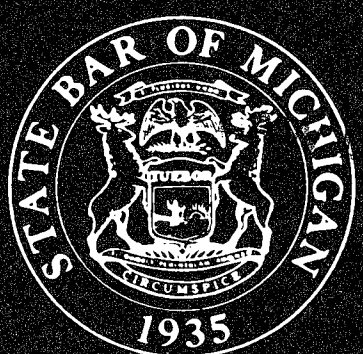
MICHIGAN TAX LAW JOURNAL

January - March 1981



TAXATION SECTION

MICHIGAN TAX LAW JOURNAL

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We are pleased that one of our readers, Ernest Getz of Dickinson, Wright, McKean, Cudlip & Moon took the time to share his comments on a recent article in the Journal. His letter appears at the end of this issue. We appreciate all comments and criticisms and invite our readers to advise us how we can improve our magazine and better serve the Section membership.

As always the entire staff is determined to bring to our readers the most up-to-date tax information and best quality writing of which we are capable. If you have ideas for articles, or announcements of general interest to the Section, please address them to the Journal, c/o University of Detroit Law School, 651 E. Jefferson, Detroit, Michigan 48226.

We wish all of our readers much success in 1981.

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TAXATION SECTION
STATE BAR OF MICHIGAN

MINUTES OF REGULAR MEETING OF COUNCIL OF TAXATION SECTION OF STATE BAR OF MICHIGAN

A regular meeting of the Council of the Taxation Section of the State Bar of Michigan was held at the conference room of Bassey, Selesko, Couzens & Murphy, 1400 American Center, Southfield, Michigan at 4:00 p.m. on Wednesday, January 21, 1981.

Council Members Present Present

Allan J. Claypool
Joseph F. Dillon
James A. Durkin
Eugene A. Gargaro, Jr.
John G. Gibbons
Edward B. Goodrich
John W. McNeil
Erwin A. Rubenstein
Andrew M. Savel
Peter S. Sheldon
Lawrence R. Van Til
Susan Westerman

Lawrence J. Murphy, ex-officio

Guests

In attendance was Richard Hardin, C.P.A., liaison member from the Michigan Association of Certified Public Accountants (State and Local Tax Committee). Also in attendance was Austin Anderson of the Institute of Continuing Legal Education.

Council Chairperson, John W. McNeil presided and Council Secretary-Treasurer, Lawrence R. Van Til, acted as Secretary of the meeting.

Minutes of October 16, 1980 Meeting: The minutes of the meeting of the Council of the Taxation Section, held on October 16, 1980, were approved as submitted to the Council members.

Treasurer's Report: Mr. Van Til reported that for the three months ended December 31, 1980, the revenues of the Taxation Section were $16,934.00. Total expenses had been $482.13. Excess revenue over expense was $16,451.87. The current fund balance of the Taxation Section is $22,599.25.

Mr. Van Til reminded the Council members that the State Bar requests that a receipt accompany a request for reimbursement for all expenditures over $25.00.

COMMITTEE REPORTS

Sixth Annual Tax Institute: Mr. Gargaro reported that the Sixth Annual Tax Institute will be held on October 22 and 23, 1981 at the Michigan Inn, Southfield, Michigan. Mr. Gargaro reported that an initial planning session for the Institute had been held at 1:00 p.m. just prior to the Council's meeting at which time many suggestions for program format and topics were discussed. Mr. Gargaro reported that the proposed program would be circulated to the Council members for comment and for specific suggestions for speakers.

Single Business Tax Rules: Mr. Murphy reported that the Department of Treasury, Revenue Division, has begun drafting proposed Single Business Tax Rules. The proposed rules received so far relate to specific matters and are not indexed nor organized. Mr. Murphy reported that on February 12, 1981 there will be a meeting of the review committee to study the rules that have been drafted to date. The committee is considering combining its efforts with those of the State and Local Tax Committee of the Michigan Association of Certified Public Accountants to jointly work on proposed changes to the rules.

Michigan Tax Law Journal: Mr. Gargaro distributed for information and comment a memorandum regarding publication procedures together with a calendar and deadlines for publication of journals.

Mr. Gargaro reported that Professor Patrick A. Keenan of the University of Detroit Law School has worked hard and effectively to make the journal into a good publication. He noted that Professor Keenan is not adequately compensated for his effort. Upon motion it was unanimously

> RESOLVED: that the journal editor be paid the sum of $450.00 quarterly as compensation for services as editor of the Tax Law Journal.

Annual State Bar Meeting: Mr. Durkin reported that the Annual Meeting of the State Bar of Michigan would be held at the Grand Plaza in Grand Rapids on September 23 through 25, 1981. The Taxation Section Annual Meeting and Program would be held on September 23, 1981. Mr. Durkin attended a December 6, 1980 meeting in Lansing at the State Bar Offices to participate in planning for the Annual Meeting. Mr. Durkin reported that the State Bar must know by March 31, 1981 what our program will be. Mr. Durkin reported that he intends to present a program similar to that of two years ago where representatives of the District Director's Office of the Internal Revenue Service made presentations.

