to facilitate the forward sale of securities in a VPFC transaction and the sale of interests in that trust does not alter the common law sale analysis employed in Revenue Ruling 2003-7. Having reached this conclusion, the IRS next turned to analysis of the partnership taxation issues.

The Trust Obligation as a Partnership Liability

The taxpayer in TAM 200341005 used a partnership as a vehicle to implement the trust structure VPFC transaction, with the contributions of Corporation A stock to the Partnership constituting a part of the overall transaction. The use of a partnership may also arise in connection with a trust structure VPFC in slightly different contexts, for example, where a taxpayer previously contributed appreciated stock to a family limited partnership for estate planning and liability protection purposes and is now seeking to lock in gain attributable to the stock while deferring recognition of the gain. Critical to whether a trust structure VPFC is viable when a partnership is involved is whether the forward seller's obligation to deliver securities and/or cash under the VPFC is a liability for purposes of IRC § 752.[19]

IRC § 752 applies to determine a partner's share of partnership liabilities. Under IRC § 752, a partner is deemed to have made a contribution of money to the partnership to the extent his share of partnership liabilities increases.[20] On the other hand, a partner is deemed to have received a distribution of cash to the extent his share of partnership liabilities decreases.[21] A deemed contribution increases the partner's basis in his partnership interest and a deemed distribution decreases (but not below zero) the partner's basis in his partnership interest.[22] Thus, if a forward seller's obligation to deliver securities and/or cash under a VPFC is a liability for purposes of IRC § 752, then the distribution of the proceeds from the VPFC to the partners is generally not taxable to them because there is sufficient basis in their partnership interests to absorb the distribution.[23]

Thus, if a forward seller's obligation to deliver securities and/or cash under a VPFC is a liability for purposes of IRC § 752, then the distribution of the proceeds from the VPFC to the partners is generally not taxable to them because there is sufficient basis in their partnership interests to absorb the distribution.

In TAM 200341005, the liability issue was also important because of the potential application of the disguised sale rules of IRC § 707. Under the disguised sale rules, a contribution of property to a partnership followed shortly by a distribution of cash by the partnership to the contributing partner is generally treated as a taxable sale by the partner to the partnership of an interest in the property.[24] A disguised sale is presumed if the distribution to the partner occurs within 2 years of the contribution by the partner of property to the partnership.[25] There are a number of exceptions to the disguised sale rules, one of which applies where the cash distributed to the contributing partner is from proceeds of a liability incurred within 90 days of the distribution, but only to the extent of the partner's allocable share of such liability.[26]

For this purpose, a partner's allocable share of a liability equals

the partner's share of the liability multiplied by a fraction (i) the numerator of which is the portion of the liability allocable to the distribution made to the partner and (ii) the denominator of which is the total amount of the liability.[27] The determination of a partner's share of a liability of a partnership depends on whether the debt is recourse or nonrecourse. If recourse, the liability is allocated among the partners in the amounts for which they would bear personal liability if the partnership's assets were to become worthless.[28] If non-recourse, the liability is generally allocated among the partners in the same proportions in which they share profits.[29]

... the IRS concluded that the simultaneous contributions of Corporation A stock by, and distributions of cash to, the Shareholder were not disguised sales.

In TAM 200341005, the IRS ruled that the Trust Obligation was a nonrecourse liability under IRC § 752. The IRS also ruled that the distributions of cash were from the proceeds of the Trust Obligation and such distributions did not exceed the Shareholder's allocable share of the Trust Obligation.[30] Accordingly, because the distributions to the Shareholder of cash were made within 90 days of the Partnership incurring the Trust Obligation, the IRS concluded that the simultaneous contributions of Corporation A stock by, and distributions of cash to, the Shareholder were not disguised sales.

During the period at issue in TAM 200341005, there was neither a statutory nor regulatory definition of liability for purposes of IRC § 752.[31] In TAM 200341005, the IRS relied on two revenue rulings to reach its conclusion that the Trust Obligation was a liability for purposes of IRC § 752. The first, Revenue Ruling 88-77,[32] addressed whether the accrued expenses and accounts payable of a cash basis partnership were liabilities for purposes of IRC § 752. The IRS explained that a partnership liability for purposes of IRC § 752 includes an obligation only if and to the extent that incurring the liability:

(i) creates or increases the basis to the partnership of any of the partnership's assets (including cash attributable to borrowings),

(ii) gives rise to an immediate deduction to the partnership,

(iii) or, under IRC § 705(a)(2)(B), currently decreases a partner's basis in the partner's partnership interest.[33]

Under this definition of liability, the IRS ruled that the accrued expenses and accounts payable were not partnership liabilities because they did not increase the basis of the partnership's assets or give rise to a deduction.[34]

The second revenue ruling relied on by the IRS to conclude that the Trust Obligation was a liability for purposes of IRC § 752 was Revenue Ruling 95-26.[35] The ruling involved a partnership that entered into a short sale of securities. The short sale was effectuated by the partnership's broker, which loaned securities that it had on hand to the partnership and then sold them on the partnership's behalf. The partnership was obligated to return identical securities to close out the short sale. The IRS, relying principally on Revenue Ruling 88-77, ruled that the short sale created a partnership liability under IRC § 752 because the partnership had an obligation to return the borrowed securities, and the cash received in the short sale increased the basis of the partnership's assets.

While the IRS discussed Revenue Rulings 88-77 and 95-26 in TAM 200341005, it did not discuss other authorities bearing on the issue of whether the Trust Obligation is a liability for purposes of IRC § 752. For starters, the IRS did not discuss Revenue Ruling 73-301,[36] where the IRS ruled that progress payments under a construction contract made to a partnership using the completed contract method of accounting did not

give rise to a liability for purposes of IRC § 752. In the ruling, the partnership, which was engaged in the construction business, reported income received under a 2-year construction contract on the completed contract method of accounting. Under the contract, the partnership received progress payments during 1971 that it was not required to report under its method of accounting. The IRS ruled that the 1971 progress payments were "unrealized receivables" that did not give rise to a liability under IRC § 752.

The IRS' holding in Revenue Ruling 73-301 is arguably inconsistent with its definition of liability in Revenue Ruling 88-77. The partnership's obligation in Revenue Ruling 73-301 to perform services under the construction contract appears to be a liability under the definition in Revenue Ruling 88-77 because the progress payments increased the basis of the partnership's assets.[37]

The IRS in TAM 200341005 also failed to mention *Helmer v. Commissioner*,[38] where the Tax Court decided that a partnership's receipt of an option premium, and its attendant obligation to credit the premium against the purchase price of the underlying property if the optionee exercised the option, did not give rise to a liability for purposes of IRC § 752. In *Helmer*, the partnership entered into an agreement under which the optionee had the option to purchase certain real estate. Under the agreement, the optionee was obligated to make an initial payment to the partnership and annual payments thereafter in consideration for the option. The partners of the partnership argued that the option premium created a liability under IRC § 752 and, accordingly, increased the basis in their partnership interests. The court, in rejecting the partners' argument, held that the partnership had no liability under the option agreement for purposes of IRC § 752. The court explained that the partnership was neither required to repay the option premium in the event the optionee allowed the option to lapse nor perform any services in the future. According to the court, the partnership's only obligation was to apply the option premium against the purchase price should the optionee exercise the option.

The *Helmer* decision seemingly conflicts with the IRS' definition of liability in Revenue Ruling 88-77. The partnership's obligation to apply the option premium against the purchase price of the real estate in the event of the option's exercise appears to be a liability under the definition in Revenue Ruling 88-77 because the option premium increased the partnership's basis in its assets. Perhaps one might argue that *Helmer* and Revenue Ruling 88-77 may be reconciled on the basis that contingent obligations should be treated differently for purposes of IRC § 752.[39] There are, however, at least two potential problems with such an argument. First, the definition of liability in Revenue Ruling 88-77 does not purport to make a distinction between fixed and contingent liabilities. Second, there is arguably no sound policy reason for treating contingent liabilities differently in this context.[40]

The* Helmer *decision seemingly conflicts with the IRS' definition of liability in Revenue Ruling 88-77.

Another court decision the IRS failed to discuss in TAM 200341005 is *Salina Partnership LP, FPL Group, Inc. v. Commissioner*,[41] a case which arguably supports the IRS' conclusion. In *Salina,* the taxpayer, which had substantial capital losses, became a partner in a newly formed limited partnership. The partnership then immediately liquidated its position in a short sale of U.S. Treasury bills, with the taxpayer reporting a capital gain from the transaction. Relying principally on Revenue Ruling 88-77, the IRS argued that

the obligation to return the borrowed securities under the short sale was a liability for purposes of IRC § 752, with the consequence that the reported capital gain was virtually eliminated.[42] The taxpayer, relying on Revenue Ruling 73-301 and *Helmer* among other authorities, argued that there was no liability for purposes of IRC § 752.

The court rejected the taxpayer's argument that there was no liability under IRC § 752. The court reasoned that Revenue Ruling 73-301 and *Helmer* recognize that there are cases in which a taxpayer's obligation under an open transaction is a liability for purposes of IRC § 752. The court then concluded that a short seller's obligation to return borrowed securities is such an obligation.[43] The court, however, failed to adequately explain why a short seller's obligation to return borrowed securities should be treated differently than the obligations in Revenue Ruling 73-301 and *Helmer*. The court did not attempt to distinguish the taxpayer's obligation in Revenue Ruling 73-301. As for the taxpayer's obligation in *Helmer*, the court attempted to distinguish it on the basis that the option premium in *Helmer* "represented fixed payments on the sale of a partnership asset that were free and clear of any claim for repayment or demand for further services." The court did not recognize and address the fact that, under any characterization, the taxpayer in *Helmer* had a contingent obligation (*i.e.*, the obligation to apply the option premium against the purchase price of the real estate in the event of the option's exercise).

In short, the holdings in Revenue Ruling 73-301 and *Helmer* arguably undermine Revenue Rulings 88-77 and 95-26. While TAM 200341005 provides some comfort to taxpayers that have entered into, or are considering entering into, a VPFC involving a partnership, there is sufficient authority for the IRS to reverse course and to treat a forward seller's obligation to deliver securities and/or cash under a VPFC as something other than a liability for purposes of IRC § 752. Taxpayers should be careful not to take too much comfort from TAM 200341005.

While Tam 200341005 provides some comfort to taxpayers that have entered into, or are considering entering into, a VPFC involving a partnership, there is sufficient authority for the IRS to reverse course and to treat a forward seller's obligation to deliver securities and/or cash under a VPFC as something other than a liability for purposes of IRC § 752.

Recently Proposed Treasury Regulations

In June of 2003, after the period at issue in TAM 200341005, the IRS issued proposed regulations defining liability for purposes of IRC § 752, applicable to liabilities incurred or assumed by a partnership after June 23, 2003. The proposed regulations provide that an obligation is a liability for purposes of IRC § 752 only if and to the extent that incurring the obligation:

(i) creates or increases the basis of any of the obligor's assets (including cash),

(ii) gives rise to an immediate deduction to the obligor, or

(iii) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.[44]

In addition, the proposed regulations provide that an obligation is any fixed or contingent obligation to make payment (without regard to whether it is otherwise taken into account for other federal tax purposes), including debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative instruments such as options, forward contracts and futures contracts. Therefore, under the proposed regulations, an obligation to deliver securities and/or cash under a VPFC is a liability for purposes of IRC § 752. The preamble to the proposed regulations explicitly states that

the regulations do not follow the *Helmer* decision.[45]

Notwithstanding that under the proposed regulations an obligation to deliver securities and/or cash under a VPFC is a liability, taxpayers should still use caution in structuring VPFCs involving a partnership. While proposed regulations can be used to avoid the substantial understatement of tax penalty[46] and the tax return preparer penalty,[47] the weight given to proposed regulations for other purposes (*e.g.*, determining the merits of a case) is unclear. The IRS has recently stated that it generally will not take a position in litigation inconsistent with a position in proposed regulations.[48] The IRS has warned, however, that proposed regulations may not be relied upon for planning purposes unless they explicitly state they may so be relied upon.[49] Therefore, if proposed regulations do not state that they may be relied upon, taxpayers planning their affairs based on such regulations are at risk that they might change by the time of any resulting litigation. Unfortunately for taxpayers, the new proposed regulations defining liability for purposes of IRC § 752 do not state that taxpayers may rely on them for planning purposes.

Conclusion

The issuance of TAM 200341005 is a positive development for taxpayers that have entered into, or are considering entering into, a VPFC, especially those transactions where the shares are held by a partnership that intends to distribute the sale proceeds. The TAM first confirms that taxation of a VPFC using a trust structure will not vary from the taxation of the over-the-counter VPFC analyzed in Revenue Ruling 2003-7. In addition, the TAM posits that an obligation to deliver securities and/or cash under a VPFC is a liability for purposes of IRC § 752. On this point, however, taxpayers considering entering into a VPFC involving a partnership should proceed with caution because Revenue Ruling 73-301 and *Helmer* arguably conflict with the authorities underlying TAM 200341005 and the proposed regulations.

JAMES H. COMBS is a Partner in Honigman Miller Schwartz and Cohn LLP's Detroit office. Mr. Combs concentrates his practice on corporate taxation, mergers and acquisitions, tax credit projects and financial products taxation. Mr. Combs graduated from Williams College in 1994, with a B.A. in Political Economy, and from the University of Texas at Austin School of Law, where he received his J.D. with honors in 1997. Mr. Combs is a member of the Michigan and Texas bars, and is a member of the American Bar Association (Tax Section) Committee on Financial Transactions.

ALEXANDER G. DOMENICUCCI is a Partner in Honigman Miller Schwartz and Cohn LLP's Detroit office. Mr. Domenicucci concentrates his practice on federal income tax matters, with an emphasis on partnership tax issues. Mr. Domenicucci earned a B.B.A., with high distinction, from the University of Michigan in 1994, and a J.D., *cum laude*, from Wayne State University Law School in 1998.

... the weight given to proposed regulations for other purposes ... is unclear.