It was suggested that since the Section's program is not conspicuous in the State Bar Annual Meeting announcements that the Section should send a separate mailing to the Section members announcing the program. Formal action of this suggestion was deferred to the May meeting of the Council.

Austin Anderson requested that the Taxation Section participate in the annual State of the Law portion of the State Bar of Michigan's Annual Meeting. After discussion the Chairman requested Mr. Durkin to expand his activities to include a plan for participation in the State of the Law program. Mr. Durkin will report at the next regularly scheduled meeting of the Council.

Tax Court Luncheon: Mr. Gibbons reported that approximately 40 people attended the last Tax Court Luncheon which was held on September 15, 1980 at the University Club in Detroit. Judge Cynthia Holcolm Hall was honored. The next Tax Court luncheon will also be held at the University Club and will honor Judge Howard A. Dawson, Jr. The luncheon is scheduled for Wednesday, March 4, 1981. Another session of

the Tax Court will begin on May 11, 1981. The judge presiding is expected to be Judge Irene F. Scott. A luncheon has been tentatively scheduled at the University Club for Tuesday, May 12, 1981.

Legislative Review: Mr. Sheldon reported on Act 62 of 1980, whereby it is provided that all non-property tax cases are to be filed with the Michigan Tax Tribunal. The Tax Tribunal Act was also amended to provide that the attorney or accountant member of the Tax Tribunal will no longer be required for non-property tax cases. Mr. Sheldon also reported that he is currently watching House Bill 4280 and will keep watch of subsequent legislation to extend the life of the State Board of Tax Appeals. Mr. Sheldon recommended that the Section support legislation to extend the life of the State Board of Tax Appeals. No action was taken.

Intangibles Tax Rules: Mr. Savel reported that the revised rules have been received from the Revenue Division of the Michigan Department of Treasury. The Chairman appointed Mr. Savel, Mr. Sheldon and Mr. McNeil to review and comment on the new rules.

LIAISON REPORTS

State and Local Tax Committee: Mr. Hardin reported that the MACPAs have appointed a committee to review the proposed single business tax rules and that it intends to cooperate with the Taxation Section in the review of those rules.

NEW BUSINESS

Mr. McNeil reported that a letter had been received from the State of New York Temporary State Commission on the Real Property Tax requesting information concerning Michigan's experience with the Small Claims Division of the Michigan Tax Tribunal. It was suggested that Mr. McNeil forward the request to Mr. Richard Erickson, Chief Clerk of the Michigan Tax Tribunal for preliminary answer.

The next meeting of the Council will take place on March 4, 1981 immediately after the Tax Court luncheon. Mr. McNeil reported that the May meeting of the Council will be held in the third week of May, probably on May 21, 1981.

There being no further business, the meeting was adjourned.

LAWRENCE R. VAN TIL,
Secretary

Approved By:

JOHN W. McNEIL,
Chairperson

MINUTES OF REGULAR MEETING OF COUNCIL OF TAXATION SECTION OF STATE BAR OF MICHIGAN

A regular meeting of the Council of the Taxation Section of the State Bar of Michigan was held at the University Club, Detroit, Michigan at 2:00 p.m. on Wednesday, March 4, 1981.

Council Members Present

Allan J. Claypool
Joseph F. Dillon
James A. Durkin
Eugene A. Gargaro, Jr.
John G. Gibbons
Edward B. Goodrich
John W. McNeil
Erwin A. Rubenstein
Andrew W. Savel
Peter S. Sheldon
Lawrence R. Van Til
Susan Westerman

Council Member Absent

Lawrence J. Murphy (ex-officio)

Guests

In attendance was Richard Hardin, C.P.A., liaison member from the Michigan Association of Certified Public Accountants (State and Local Tax Committee).

Council Chairperson, John W. McNeil, presided and Council Secretary-Treasurer, Lawrence R. Van Til, acted as Secretary of the meeting.

TREASURER'S REPORT

Mr. Van Til reported that for the four months ended January 31, 1981 revenues of the Section totaled $17,464.00. Expenses totaled $3,665.71 and that current fund balance was $19,945.67. For the five months ended February 28, 1981, total revenues were $17,493.00, total expenses were $3,451.98. The current fund balance as at February 28, 1981 was $20,188.40. Mr. Van Til also reported that a check in the amount of $1,430.72 which represented the Taxation Section's portion of registration fees for the Joint Seminar with the MACPA had been incorrectly credited to another section. The State Bar determined that the most expeditious way to account for the money was to use it as an offset against current expenses rather than adding it to the fund balance from October 1, 1980. This change results in the expenses as at February 28, 1981, being lower than at January 31, 1981, even though $1,216.99 was spent during the month of February.

COMMITTEE REPORTS

Sixth Annual Tax Institute: Mr. Gargaro reported that final refinements of the program were completed and that the program would be circulated to the Council members for final comments. He requested that any

comments be made within a few days after receipt. Mr. Gargaro intends to also pre-circulate the list of potential speakers to the Council. Mr. Gargaro stated that he intends to send invitations by March 15, 1981.

Michigan Tax Law Journal: Mr. Gargaro reported that Professor Keenan was pleased with the Council's decision to pay him $450.00 per issue. Mr. Gargaro also reported that he and Professor Keenan are trying to reduce the time of publication to no more than four or five weeks after the end of a calendar quarter.