ENDNOTES

1. 2003-5 I.R.B. 363.
2. The facts do not indicate whether the shares of Corporation A stock held by the Partnership were appreciated on the Execution Date or the Option Date. TAM 200341005 does not discuss the constructive sale rules of IRC § 1259, although the "Law and Analysis" section of the TAM states that the number of shares potentially deliverable under the Exchange Formula "varies significantly." This suggests that IRC § 1259(c)(1)(C), which requires the recognition of gain upon entry into a "forward contract" with respect to an appreciated financial position, is not an issue. A "forward contract" is defined in IRC § 1259(d)(1) as a contract calling for future delivery of a "substantially fixed" amount of property (including cash) for a "substantially fixed" price. The amount of property is not "substantially fixed" if there is a "significant variation." S. Rep. No. 105-33, 105th Cong. 1sst Sess., (1997) at 125-126; Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997," (JCS-23-97) at 178. Revenue Ruling 2003-7 provides that a 20% variation in shares is significant and that a VPFC with such variation is not a forward contract. It should also be noted that the Treasury Department has authority to issue regulations under IRC § 1259(c)(1)(E) to address financial transactions, such as option collars, that have "substantially the same effect" as the constructive sale transactions listed in IRC § 1259(c)(1)(A)-(D). This provision is potentially relevant to VPFC transactions, which are economically similar to option collars. *See* David H. Shapiro, Taxpayer-Friendly Result in Rev. Rul. 2003-7 May Create a False Sense of Security, 98 Tax Notes 1265 (February 24, 2003) (stating that it appears that taxpayers can assume that the VPFC described in Revenue Ruling 2003-7 is not equivalent to an "abusive" option collar that Treasury may target retroactively in regulations to be issued under IRC § 1259(c)(1)(E)). It has been reported that Treasury recently withdrew IRC § 1259 from its 2003-2004 guidance plan. *See* Lee A. Sheppard, ABA Meeting Ponders Tax Shelters and Financial Transactions, 100 Tax Notes 1490 (September 22, 2003).
3. *See* Robert A. Rudnick and Michelle L. Petock, Forward Sale Contracts: The IRS's Recent Attempts to View Code Sec. 1259 As a Trap for the Wary, 3 Taxation of Financial Products 19 (Summer 2002); Edward D. Kleinbard, Risky and Riskless Positions In Securities, 71 Taxes 783 (1993).
4. An over-the-counter derivative is not traded on an established market.
5. *See* David M. Schizer, Frictions as a Constraint on Tax Planning, 101 Columbia Law Review 1312, 1349-1356 (October 2001).
6. Schizer, Frictions..., *supra* at 1353-1355 (reporting the use of a trust structure derivative by individuals with positions having a value of $75 million or more).
7. Investors may desire to take a long position in a trust structure VPFC because the derivative financial instruments typically provide a coupon payment that exceeds the dividend on the underlying shares. This permits investors who would otherwise eschew investments in low or non-dividend paying stocks (*e.g.*, growth stocks) to invest in the issuer while earning a current return. *See* Linda E. Carlisle, Financial Products Exchangeable into Common Stock: Tax Opportunities and Issues, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings – 2002, 553 Practicing Law Institute 268 Volume 16 (2002) at 1268-1270; David M. Schizer, "Debt Exchangeable for Common Stock: Electivity and the Tax Treatment of Issuers and Holders," 1 Derivatives Report 7 (March 2000).
8. For a discussion of Revenue Ruling 2003-7 and the taxation of VPFCs, *see* James H. Combs, Will Variations Pave the way For Consistency? Implications of Revenue Ruling 2003-7 for Structuring VPFCs (and Other Financial Transactions?) (unpublished manuscript on file with authors).
9. Corporations also issue VPFC-type instruments generally known as "debt exchangeable for common stock." *See, e.g.,* Robert S. Bernstein, Are VPFCs, Collars, and DECs Still Viable Hedging and Monetization Strategies? 30 Corporate Taxation 2 (March/April 2003).
10. *See Cruttenden v. U.S.,* 644 F.2d 1368 (9th Cir. 1981); *Lorch v. Commissioner,* 70 T.C. 674 (1978), *aff'd,* 605 F.2d 657 (2nd Cir. 1979), *cert. denied,* 444 U.S. 1076 (1980); and *Miami National Bank v. Commissioner,* 67 T.C. 793 (1977).
11. *See Richardson v. Commissioner,* 121 F.2d 1 (2nd Cir. 1941), and *Klinger v. Commissioner,* 1949 PH T.C. Memo ¶49,132.
12. 55 T.C. 1020 (1971), *aff'd,* 471 F.2d 738 (3rd Cir. 1973), *cert. denied,* 414 U.S. 824 (1973). The IRS had previously cited *Hope* in a field service advice ("***FSA***") that concluded that execution of another VPFC-type contract had resulted in a current sale of stock. The analysis in FSA 200111011 (December 6, 2001) was heavily criticized by commentators because it employed a benefits and burdens test of ownership applied to property other than publicly traded securities. *See* Rudnick and Petock, *supra.* The publication of Revenue Ruling 2003-7 generally has made FSA 200111011 of historical interest only.
13. Government officials have subsequently downplayed the necessity of having an unrelated, third party trust hold the pledged shares. *See* Sheryl Stratton, Dilating Derivatives Guidance Requires Industry Input, IRS Says, 99 Tax Notes 9 at 1315 (June 2, 2003) (reporting comments of Christina Morrison, IRS associate chief counsel (Financial Institutions and Products)). In many VPFC transactions, an affiliate of the financial institution will act as the collateral agent. The affiliate will often seek the right to borrow the shares pledged as security in order to provide a ready source of shares available for hedging through short sales of the stock. Although the right to borrow itself may not affect the open transaction status of the forward sale, an actual borrowing may not be protected by IRC § 1058 and could result in a taxable event. *See* Shapiro, *supra* at 169; Schizer, Frictions..., *supra* at 1355-1356.

ENDNOTES continued

14. Revenue Ruling 2003-7 does not provide any cites to authority for the inclusion of these factors nor does the revenue ruling provide much helpful detail on how these factors will be applied. In Revenue Ruling 2003-97, 2003-34 I.R.B. 1, which involved a similar forward sale of securities, the IRS did cite cases and rulings (including Revenue Ruling 2003-7) that considered "unrestricted legal rights" and "economic compulsion." These cases and rulings presumably are relevant to applying the two factors for purposes of Revenue Ruling 2003-7. *See also* Shapiro, *supra* (discussing these factors).
15. The revenue ruling stated that an expectation that the taxpayer would have insufficient resources to deliver property other than the pledged shares on the settlement date is an example of economic compulsion.
16. *See* Shapiro, *supra* (concluding that the execution date of the contract is the relevant testing date).
17. The TAM stated that the facts did not indicate economic compulsion.
18. In a footnote, the TAM indicates that the Shareholder could exercise the cash settlement option without restriction as of the Option Date.
19. Revenue Ruling 2003-7 does not treat the VPFC as a combination of financial transactions that includes a debt component. *See* John F. Prusiecki, Interesting Implications of Revenue Ruling 2003-7, 98 Tax Notes 775 (February 3, 2003). The similarities of VPFCs to other financial transactions, including debt instruments, have been noted by commentators. *See, e.g.,* David F. Levy, Disparities in Treatment Among Prepaid Forward Contracts, Deep in the Money Options, Prepaid Swaps, and Contingent Debt Instruments, Derivatives (November/December 1998); Edward D. Kleinbard and Erika W. Nijenhuis, Everything I Know About New Financial Products I Learned From DECS, 553 PLI 260 Volume 16. The status of a VPFC as an instrument other than debt (or a combination of instruments with a debt component) raises the issue of whether such contracts give rise to a liability under IRC § 752.
20. *See* IRC § 752(a).
21. *See* IRC § 752(b).
22. *See* IRC §§ 722, 733.
23. *See* IRC § 731.
24. *See* Treas. Reg. § 1.707-3.
25. *See* Treas. Reg. § 1.707-3(b), (c).
26. *See* Treas. Reg. § 1.707-5(b)(1).
27. *See* Treas. Reg. § 1.707-5(b)(2).
28. *See* Treas. Reg. §§ 1.707-5(a)(2)(i); 1.752-2.
29. *See* Treas. Reg. §§ 1.707-5(a)(2)(ii); 1.752-3.
30. In addition, the IRS ruled in TAM 200341005 that the Series A Sub Trust was a grantor trust whose grantor was the Partnership. Accordingly, the Trust Obligation was treated as a liability of the Partnership and the distributions from the Series A Sub Trust to the Partnership was without tax consequence.
31. In June of 2003, the IRS issued proposed regulations, which are discussed below, defining liability for purposes of IRC § 752.
32. 1988-2 C.B. 128.
33. IRC § 705(a)(2)(B) provides that expenditures of the partnership not deductible in computing taxable income and not properly chargeable to the capital account decrease a partner's basis in his partnership interest.
34. Shortly after the issuance of Revenue Ruling 88-77, the IRS issued temporary regulations defining liability for purposes of IRC § 752. *See* Former Temp. Treas. Reg. § 1.752-1T(g). The definition under the temporary regulations was substantially the same as the definition in Revenue Ruling 88-77. The temporary regulations defined liability as an obligation giving rise to: (i) the creation of, or an increase in, the basis of any of the obligor's property (including cash attributable to borrowings), (ii) a deduction taken into account in computing taxable income of the obligor, or (iii) a nondeductible, noncapitalizable expenditure. When the temporary regulations were finalized, however, the definition of liability was excluded without explanation. The preamble to proposed regulations issued in June of 2003, which are discussed below, indicates that the definition of liability in the temporary regulations was excluded because, in light of Revenue Ruling 88-77, the definition was redundant and unnecessary. *See* Preamble to Prop. Treas. Reg. § 1.752-1 (6/24/2003) (Fed. Reg. Vol. 68, No. 121, p. 37434). The issuance of the temporary regulations was precipitated by Congress' view, as expressed in the legislative history of the Deficit Reduction Act of 1984, that accounts payable of a cash basis partnership should not be treated as liabilities, as they had been in Revenue Ruling 60-345, 1960-2 C.B. 211, *revoked by* Rev. Rul. 88-77, 1988-2 C.B. 128, unless they give rise to a deduction or increase the basis of a partnership asset.
35. 1995-1 C.B. 131.
36. 1973-2 C.B. 215.
37. Commentators have suggested that the holding in Revenue Ruling 73-301 may possibly be reconciled with Revenue Ruling 88-77 on the basis that the partnership had earned the progress payments and had no obligation to return them if it failed to perform additional services under the construction contract. *See* Monte A. Jackel and Jerred G. Blanchard, Jr., Reflections on Liabilities: Extension of New Law to Partnership Formations, 91 Tax Notes 1579, 1589 (May 28, 2001).
38. T.C. Memo 1975-160.