Annual State Bar Meeting: Mr. Durkin reported the program for the State Bar Meeting will feature Mr. John Murray, an assistant attorney general for tax matters, as one of the principal speakers. The new Detroit District Director, Mr. James Caldwell, and several persons from his staff will also make presentations. The program will begin in the morning and will continue until 3:00 in the afternoon. The afternoon program will be a kind of district liaison meeting.

Mr. Goodrich reported that there have been several very successful informal meetings with special agents of the IRS and with other employees of the district offices. One such meeting recently took place in Grand Rapids. Upon discussion it was determined that upon adjournment of the program at the Annual Meeting of the State Bar that members of the Section would be invited to an informal meeting and reception with employees of the IRS.

State of the Law: Mr. Durkin reported that the Taxation Section will participate in the Annual State of the Law program on Friday, September 25, 1981 from 2:40 p.m. to 3:20 p.m. In the interest of time, speaker availability and relevancy, he determined that the topic and the speaker should be someone who is making a presentation at the Sixth Annual Tax Institute. He intends to ask the speaker chosen to present Highlights of 1980-81 Federal Tax Developments to be the speaker for the State of the Law program.

Michigan Tax Procedures Manual: Mr. Van Til reported that Austin Anderson has agreed to send letters to the authors of the Michigan Tax Practice and Procedures Manual requesting the authors to review their chapters to determine whether any updating and revision is necessary.

Tax Court Luncheons: Mr. Gibbons reported that approximately 50 people attended the Tax Court Luncheon which honored Judge Howard A. Dawson, Jr. The next luncheon will be held on May 12, 1981 and will honor Judge Irene Scott. It will most likely be held at the University Club in Detroit.

Legislative Review: Mr. Sheldon reported that several bills have been drafted to reinstitute the State Board of Tax Appeals in full, partially, and/or cure jurisdictional defects. None of the bills have been introduced as yet. Mr. Sheldon distributed for review the draft legislation and asked that any comments be sent to him as soon as possible.

Employee Benefits: Mr. McNeil reported for the committee that a meeting of the committee was held on February 20, 1981. The meeting

consisted of a discussion of Multi-Employer Pension Plan Amendments Act of 1980, recent amendments to IRC Section 414 (enacted for the purpose of countering the *Kiddie* and *Garland* cases), and the final regulations with respect to IRC Section 501(c)(9). It was determined at that meeting to conduct a survey concerning problems encountered by attorneys requesting determination letters from the Internal Revenue Service and with audits of qualified plans. The survey was drafted and has been sent to all Tax Section members. Comments should be directed to Mr. Steven I. Jurmu, 313 South Washington, Lansing, Michigan 48933.

Mr. Claypool reported that the American Bar Association is considering the establishment of a new section devoted to employee benefits.

Single Business Tax Rules: Mr. McNeil reported for Mr. Murphy. The Revenue Division intends continued use of the single business tax act bulletins to report their regulations. They are working on drafting regulatons but expect the project to extend over the next few years.

Intangibles Tax Rules: Mr. Savel reported that the committee has met to review the intangible tax rules. The committee is soliciting comments on the rules from members of the Section. Comments received will be reviewed for inclusion in the committee's review of the rules.

LIAISON REPORTS

Mr. Savel reported for George Walker that work on the joint program for attorneys and CPAs is progressing. Mr. Joseph Dillon, a Council member, will be on the program. Mr. Richard Hardin reported that at the most recent meeting of the Tax Executive Institute, Mr. Sydney Goodman asked for comments on the proposed single business tax rules.

OLD BUSINESS

Central Region Bar Liaison Meeting: Mr. Rubenstein and Mr. Durkin presented a joint report. Mr. Leon Green, the Regional Commissioner of the IRS indicated that the Internal Revenue Service staff is currently demoralized because of budget problems, staffing problems and problems relating to difficulties in recruiting well qualified people to the IRS. Mr. Jerry Cohan, former Chief Counsel of the IRS, discussed problems relating to published and unpublished rulings. Mr. Cohan indicated that one should not rely upon unpublished rulings. Circular 230 is under discussion and it is expected that there will be some revision. The IRS intends to begin looking at "total positive" income instead of adjusted gross income for audit purposes, especially in the tax shelter area where the Service is also considering recommending adoption of a "down side" penalty.

The IRS is currently aggressively pursuing withholding tax cases. It is the Service's view that it does not care whether its attempts to collect withholding taxes would push a taxpayer into bankruptcy. If a company is in bankruptcy, at least it will keep current on employee withholding.

In the Tax Court, there appears to be a big push to settle cases involving valuation questions. There is sentiment in favor of granting attorney fees and expenses to successful petitioners in Tax Court.

If the minutes of the Liaison meeting are not forthcoming within the reasonably near future, Messrs. Rubenstein and Durkin will draft a summary of the meeting for publication to the members of the Section.

Council Member Recognition: Mr. Rubenstein reported on his progress in finding a suitable plaque or certificate of recognition to give retiring Council members. He presented the Council with several styles of plaques. After discussion it was concluded that he would check with the State Bar to determine what other sections are doing and would get a second bid on the plaques.

Mailing List: Mr. McNeil reported that there is a seminar in June at Walsh College being sponsored jointly by Walsh College and the MACPA. The seminar will present several general tax subjects. There was a consensus in opposition to providing the Section's mailing list for this program.

After discussion, it was determined that the Section would not adopt any written policy on distribution of its mailing list. It is generally agreed, however, that mailing lists may be provided to non-profit organizations presenting programs the Council believes to be of benefit to the members of the Section and which are not in conflict with Section programs or ICLE programs.

NEW BUSINESS

Anti-trust Seminar: Mr. McNeil reported that a letter had been received from the Anti-trust Section of the State Bar concerning a seminar to be held on June 12, 1981. One of the topics to be covered at that seminar would be a discussion of the *Upjohn* case. After some discussion, it was determined that it would not be appropriate for the Section to mail information to the membership to promote this anti-trust seminar for the reason that the Section is co-sponsoring a seminar with the MACPA at about the same time where one of the major topics will specifically relate to attorney-client confidential relationships and the *Upjohn* case.

National Conference of Taxation Sections: Mr. McNeil reported that the National Conference of Taxation Sections would be held in Chicago in June. Council members interested in attending are invited to do so. Details may be obtained from Mr. McNeil.

NEXT MEETING

The next meeting of the Council will be held in Lansing at the University Club at 4:00 p.m. on May 21, 1981. The meeting will be followed by a dinner for Council members.

LAWRENCE R. VAN TIL,
Secretary

Approved By:

JOHN W. McNEIL,
Chairperson

INCOME TAX RETURN PREPARERS: BEWARE OF CIVIL PENALTIES UNDER I.R.C. §6694!!!

Robert J. Kolasa

The complexity of the tax laws and the desire to shelter as much income as possible from the tax collector's grasp, has led taxpayers in increasing numbers to seek assistance in preparing their tax returns. It may be that many lawyers do not realize the liabilities they expose themselves to by preparing returns. Preparers can be subject to common law liability in fraudulent misrepresentation and negligence actions brought by disgruntled clients,[1] as well as statutory liability imposed by the I.R.S. Because criminal prosecution normally involves only flagrant misconduct and significant amounts, the government's most effective tool for regulating the general competence of tax practitioners and return preparers are the civil penalties contained in I.R.C. §6694(2). This article will present a brief overview of I.R.C. §6694 and the types of conduct by income tax preparers which may trigger its sanctions.

A. INCOME TAX RETURN PREPARER

I.R.C. §6694 imposes a $100 penalty for any understatement of income tax liability due to the "Negligent or Intentional Disregard of Rules and Regulations" and a $500 penalty for the "Willful Understatement of Liability" by an income tax return preparer. The threshold question a lawyer must ask is: Am I an "Income Tax Return Preparer" within the context of I.R.C. §6694? This term is defined in I.R.C. §7701(a)(36) as:

> "any person who prepares for *compensation* or employs one or more person to prepare for compensation, any return of tax imposed by Subtitle A or any claim for refund of tax imposed by subtitle A. For purposes of the preceding sentence the preparation of a *substantial portion* of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund." (emphasis added)

More than one person can be considered the "Income Tax Return Preparer" of the same return. An important distinction is that the term may include different individuals for the different section of the Return Preparers Program. For example, a law firm which employs young lawyers to prepare returns may be labeled an income tax return preparer and be liable for penalties under I.R.C. §6695, for oversights such as failure to furnish a copy of the return to a taxpayer, failure to show identification numbers, negotiation of a refund check, etc. But I.R.C. §6694 penalties are imposed only on the actual preparer who does the work and not on his employer, unless the employer actively participated in the negligent, intentional or willful conduct.[3] If another employee supervised the preparation of a return by an income tax return preparer, any negligent or intentional disregard of rules and regulations that occured in connection with the return

may be attributable to the person supervising if he had responsibility for determining whether the rules and regulations were followed.

The preparer status applies only to those who prepare for compensation. A lawyer who gratuitously prepares a return for a friend or relative is not covered, even though there may be some expression of gratitude such as an invitation to dinner.[4]

A person who prepares a substantial portion of return is considered an income tax return preparer. Substantial performance is determined by comparing the length, complexity and amount of tax involved in the prepared portion with similar items in the return as a whole.[5] The regulations give no indication of the various weights of these factors. Attorneys who prepare a single schedule for a return would not be income tax return preparers, unless that schedule was the "dominant portion" of the return[6] such as completion of Schedule C or D reflecting the main source of the taxpayer's income. Treas. Reg. §301.7701 15(b)(2)(1976) provides something of a "safe harbor" within which partial preparation will not constitute a substantial portion. If the amount involved (gross income, deductions or the basis of credits) in the schedule or entry is less than $2,000 in the absolute or is less than $100,000 and less than 20% of gross income (or adjusted gross income), that item is not a substantial portion.