ENDNOTES continued

39. The regulations under IRC § 752 suggest that contingent obligations are not liabilities for purposes of IRC § 752. *See* Treas. Reg. § 1.752-2(b)(4). In addition, before the IRS issued Revenue Ruling 88-77, the Tax Court in one case had held that contingent obligations do not increase partners' basis under IRC § 752. *See Long v. Commissioner,* 71 T.C. 1 (1978), *aff'd in part and rev'd in part on other issues,* 660 F.2d 416 (10th Cir. 1981). However, under proposed regulations issued in June of 2003, which are discussed below, a contingent obligation may be treated as a liability for purposes of IRC § 752. *See* Prop. Treas. Reg § 1.752-1(a)(1).
40. *See* Jackel and Blanchard, *supra* at 1590. *But see* William S. McKee, William F. Nelson and Robert L. Whitmire, Federal Taxation of Partnership and Partners ¶ 7.01[1] n. 10 ("contested or contingent liabilities are not deductible until the requirements of § 461 are satisfied and should not be treated as § 752 liabilities until they become deductible)."
41. T.C. Memo 2000-352.
42. The IRS also relied on the former temporary regulation described in footnote 32, *supra.*
43. Assuming the court's analysis is correct, there are nevertheless good arguments that a forward seller's obligation to deliver securities and/or cash under a VPFC should not be treated as a liability for purposes of IRC § 752. In this regard, commentators have argued that obligations under VPFCs and short sales are substantively different because VPFCs are executory contracts and short sales are borrowing transactions. *See* Bruce Lemons, James Whitmire and Randy Bickham, The New Definition of "Liability" and its Effect on Prepaid Forward Contracts, Tax Notes Today (September 9, 2003).
44. *See* Prop. Treas. Reg. § 1.752-1(a)(1).
45. *See* Preamble to Prop. Treas. Reg. § 1.752-1(a)(1) (6/24/2003) (Fed. Reg. Vol. 68, No. 121, p. 37434).
46. *See* IRC § 6662(b)(2).
47. *See* IRC § 6694.
48. *See* Chief Counsel Notice 2003-014 (May 8, 2003), *superceding* Chief Counsel Notice 2002-043 (Oct. 17, 2002).
49. *See id.; see also* Sheldon I Banoff and Richard M. Lipton, IRS Chief Counsel Will Follow Prop. Regs. — Sometimes!, 98 Journal of Taxation 380 (June 2003); Sheldon I Banoff and Richard M. Lipton, IRS Chief Counsel Will Follow Prop. Regs. – But Don't Plan on Them!, 98 Journal of Taxation 187 (March 2003).

Is Bonus Depreciation the Death of the 1031 Exchange?

By: Don Katz and Paul McCord

If you are planning to purchase, replace or contract for new equipment or an aircraft, please take note. The Job and Growth Tax Relief Reconciliation Act of 2003 turns some conventional wisdom regarding 1031 exchanges on its head and state tax issues may confuse the analysis even more.

Traditionally, companies have used a 1031 exchange to defer taxable gain on the sale or replacement of aircraft. But, under certain provisions of the Job and Growth Tax Relief Reconciliation Act of 2003 (the "Act")[1], other options—namely the bonus depreciation—could be far more advantageous.

The Act increases the bonus depreciation allowance from 30% to 50%, extends the window of opportunity through 2004[2], and front loads depreciation benefits in the earliest years of ownership—thus offering a significant tax incentive to replace property before January 1, 2005.

To be eligible for the 50% bonus, qualified tangible property (such as aircraft, trucks, or equipment) must be contracted for, purchased, and placed in service during a specified period of time and meet these other criteria:

- The property must have a recovery period of 20 years or less
- The property must be purchased between May 5, 2003, and January 1, 2005 (timing the execution of the purchasing contract is critical)
- The original use of the property must begin on or after May 5, 2003 (although certain improvements to used property also qualify)[3]
- With few exceptions, the equipment must be placed in service before January 1, 2005

The bonus depreciation benefit works this way. In the year in which the aircraft is first placed into service, the taxpayer can take a deduction equal to half of the property's adjusted basis. The remaining 50% of the property's basis is subsequently depreciated over the remaining period, including the first year's depreciation allowance. That means the bonus is in addition to the first year's depreciation, not in lieu of it—making the effective cost recovery during that first year well above 60%.[4]

That means the bonus is in addition to the first year's depreciation ...

However, although it is anticipated that the bonus depreciation provision introduced in the 2002 tax act and increased by the 2003 tax act will have a stimulative effect for the national economy generally, and sales of new aircraft in particular, this change in federal tax law will produce a corresponding negative impact on state tax revenues.[5] As a result, most states have taken steps within their own tax laws to reverse or "de-couple" from the federal bonus depreciation provisions. This state action undermines some of the benefit of the federal incentive.[6]

Many states, including the District of Columbia that previously followed the federal depreciation rules have now de-coupled.[7] Those states include: Arkansas, Arizona, Connecticut, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine (for property placed in service in tax years 2002 though 2004), Maryland, Massachusetts, Minnesota, Mississippi, Missouri (with respect to 30% bonus depreciation under the 2002 Act, but not 50% bonus depreciation under the 2003 Act), Nebraska,

New Hampshire, New Jersey, New York, North Carolina (beginning with tax year 2002, 70% add back), Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Vermont (corporate income taxes only), Virginia, and Wisconsin.