It is not unusual for lawyers to give tax advice that will directly reflect on the client's tax return. The lawyer who furnishes the taxpayer or another preparer sufficient information and advice so that completion of the return is largely a "mechanical or clerical matter" cannot avoid preparer status under Treas. Reg. §6301.7701 15(a)(1)(1976). This regulation is directed to prevent elusion of the preparer rules simply by having someone else fill in the form. Advice which does not relate to any specific amounts which are to be placed on the return will not constitute preparation. A person is considered to have prepared an entry if his advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return.[7] However, not all advice imputes preparer status. If directly relevant advice, such as a legal memorandum, is given *prior* to a proposed or contemplated action or transaction, the writer is not considered to have prepared the entry on the return.[8]

The practitioner should note that the regulations have a far reaching effect in making a person who has no direct involvement with a return the "Income Tax Return Preparer." The sole preparer of a partnership return or a Subchapter S return is also the preparer of the *partner's* return or *shareholder's* return, if the entries on the business return constitutes a substantial portion of the *individual* return.[9] This seems frightening if one of the partners prepares his own return and takes a deduction for a substantial loss, even though the loss is not allowable as he has no remaining basis in the partnership. A literal reading would make the preparer of the partnership return subject to penalties as a preparer of the erroneous *individual* return. But a reasonable interpretation is that the preparer is not liable for I.R.C. §6694 penalties, as he did not "Negligently or Intentionally" disregard the rules and regulations or "Willfully" understate liability in the preparation of the *partnership* return.

B. NEGLIGENT DISREGARD OF RULES AND REGULATIONS

I.R.C. §6694 imposes a $100 penalty for the negligent disregard of rule and regulations by an income tax return preparer resulting in an understatement of tax liability. By definition, negligence is a lack of due care in failing to do what a reasonable and ordinarily prudent person would have done under the circumstances. Treas. Reg. §1.6694 1(a)(1)(1976) provides that a preparer is not considered to have negligently or intentionally desregarded a rule or regulation if the preparer exercises due diligence. The I.R.S. has set forth its position on the imposition of the I.R.C. §6694 penalty for negligent disregard in Rev. Proc. 80 40, I.R.B. 1980 40,22. The factors the I.R.S. considers are the nature, frequency and materiality of the error along with normal offices procedures in preventing errors.

An isolated mathematical or clerical error ordinarily reflects no more than mere inadvertence and will not result in the penalty unless the error is of such magnitude or so conspicuous that it should have been discovered after its commission.[10] Rev. Rul. 80 262, I.R.B. 1980 40, at 17 concerned errors involving interest income reported on Form 1099 INT. In situation #1, the preparer overlooked one item and in situation #2 he incorrectly totalled the amounts. These clerical and mathematical errors did not justify the penalty, especially when the error was the only error on the return and the amount of understatement was not substantial. But a pattern of errors on a return creates a presumption of negligence and generally will result in the assertion of the penalty even though no one error occuring in isolation would have triggered the sanction.[11] The lawyer should ask if the understatement is material in relation to the correct tax liability. An error resulting in a material understatement may be a greater indication of negligence than a similar error resulting in a less material understatement.[12]

Treas. Reg. §1.6694 1(a)(5)(1976) states that if the preparer presents evidence that the normal practice of the preparers concerning the treatment of a particular credit, allowance, deduction, or item of income was not negligent and that this normal practice was followed, the preparer has satisfied the burden of proof that he did not negligently disregard a rule or regulation. Similarly, Rev. Proc. 80 40, I.R.B. 1980 40, at 22 states that where all the relevant facts and circumstances suggest that the return was negligently prepared, the penalty will generally not be asserted if the preparer's normal office practice, when considered together with other facts and circumstances such as the knowledge of the preparer, indicates that the error would rarely occur. These are inducements to all practitioners to develop an office system to promote accuracy and consistency in the preparation of returns.

In Rev. Rul. 80 264, I.R.B. 1980 40, at 18, the preparer's failure to report the minimum tax resulted in a substantial understatement of tax liability which would normally invoke I.R.C. §6694 sanctions. The preparer presented as evidence a checklist to prove that his normal office practice was to correctly apply the minimum tax provisions. The workpapers indicated that the checklist had been reviewed. This was enough to convince the I.R.S. that the preparer was not negligent, as the

error in question would rarely occur. But the normal office practice "escape clause" will not be available where the error is flagrant, or there is either a pattern of errors on a particular return or an error is repeated on numerous returns.[13] Hence, the rules and regulations indicate that the I.R.S. has chosen a flexible approach in balancing the nature, frequency and materiality of the error causing the understatement, against the preparer's normal office practice. It therefore behooves the practitioner to exercise great care not only in preparation, but in documenting his procedures to prove due his care.[14] Suggestive elements of due care include arithemetical verification, examination of prior year's returns, proofing of all computer processing, and a written quality control program and record of implementation.