A handful of states still conform to the federal depreciation rules including the bonus depreciation provisions. Those states include Alabama, Colorado, Delaware, Florida, Kansas, Louisiana, Michigan (no corporate income tax, but see the discussion of SBT below, federal rules apply, however, for personal income tax purposes), Montana, New Mexico, North Dakota, Oregon, Utah and West Virginia.[8]

... the state legislature simply took no action to incorporate the new bonus depreciation rules.

Some states achieved this de-coupling by requiring taxpayers to simply add back the bonus depreciation claimed on their federal return to their adjusted gross income, while others require taxpayers to re-compute their depreciation on property placed in service on or after January 1, 2001, under the Internal Revenue Code as it stood prior to amendment by the 2002 tax act. In those states where their tax law was tied to the Internal Revenue Code as of certain dates, the state legislature simply took no action to incorporate the new bonus depreciation rules.

Under Michigan's Single Business Tax, federal depreciation (including bonus depreciation) claimed on your aircraft must be added to your Michigan tax base to the extent deducted in arriving at federal taxable income. Although federal depreciation must be added back to the tax base for Michigan SBT purposes, you may claim an investment tax credit (ITC) against your SBT liability for a percentage of the net costs paid or accrued in a taxable year for your aircraft if it is physically located in Michigan. Under the ITC, qualifying assets must be of a type that are or will become eligible for depreciation or amortization for federal income tax purposes, such as aircraft. Assets purchased or acquired for use outside the state, but later moved into Michigan, also qualify for the ITC. Of course, the cost of mobile tangible assets, wherever located, is subject to apportionment in the same manner as the tax base.

Depreciation also affects the bases of assets, which, in turn, affects the amount of gain or loss realized when the assets are disposed of. If there are differences in the allowable amounts of depreciation for both federal and state tax purposes, disposing of an asset before the end of its depreciable life will result in a difference in the amount of taxable income for both federal and state tax purposes.[9] As a result, individuals and businesses that file returns in those states that have decoupled will need to maintain separate sets of books for tax reporting purposes, one set for federal tax reporting purposes and another for state income tax reporting purposes.

Apart from the timing differences as a result of the various states' decoupling from the federal bonus depreciation provisions, things also get more complicated when an exchange involves relinquished and replacement properties in different states. While many states conform to the federal rules regarding like-kind exchanges, some do not. For example, in Georgia, deferral of taxes on gains from a sale of property is possible in a 1031 exchange only when the replacement property is located in Georgia. In California and Oregon, if in-state property is exchanged for out-of-state replacement property, a future sale of the replacement property can trigger an obligation to pay the state tax deferred on the original exchange.

In many cases, the new tax law

makes a 1031 exchange less attractive but not necessarily obsolete. The Act postpones the appropriate time for the 1031 exchange until January 1, 2005. At that time, the adjusted cost basis for property that's been subject to the bonus depreciation will likely be below the fair market value when replacement is being considered.

This year's new tax law, intended to stimulate the economy, offers exceptional opportunities that can substantially reduce acquisition costs—but its provisions are only advantageous under particular circumstances, and each transaction should be carefully planned for and analyzed before a purchase contract is signed. That is, the key to using this strategy, just like any tax advantage structure, is proper planning before the transaction occurs; implementing the proper structure can be cost effective and boost the company's bottom line.

DONALD L. KATZ, is a senior attorney in the Business and Finance Group at Miller Canfield Paddock and Stone, PLC in Detroit, where he is also the deputy director of the firm's Aviation and Transportation group and the firm's federal contracts team. He can be reached at 313/496-8476, or by email at katz@millercanfield.com.

Paul McCord is a senior attorney in the State and Local Tax Department at Miller Canfield Paddock and Stone, PLC in Detroit. He holds an LL.M. in taxation from Georgetown University and can be reached at 313/963-6420 or use direct dial: (313) 496-7621; or by email at mccord@millercanfield.com.

ENDNOTES

1. 26 U.S.C. 168(k)(4)(a).
2. Currently, there are bills in Congress that would extend the date even further, *see* H.R. 2895, 108th Cong. (2003)(extending the bonus depreciation through 2006); *see also,* H.R. 2895, 108th Cong. (2003)(making the bonus depreciation permanent).
3. The original use of the property must commence with the taxpayer on or after May 5, 2003. The Joint Committee on Taxation, Technical Explanation of the "Job Creation and Worker Assistance Act of 2002" (JCX-12-02) (March 6, 2002) (hereinafter the "Explanation") defines "original use" as the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

   In footnote 5 of the Explanation, the committee further provides that "it is intended that, when evaluating whether property qualifies as 'original use,' the factors used to evaluate whether property qualified as 'new section 38 property' for purposes of investment tax credit would apply." Additional capital expenditures incurred to recondition or rebuild acquired property or owned property satisfies the "original use" requirement; however, the cost of reconditioned or rebuilt property acquired by the taxpayer would not satisfy the test. Treas. Reg. § 1.48-2(b)(7) and (c), Examples 4 and 5.
4. Of course, if the acquisition is eligible for section 179 deduction, this percentage would increase depending on the acquisition cost.
5. Although state sales and property taxes are administered independently from the federal government, many state income tax rules are tied to the rules and definitions in the Internal Revenue Code. The practice of mirroring federal tax provisions at the state level is commonly referred to as "conforming." As a result, certain changes in federal tax policy, such as the bonus depreciation provisions, can have a substantial impact on state tax revenues.

   With the exception of a handful of states (California, Michigan (with respect to its Single Business Tax) Nevada, Washington, and Wyoming which do not have corporate or personal income taxes), state depreciation rules have generally conformed to federal tax law.
6. The bonus depreciation rules are expected to reduce federal revenues by over $100 billion in fiscal years 2002 – 2004. The Center on Budget and Policy Priorities, a nonpartisan research organization and policy institute that conducts research and analysis on a range of government policies and programs, estimates that state revenues would be reduced by several billion dollars in the next three years if all states were to maintain their conformity to federal law.
7. *See, e.g.,* Ariz Rev Stat § 43-105(A); Ark Code Ann § 26-51-428; Cal Rev & Tax Code § 17201; Con Gen Stat § 12-701(a)(20)(A)(ix); DC Code Ann § 47-1803.03(b)(6) (decoupling from the 2002 Act, however, no

ENDNOTES continued

legislation has been enacted with respect to decoupling from the 50% bonus depreciation of the 2003 Act); Ga Dept of Rev, Income Tax Div, News Release, *2002 JCWA/2003 JGTRRA Depreciation Adjustment* (7/2/2003); HI Dept of Taxation Announcement Nos 2002-5 and 2002-15; Idaho Code § 63-30330(1), *see also* Id STC Release, *Bonus Depreciation News* (4/1/2002); ILCS Chap 35 § 5/203(a)(2); Ind Code § 6-3-1-3.5(a)(19); Iowa Code § 422.7(39), Iowa Admin Code § 701-40.60, *see also* Iowa Dept of Rev Release 4/22/2002 and Iowa Dept of Rev Notice 6/4/2003; Ky Rev Stat Ann § 141.010(3); Me Rev Stat Ann 36 § 5122(1)(N); Md Code Ann Tax-Gen § 10-210.1, *see also* Md Admin Release No 38 (9/30/2002); Mass Gen L Chap 62 § 2(d)(1), Mass Technical Information Release No 02-11 (8/01/2002; Minn Stat § 290.01 Subd 19a(17); Miss Income Tax R § 504, *see also* Miss STC Release, Apr 2002; Mo Rev Stat § 143.121(2)(c), Mo Rev Stat § 143.431(2) (Missouri specifically decoupled from the 30% bonus depreciation under the 2002 Act without reference to the 50% bonus depreciation contained in the 2003 Act. Therefore, the 50% bonus depreciation is allowed on the Missouri return, see Missouri Dept of Rev, FAQs *About Changes in Depreciation*); Neb Rev Stat § 77-2716(10); NY Tax Law §§ 208(9)(a)(17), (b)(17) and (9)(o); NC Gen Stat § 105-134.6(c)(8); Ohio Rev Cod Ann § 5733.04(I)(17) and (18) (Ohio defers the state tax benefits that would have resulted from the accelerated depreciation deduction by means of an add-back and subtractions of the add-back that spread out the benefits of the otherwise upfront deduction over six years. Specifically, taxpayers must add back 5/6 of any bonus depreciation claimed, then deduct 1/5th of the add-back for each of the succeeding five years); Okla Stat 68 § 2358.6, Olka Admin Code § 710:50-17-51(21) (federal taxable income must be increased by 80% of any amount of bonus depreciation. The amount of bonus depreciation added back may be subtracted in a later taxable year: 25% of the total amount may be subtracted in the first taxable year following the year of the addition and 25% may be subtracted in each of the next three following taxable years); Pa Stat Ann 72 § 7401 (provides a specific formula for adding bonus depreciation back to federal income and provides a formula for computing an additional Pennsylvania depreciation deduction for tax years after 2000. Examples of decoupling computations are contained in *Decoupling Instructions for Corporations*, Pa Dept of Rev, 7-3-2002); RI Gen Laws § 44-61-1; SC Information Ltr No 03-17 (7/24/2003); Tenn Code Ann § 67-4-2006(b)(1) (providing that any depreciation permitted as a deduction in computing federal taxable income solely as a result of the federal 2002 Act, must be added to federal taxable income but is silent with respect to the increased 50% bonus depreciation enacted as part of the federal 2003 Act); Texas Policy Ltr Rul No 200203898L (The Texas franchise tax is calculated based upon the Internal Revenue Code of 1986 in effect for the tax year beginning January 1, 1996 and before January 1, 1997, and any regulations adopted under that code applicable to that period. Any changes require new legislation to be passed by the Texas legislature. However, bonus depreciation does apply for corporations that use the FIT method in their Texas franchise reports. *See* Texas Policy Ltr Rul No 200204014L); Va Tax Bulletin Nos 02-2, 02-3, and 03-1; Wis Stat § 71.01(7r), *see also* Wis Dept of Rev Bulletin 0131.

8. *See, e.g.,* Del Div of Rev Release, 04/16/2002; La Rev Stat Ann § 47:293, *see also* La Rev Rul No 02-009; Mont Code Ann § 15-31-114; NM Instructions for Corporate Income and Franchise Tax Return, CIT-1; ND Cent Code § 57-38-01; Or Rev Stat § 317.010(7).

9. For example, if a state has decoupled from the federal bonus depreciation method, there will be less state depreciation expense claimed in the year the asset is placed in service as compared to the amount of federal depreciation, and more state income is recognized in that year for state income tax purposes. However, if the asset is sold before it is fully depreciated, the gain (and depreciation recapture) for state reporting will be less than for federal reporting and, therefore, less income is recognized for state tax purposes. It is a wash in the end when the asset has been fully depreciated for both federal and state tax purposes.

Harry Potter and the Incredible Irrevocable Insurance Trust

By: Dennis M. Mitzel

I was asked by the Taxation Section to prepare a book review on Sebastian Grassi's excellent new book on irrevocable life insurance trusts ("ILITs"). I have not prepared a book report since eighth grade, and my recollection is that no one but a teacher would read such a report. Therefore, in the interest of increasing readership, I thought I would do a comparison of one of the most popular current books, *Harry Potter and the Order of the Phoenix,* and Sebastian Grassi's new book *A Practical Guide to Drafting Irrevocable Life Insurance Trusts.* One of these books has interesting characters, an intriguing plot, a thrilling climax (sounds like my email), and will keep you on edge from cover to cover. The other is a silly story of student sorcerers.

As a general overview, Sebastian has done a wonderful job of setting forth tax laws and practical implications of ILITs in an extremely straightforward and readable manner. There is no question that Sebastian is extremely knowledgeable, and technically accurate and detailed. This is evidenced in his numerous articles and seminar presentations, as well as in this book. I was pleased to see that in the book, Sebastian has set forth the information in an extremely usable, readable and practical format. In addition to reviewing the book myself, I also had it reviewed by a newer tax associate with less experience in this area of the law. He agreed that the book was extremely readable, and plainly illustrated tax concepts that he had not previously considered. The Harry Potter book is also written in a straightforward, readable manner. On the other hand, it has almost no useful information on the Internal Revenue Code, the regulations, or life insurance trusts in general.

Grassi's book breaks down each of the subjects into numerous smaller subparts, which from a practical standpoint, makes the material far easier to follow and digest. Sebastian reviews the Income Tax, the Gift Tax, the Estate Tax, and then the Generation Skipping Transfer Tax rules associated with irrevocable trusts. As each of these topics is addressed, the specific code sections impacting ILITs are reviewed. Pertinent case law and IRS rulings are also cited. This systematic approach not only helps to make this technical material more understandable, but it also makes the book very useful as a reference tool when needing to find a specific topic or concern.

There is no question that Sebastian is extremely knowledgeable, and technically accurate and detailed.

Numerous practice pointers are included throughout Sebastian's book. Some of these are specifically stated to be practice points, but many others are interspersed throughout the text of the entire book. To me, these practice pointers may be the most useful portion of the book as they set forth numerous common situations, traps, and pitfalls which we all encounter. They are excellent reminders of facts and circumstances of which we should be aware when drafting irrevocable trusts.

Sebastian has provided a complete sample ILIT for a single life policy, and a second sample ILIT designed to hold a joint and survivor life insurance policy. The second sample form also includes generation skipping provisions. As to be expected, Sebastian's documents are extremely thorough and technically precise. For practitioners who already have their own form of ILIT that they are comfortable with, a review of Sebastian's sample trust provisions will give

insight into how he has handled various administrative, technical, and tax issues and will provide ideas to practitioners on how to modify or add to their own documents. (For Michigan practitioner's, it should be noted that the sample forms comply with the requirements of Michigan's Estate and Protected Individuals Code ("EPIC"), which went into effect April 1, 2000.) Since styles vary considerably for each drafter, the sample language provided by Sebastian will need to be modified to fit the user's own specific documents. For a practitioner who does not have model documents, Sebastian's documents could clearly be used in their entirety. On the other hand, I would not recommend drafting a life insurance trust unless the practitioner thoroughly understands the trust from start to finish. This could be a daunting task for someone who does not already have his or her own life insurance trust form. My own personal preference for any set of sample documents or language, including Sebastian's sample forms, is to review those documents with the goal of adding to or improving my own current documents.

... the use of these provisions would give far less guidance to the trustee and would violate numerous copyright laws.

Using excerpts from *Harry Potter and the Order of the Phoenix* would certainly make any life insurance trust far more readable. On the other hand, the use of these provisions would give far less guidance to the trustee and would violate numerous copyright laws.