Included in the scope of I.R.C. §6694 "Negligent Disregard of Rules or Regulations", is when a preparer simply does not keep informed as to current changes in the law. An example of this type of negligence would be a tax preparer who prepares returns for ten years, based on a revenue ruling which the I.R.S. revoked during the fifth year. The preparer would be considered negligent, at least with regard to returns prepared in accord with the ruling for the sixth, seventh, eighth, ninth and tenth years and (depending upon the facts and circumstances) perhaps also for the fifth year.[15]

C. INTENTIONAL DISREGARD OF RULES AND REGULATIONS

More difficult to comply with are the I.R.C. §6694 provisions concerning understatement of income tax liability because of intentional disregard for rules and regulations. The "Rules and Regulations" include the provisions of the I.R.C., the Treasury Regulations and Internal Revenue Service Rulings published in the Cumulative Bulletins. The incorporation of revenue rulings within "Rules and Regulations", would seem to pose a hardship to many practitioners who are not familar with every revenue ruling currently in effect. It is also inconsistent with the following notification which is published in each Cumulative Bulletin: "Rulings and Procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations. . . ." The different weights of authority may be enough to invoke a somewhat looser standard of compliance when revenue rulings are involved.

Of major concern to practitioners are those situations where disagreements exist on the ultimate propriety of a particular ruling or regulation. Treas. Reg. §1.6694(1) (1976) provides that if a preparer in good faith and with reasonable basis takes the position that a rule or regulation does not accurately reflect the Code and does not follow it, the preparer has not negligently or intentionally disregarded the rule or regulation. This discourages deliberate and unsupported disregard of clear regulations and rulings, but does not stifle legitimate challenges brought in good faith. The regulation does not state that a conflicting court decision need actually exist in order to take the position that the rule or regulation does not agree with the Code. But the preparer bears the burden of proof on the issue

whether he has negligently or intentionally disregarded a rule or regulation.[17] It would thus appear prudent for the lawyer to document in the file the justification for a position taken on a return contrary to a ruling or regulation. Although preparation of the memo could be deferred until after the tax season, it is necessary to demonstrate that the return preparer did not meet the proscribed conduct. A memorandum written after the fact could be less persuasive than one written at the time the return was prepared.

The Regulations do not require disclosure of a contrary position in order to avoid the penalties. The lawyer should consider making full disclosure to the I.R.S. of his justifications as this arguably butresses good faith. Of course this may not be desirable if it invites examination and litigation. It has been suggested that a preparer acting in good faith should only disclose when taking a position directly contrary to the rules and regulations on all points.[18] The bottom line is that as one's position strays further from the government's, the burden of proving good faith in disputes becomes harder to justify. There certainly is the danger that to the extent preparers unquestionably acquiesce to tenuous I.R.S. determinations, taxpayers are deprived of their right to oppose the government's interpretation of the income tax laws.

D. WILLFUL UNDERSTATEMENT OF LIABILITY

Contrary to the negligence and intentional penalty, the I.R.S. has the burden of proof for proving a "Willful Understatement of Liability." A preparer is considered to have willfully attempted to understate liability if he disregards information furnished by the taxpayer or other persons in an attempt wrongfully to reduce tax liability.[19] This penalty focuses on the preparer's acceptance of facts from the taxpayer. It is clear a preparer cannot simply ignore furnished information. For example, if a taxpayer states that he has only two dependents, and the preparer reports six dependents, the preparer would be subject to the penalty.[20] But more often, the issue is to what extent should the preparer blindly accept facts without independent verification. Generally, a preparer may in good faith rely without verification upon information furnished by the taxpayer. But the preparer cannot ignore the implications of information furnished and must make reasonably inquiries if the information appears to be incorrect or incomplete.[21] This standard rests upon the personal knowledge of the preparer and suggests that a person who annually prepares the same return is held to a higher scrutiny than first time preparer.

The sanction has its biggest effect in relation to the Code sections which require the existence of specific facts and the maintenence of specific documentation before a deduction may be claimed (such as deductible travel and entertainment expenses). In these cases, Treas. Reg. §1.6694 1(b)(2)(1976) states that a preparer must make inquiry of the taxpayer as to documentation maintained and receive a reasonable response before claiming such deductions on a return.

For example, assume that a taxpayer, during the tax interview conducted by a preparer, stated that he had paid $2,500 in

> doctor bills and $4,000 in deductible travel and entertainment expenses during the tax year when in fact he had paid smaller amounts. . . . The preparer had *no reason to believe* that the medical expense and travel and entertainment expense information presented was incorrect or incomplete. The preparer did not ask for underlying documentation of the medical expenses and, upon inquiry was *resonably satisfied* by the taxpayer's representation that the taxpayer had adequate records (or other sufficient corroborative evidence) for the deduction of $4,000 for travel and entertainment expenses. The preparer is not subject to the penalty.[22] (emphasis added)