Neither of these books provides much information on split dollar insurance. It can be presumed that a good deal of Hermione's time in the Library is spent researching split dollar issues. (The movie may clarify this point.) Due to the uncertainty of split dollar issues at the time that Sebastian's book was written, his book also has very little on this topic. (Don't wait for the movie.) Even before the publishing of new Internal Revenue Service Final Regulations on split dollar (9/11/2003), the inclusion of split dollar rules would have been a daunting task. This has always been a confusing area of the law used by a relatively small group of practitioners. It was a technique, however, that needed to be better understood by estate planners. Although as I first reviewed the book, I would have liked to have seen some explanation of split dollar issues, I recognize that this would have been an extremely difficult task, especially in light of the changes in split dollar rules occurring during (and after) the time of publication of the book.

In summary, I highly recommend Sebastian's new book on irrevocable life insurance trusts. It is an excellent learning tool for new or experienced attorneys, and a valuable desk reference manual. It raises numerous points that need to be considered and understood to properly serve our clients and prevent dangerous drafting errors. The new Harry Potter book falls short of my expectations. It is true that it is an entertaining book, and it is substantially less frightening for young children, but even Professor Dumbledore could not handle the Generation Skipping Transfer Tax and other monsters taken head on by Sebastian in his book. Sebastian should be applauded for this effort and his service to the members of the tax bar. As for J. K. Rowling's efforts, well, better luck next time.

For more information about Sebastian's book, *A Practical Guide to Drafting Irrevocable Life Insurance Trusts,* ALI/ABA, Philadelphia, PA (2003), (800) 253-6397, please go to http://www.aliaba.org/aliaba/BK28.htm. The book is 365 pages and costs $147.50. Accompanying the book is

a free CD-ROM (in Rich Text Format) that contains the whole book itself and all the sample drafting language and sample forms. Another useful aspect of he CD-ROM is that the book's numerous practice points are hot keyed (linked) to the sample forms.

DENNIS M. MITZEL, ESQ. is a shareholder with the law firm of Berry Moorman, P.C. where he heads the firm's estate planning practice group. He is a Fellow of the American College of Trust and Estate Counsel, a frequent lecturer for ICLE (especially on the GST tax, and recently on split dollar issues), and is a past Chairperson of the Taxation Sections of the State Bar of Michigan and the Detroit Metropolitan Bar Association. Mr. Mitzel is currently serving as vice chairman of the Planned Giving Roundtable of Southeastern Michigan and is acting as Parish Council chairman for Christ the King Catholic Church.

Recent Developments

Michigan Court of Appeals Upholds Successor Liability Tax Assessment

Affirming the Tax Tribunal, the Michigan Court of Appeals upheld a successor liability tax assessment for the Single Business Tax arising from the taxpayer's purchase of a McDonald's restaurant in *S.T.C., Inc. v. Dep't. of Treasury*, 669 N.W.2d 594, 257 Mich. App. 528 (July 15, 2003).

The taxpayer, Vasant Chapatwala, examined Masteau's (the seller's) accounting books and records and determined that Masteau was current in its payment of estimated SBT taxes as of the purchase date, August 4, 1993. Chapatwala was trained in accounting, but he did not consult his outside accountant about reviewing the records. Because Chapatwala concluded that the seller was current in tax payments, he did not escrow any funds for potential tax liabilities. Later, Masteau filed its 1993 SBT return showing a balance due of $12,633, but payment was not made.

Chapatwala was trained in accounting, but he did not consult his outside accountant about reviewing the records.

M.C.L. § 205.27a(1) provides that the purchaser "shall escrow sufficient money to cover the amount of taxes, interest, and penalties as may be due and unpaid." The statute requires that the escrow be maintained until the purchaser receives (1) a receipt from the commissioner showing that taxes due are paid or (2) a certificate stating that taxes are not due. Analyzing the phrase "as may be due and unpaid," the court noted that the tax payments made were estimates. Estimates are treated the same as taxes due, according to M.C.L. § 205.23(2). The court also examined dictionary definitions to conclude that the contested phrase includes both present and future time periods and reasoned that the statute does not limit the tax liability to the purchase date. Thus, because the taxpayer did not escrow funds as statutorily required, the court concluded that the SBT tax assessment was proper.

New Developments in Sales, Use, and Withholding Taxes

- *Corporate Flight, Inc. v. Dep't. of Treasury,* 469 Mich. 853, 666 N.W.2d 665 (July 17, 2003). The Michigan Supreme Court issued an order to remand the case to the Tax Tribunal for additional fact-finding regarding the use tax sale for resale exemption.
- *Birchwood Manor, Inc. v. Commissioner of Revenue,* 2003 Mich. App. LEXIS 2400 (September 23, 2003). Finding itself bound by *CompuPharm v. Department of Treasury,* the Michigan Court of Appeals held that the non-legend drugs (e.g., over-the-counter drugs) were subject to use tax when purchased for nursing home residents.
- On June 26, 2003, Gov. Jennifer Granholm signed House Bill 4219 (Public Act 27 of 2003) into law to amend M.C.L. § 205.93. The law revises the taxability presumptions for use tax.

New Developments in Property Tax

- *City of Detroit v. 19675 Hasse and Acorn Investment Co.,* et al., 2003 Mich. App. LEXIS 2251 (September 16, 2003). Noting that statutes of limitation do not run against the state or its subdivisions without an express Legislative enactment, the appellate court found that Detroit was not barred from pursuing *in rem* tax lien foreclosures for unpaid taxes back to 1989.
- *SG Cemetery Assoc., Inc. v. Sterling Heights*, Mich. Ct. of Appeals Docket No. 239000 (unpublished, July 31, 2003). The Court of Appeals ruled that only a portion of the land could be characterized as a cemetery under M.C.L. §§ 211.7t, 456.108.
- *Detroit Tax Lien Co. v. Kirman Dante Paul, et al.,* Mich. Ct. of

Appeals Docket No. 239905 (unpublished, August 12, 2003). The appellate court found that the redemption period had not started because Detroit Tax Lien did not strictly comply with the statutory notice requirements in M.C.L. § 211.140.

- *Lutheran Social Services of Michigan v. Bloomfield Twp.,* Mich. Ct. of Appeals Docket No. 239460 (unpublished, September 11, 2003). The Court of Appeals concluded that the apartment complex for the aged did not qualify as a charitable institution under M.C.L. § 211.7o.
- *Whispering Pines Golf Club, LLC v. Township of Hamburg,* Mich. Ct. of Appeals Docket No. 233218 (unpublished, September 16, 2003). Reversing the Tax Tribunal, the appellate court held that the lower court properly used the income approach to value the golf course, but that the evidence did not support some of the facts.
- *Fonda Place Partners v. Township of Brighton,* Mich. Ct. of Appeals Docket No. 240692 (unpublished, September 23, 2003). The Michigan Court of Appeals affirmed the Tax Tribunal and found that the Tribunal did not abuse its discretion when it denied the taxpayer's motions.
- *Harry R. Javens v. Madison Heights,* Mich. Ct. of Appeals Docket No. 235301 (unpublished, October 28, 2003). Affirming the Tax Tribunal, the appellate court held that the taxpayer's self-imposed deficiencies and inefficient management were not appropriate reasons to lower the rental property's true cash value.
- *Workmen's Circle Educational Centre v. City of Oak Park,* Mich. Ct. of Appeals Docket No. 240792 (unpublished, October 28, 2003). The Michigan Court of Appeals affirmed the Tax Tribunal and determined that the taxpayer's property tax assessment appeal was properly dismissed for lack of jurisdiction due to late filing.
- *Michigan State University v. City of Lansing,* Mich. Tax Tribunal Docket No. 286639 (August 19, 2003). The Michigan Tax Tribunal concluded that the disputed property, Candlewood Suites Hotel and Executive Development Convention Center, was exempt under M.C.L. § 211.71 (public property owned by the state).
- *Fairview Enterprises Inc. v. Township of Mitchell,* Mich. Tax Tribunal Docket No. 276328 (August 4, 2003). The Michigan Tax Tribunal accepted the taxpayer's sales comparison method to determine the real property's true cash value as well as the cost-less-depreciation method to value improvements.
- *Wexford Medical Group v. City of Cadillac,* Mich. Tax Tribunal Docket No. 276304 (July 17, 2003). The Michigan Tax Tribunal found that the personal and real property were not entitled to an exemption under M.C.L. § 211.7o (charitable use), M.C.L. § 211.9a (charitable institution), or M.C.L. § 211.7r (public health).
- *Michigan State Tax Commission v. Grosse Pointe,* Mich. Tax Tribunal Docket No. 284585 (July 17, 2003). The Michigan Tax Tribunal determined that the park was not "open to the public generally" under M.C.L. §§ 211.7m and 211.7x, and thus was not entitled to the property tax exemption.
- *Detroit Athletic Club v. City of Detroit,* Mich. Tax Tribunal Docket No. 292030 (July 17, 2003). The Michigan Tax Tribunal adjusted the taxpayer's taxable value for the disputed