An enigma of Treas. Reg. §1.6694 1(b)(2)(1976) is Rev. Rul. 80 266, I.R.B. 1980 40, at 20, which imposes the I.R.C. §6694(a) *negligent* penalty in situations where a literal reading of the regulations indicates that the I.R.C. §6694(b) *willful* penalty applies. In situation #1, the preparer failed to inquire whether the taxpayer had records adequate to meet the specific documentation requirements of IRC §274(d). In situation #2, the preparer had reason to believe (from awareness of insufficient records in the prior year) that the taxpayer might not have adequate records for the current year, yet failed to make further inquiries. This indicates that the boundaries between I.R.C. §6694(a) and I.R.C. §6694(b) are overlapping. Indeed, the preparer may even be simultaneously liable for both sanctions (even thoughthe maximum fine cannot exceed $500).[23] A preparer who claims a personal exemption deduction for the taxpyer's mother with knowledge that the taxpayer is not entitled to the deduction will have both intentionally disregarged rules and regulations and willfully understated liability.[24] The practitioner should bear in mind that this simultaneous and overlapping liability is an additional incentive for him to establish office practice guidelines of the type mentioned in "B" above. (In the case of specific documentation requirements such as I.R.C. §274(d), tax questionaires to demonstrate inquiry as to the existence of records are adequate).[25] For a preparer may win the I.R.C. §6694(b) fight if the government cannot sustain its burden of proof, but lose the lesser I.R.C. §6694(a) battle if the preparer similarly does not sustain the burden. A final dichotomy is that the I.R.C. §6694(a) negligent/intentional penalty is subject to a 3 year statute of limitations, while there is no such statute for the I.R.C. §6694(b) penalty.

E. CONCLUSION

The above discussion illustrates the I.R.C. §6694 civil penalties to which an "Income Tax Return Preparer" finds himself or herself exposed. With the increasing number of preparers in the land, obviously the I.R.S. hopes to increase professional competency. In this respect heavy emphasis is placed on sound office procedure. "Income Tax Return Preparers" can be reasonably certain of avoiding I.R.C. §6694 penalties if income tax returns are prepared truthfully, accurately, carefully and with adequate documentation. There is clearly room for legal disputes between the preparer and the I.R.S. as to issues of law on any return, but the requirement of good faith should be remembered. Never assume that improprieties and

mistakes can be covered up, or that the preparer and taxpayer will be able to protect each other. As Professor Bittker once counselled, "in advising a client, one surely ought, as a general rule, to assume that everything will come out into the open sooner or later."[26]

NOTES

1. Santi, *Legal Liability of the Professional Tax Practitioner,* 26 Emory L. J. 403, 404 406 (1977)
2. Ibid., 421
3. Treas. Reg. §1.6694 1(a)(1976) and Teas. Reg. §1.6694 1(b)(1976)
4. Benjamin, *Definition of a preparer—who is he?,* 10 Tax Advisor 516, 526 (1979)
5. Treas. Reg. §301.7701 15(b)(1)(1976)
6. S. Rep. No. 94 938, 94th Cong., 2d Sess. 351 (1976)
7. Treas. Reg. §301.7701 15(b)(1)(1976)
8. Treas. Reg. §301.7701 15(a)(2)(1976)
9. Treas. Reg. §301.7701 15(b)(3)(1976)
10. Rev. Proc. 80 40, I.R.B. 1980 40,22
11. Id., 22
12. Id., 22
13. Id., 22
14. Pennel and Stevens, *The Professional as a Tax Return Preparer: From the Perspective of the Accountant and the Lawyer,* 56 The Tax Magazine 726, 735 (1978)
15. Tom, *Most Lawyers Will Now be "Income Tax Return Preparers,": Are You?* 63 A.B.A.J. 402, 405 (1977)
16. Treas. Reg. §1.6694 1(a)(3)(1976)
17. Treas. Reg. §1.6694 1(a)(5)(1976)
18. Kamerow, *Return preparation requirements in new law will force accountants to change procedures,* 18 Tax. for Accountants 4, 5 6 (1977)
19. Treas. Reg. §1.6694 1(b)(2)(i)(1976)
20. Id.
21. Treas. Reg. §1.6694 1(b)(2)(ii)(1976)
22. Treas. Reg. §1.6694 1(b)(2)(iii)(1976)
23. Treas. Reg. §1.6694 1(b)(4)(1976)
24. Treas. Reg. §1.6694 1(b)(2)(iv)(1976)
25. Pennel and Stevens, supra, at 737
26. Zanger, *Caveat Praeparator Let The Preparer Beware,* 64 Illinois B.J. 178, 181 (1975)

TAX CONSEQUENCES OF FAMILY PARTNERSHIPS

David Williams II

Under the pressure of high tax rates, it has become natural for taxpayers to seek legal means to reduce their tax burdens. By incorporating a business previously operated as a sole proprietorship or partnership, a taxpayer may be able to realize a savings in taxes. Also, by giving income producing property to relatives, a reduction of tax liability to an owner in the high tax brackets may result. A third possibility is to have the business owned and operated by a partnership composed of family members, hence the "family partnership".

HISTORY

Historically, the concept of the family partnership can be divided into four eras. The first, was before *Commissioner v. Tower,*[1] when the general approach of the lower courts was to apply tax principles applicable to income splitting devices in general. The very early cases dealing with partnerships were liberal in finding the existence of a partnership among family members if the arrangement constituted a partnership under local law. See, e.g., *Commissioner v. Olds, Crane v. Commissioner, Phelps v. Commissioner.*[2]

During the 1930's the situation began to change as the Supreme Court decided many landmark cases in the assignment of income area. In the landmark case of *Lucas v. Earl,*[3] the Supreme Court held that income is taxable to the person who earns it. Therefore, an assignment of income earned or to be eanred will not be recognized for income tax purposes. This concept is still applicable and is recognized in the statutory provisions dealing with taxation of income of family partnerships. In *Lucas,* a contractual agreement whereby a lawyer and his wife agreed to divide their incomes equally between them was ruled ineffective as a means of shifting the incidence of tax on earnings from the husband's law practice.