... the Tribunal did not abuse its discretion when it denied the taxpayer's motions.

personal property.

- *Healthlink Medical Transportation Services v. City of Taylor*, Mich. Tax Tribunal Docket No. 275821 (July 1, 2003). The Michigan Tax Tribunal determined that the personal property was not entitled to an exemption under M.C.L. § 211.7o (charitable use), M.C.L. § 211.9a (charitable institution), or M.C.L. § 211.7r (public health).
- *Generation Ministries, Inc. v. Hamburg Township,* Mich. Tax. Tribunal Docket No. 282252 (July 18, 2003). The Michigan Tax Tribunal determined that the health and fitness center was not entitled to an exemption under M.C.L. § 211.7o (charitable use), M.C.L. § 211.7q (YMCA/YWCA), or M.C.L. § 211.7s (house of worship).
- On June 26, 2003, Gov. Jennifer Granholm signed House Bill 4008 (Public Act 28 of 2003) into law to add M.C.L. § 206.512a and companion Senate Bill 23 (Public Act 29 of 2003) to amend M.C.L. § 206.512. The changes affect the definition of "property taxes" to include certain special assessments.
- On July 24, 2003, Gov. Jennifer Granholm signed Senate Bill 520 (Public Act 105 of 2003) into law to amend M.C.L. §§ 211.7cc, 211.7ee, 211.24c, and 211.53b. The law describes the audit process for homestead exemption irregularities.
- On July 31, 2003, Gov. Jennifer Granholm signed a bill package to revise the name of the homestead exemption to "principal residence exemption" in various statutory sections. Senate Bill 129 (Public Act 126 of 2003) amends M.C.L. §§ 380.1211 and 380.1211e, Senate Bill 130 (Public Act 127 of 2003) amends M.C.L. § 207.779, Senate Bill 131 (Public Act 128 of 2003) amends M.C.L. § 207.526, Senate Bill 132 (Public Act 129 of 2003) amends M.C.L. § 125.2802, Senate Bill 133 (Public Act 140 of 2003) amends M.C.L. §§ 211.7u, 211.7cc, 211.7dd, 211.9, 211.24c, 211.27d, and 211.120, Senate Bill 134 (Public Act 141 of 2003) amends M.C.L. § 388.1620, Senate Bill 135 (Public Act 130 of 2003) amends M.C.L. § 565.957, and House Bill 4192 (Public Act 131 of 2003) amends M.C.L. §§ 205.735, 205.737, 205.743, and 205.762a.

The changes affect the definition of "property taxes" to include certain special assessments.

New Developments in Income Tax

- *Polasky v. Dep't. of Treasury,* Mich. Ct. of Appeals Docket No. 238249 (unpublished, July 29, 2003). Affirming the Tribunal, the appellate court held that the Michigan income tax assessments based on the federally-revised adjusted gross income were proper.
- *Glieberman v. Dep't. of Treasury,* Mich. Tax Tribunal Docket No. 288104 (July 11, 2003). The Michigan Tax Tribunal found that out-of-state income derived from non-unitary business activities without nexus to Michigan is not apportionable and is not subject to income tax.
- On June 24, 2003, Gov. Jennifer Granholm signed House Bill 4561 (Public Act 22 of 2003) into law to amend M.C.L. § 206.351. The law extends the income tax withholding requirements so that they apply to additional entities. House Bill 4561 was part of a package of bills: House Bill (Public Act 51 of 2003) amends M.C.L. § 206.22, House Bill 4559 (Public Act 50 of 2003) amends M.C.L. § 206.26, House Bill 4560 (Public Act 49 of 2003)

amends M.C.L. § 206.315, House Bill 4562 (Public Act 48 of 2003) amends M.C.L. § 206.355, House Bill 4563 (Public Act 47 of 2003) amends M.C.L. § 206.365, House Bill 4564 (Public Act 46 of 2003) amends M.C.L. § 206.451, and House Bill 4565 (Public Act 45 of 2003) amends M.C.L. § 206.12.

- On July 11, 2003, Gov. Jennifer Granholm signed House Bill 4557 (Public Act 52 of 2003) into law to amend M.C.L. § 206.4. The law expands the definition of "business income."

New Developments in Other Miscellaneous Tax Areas

- *DaimlerChrysler Corp. v. Dep't. of Treasury,* 2003 Mich. App. LEXIS 2126 (September 2, 2003). The Court of Appeals found that the one-year statute of limitations in M.C.L. § 207.112 allowed the taxpayer to seek a refund of taxes paid for fuel left in fuel tanks of vehicles sold out-of-state within the last year.
- *Goodyear Tire & Rubber Co. v. Roseville,* 468 Mich. 944, 664 N.W.2d 751 (July 10, 2003). The Michigan Supreme Court issued an order to remand the case to the Tax Tribunal to resolve disputed issues of fact regarding receipt of appearance notice.
- *Mapleview Estates, Inc. v. Brown City,* 2003 Mich. App. LEXIS 1627 (September 11, 2003). The Michigan Court of Appeals held that the city's tap-in fees for connecting new homes to the central water and sewer system were not a tax subject to the Headlee Amendment but rather were a fee.
- On June 24, 2003, Gov. Jennifer Granholm signed House Bill 4567 (Public Act 23 of 2003) into law to amend M.C.L. § 205.27a, House Bill 4569 (Public Act 24 of 2003) to amend M.C.L. § 205.96, and House Bill 4568 (Public Act 25 of 2003) to amend M.C.L. § 205.65. The changes affect the tax liability provisions for selling or dissolving businesses.
- On July 24, 2003, Gov. Jennifer Granholm signed Senate Bill 121 (Public Act 92 of 2003) into law to amend M.C.L. § 205.3. The changes require all Treasury bulletins and letter rulings to be available to the public in printed and electronic formats.
- On July 24, 2003, Gov. Jennifer Granholm signed Senate Bill 586 (Public Act 114 of 2003) into law to amend M.C.L. § 205.28. The law concerns access to tax information from the Department of Treasury.

... one-year statute of limitations ... allowed the taxpayer to seek a refund of taxes paid ...

This Update was prepared by **JENNIFER TROYER** of KPMG LLP.