In the same year the Supreme Court, in deciding *Corliss v Bowers,*[4] sustained a provision which made income from property transferred to a revocable trust taxable to the donor on the premise that the power to enjoy the income from the fund, by revoking the trust, constituted a sufficient basis for the imposition of a tax. Going a step further, the Court in *Burnett v. Wells,*[5] sustained a provision which required that income of an irrevocable trust used to pay life insurance premiums on the donor's life should be taxed to him. Both *Corliss* and *Burnett* dealt with the issue of the transferor's retained control over the property transferred, a central concept in the area of family partnerships.

Finally, in *Blair v Commissioner,*[6] the Court ruled that a gift of income producing property transfers to the donee the liability for tax on subsequent income from the property. In *Blair,* the life beneficiary of a trust was able to shift the incidence of tax on income from the trust by irrevocably

assigning a portion of his interest for the remainder of his life. The court reasoned that the assignment conveyed the assignor's equitable interest in the property to the donee. Therefore, the transfer was effective to transfe the incidence of the tax since income from property is taxed to the owner.

This first era established three basic principles which remain important in tax law:

1. Income from personal services is taxable to the person performing the services;
2. Income from property is taxable to the owner of the property; and
3. A transfer which is valid for purposes of state property law may not be effective to transfer the incidence of tax for federal income tax purposes if the transferor retains sufficient dominion and control over the property.

All these principles are operative and relevant in the family partnership area.

The second era was controlled by *Commissioner v Tower,*[7] where the taxpayer had transferred 39% of the stock of his closely held corporation to his wife by gift. As part of a prearranged plan, the corporation was immediately liquidated. The assets were then transferred to a limited partnership, with the taxpayer and an unrelated party as general partners and the taxpayer's wife as the sole limited partner. Mrs. Tower took no active part in the business. The I.R.S. argued that no valid family partnership existed since Mrs. Tower had contributed neither services nor capital to the partnership. Mr. Tower, while admitting that Mrs. Tower contributed no services, argued that her contribution of capital made her a valid partner. The Supreme Court expressed the question as being whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits and losses or both. The Internal Revenue Service and the lower courts interpreted *Tower* as requiring the contribution of original capital or vital services. This requirement of "original capital or vital services" became a prerequisite to the recognition of a family partnership. *Akers v. Commissioner, Friedman v. Commissioner.*[8]

The third era is highlighted by the landmark case of *Commissioner v. Culbertson.*[9] Mr. Culbertson had been a partner in a cattle breeding business with one Mr. Coon. After a while, Coon was forced to retire due to poor health, but he wished to see the business continue. Having no children of his own, Coon offered to sell his interest to Culbertson at a set price on the condition that Culbertson would sell one half interest in the herd to his (Culbertson's) four sons. Agreeing, Culbertson purchased the herd from the Coon-Culbertson partnership and sold a one half interest in the herd to his four sons in return for a promissory note. The note was repaid by partnership profits and by gifts from Culbertson. The oldest son rendered services to the new partnership until he was called into the service, while the other boys, who were in school or the military service, rendered no services other than those rendered during school vacation periods.

Based on the absence of original capital or vital services, the Tax Court found no partnership for tax purposes and held for the government. Holding that the original capital and vital services factors were not prerequisites to partnership status for federal income tax purpose and stressing the lack of a tax avoidance motive in the transaction, the Court of Appeals reversed the Tax Court. Hoping to clear away some of the confusion that existed since the decision in *Tower,* the Supreme Court granted certiorari. The Court specifically disavowed any intent to make the original capital and vital services tests anything other than factors to be considered in determining if a partnership existed for income tax purposes. The Court decided that the essential consideration was whether, in light of all the facts, the parties intended to join together in good faith to conduct a business. The Court stated:

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purpose for which it is used, and any other facts throwing light on their true intent, the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[10]

Further, the Court viewed the issue as "nothing more or less than the state of mind of the parties which must be determined by objective manifestations of intent.[11]

Taking close note of the Tax Court's "original capital" test, the Supreme Court noted that it might be proper in some cases that lack original capital to tax the income from the property to the donee as the owner. However, the court cautioned that the family relationship should be a warning that things may not be what they seem.

> But more particularly, the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used. He is able, in other words, to retain "the substance of full enjoyment of all the rights which previously he had in the property.[12]

Though the Supreme Court obviously intended that the *Culbertson* opinion would clarify the tax treatment of family partnerships, there was considerable confusion among the courts which applied the *Culbertson* doctrine.

In an effort to harmonize the rules governing interests in the so called family partnerships with those generally applicable to other forms of property or business, the Revenue Act of 1951 was adopted. This began the fourth era. The Act, which adopted specific statutory tests to apply to family partnerships, was made a part of sections 191 and 3797 of the Internal

Revenue Code of 1939 and was carried over into section 704(e) of the Internal Revenue Code of 1954. Congress, feeling that an interest in a partnership should be treated like any other property incorporated sections 191 and 3797(a)(2) into the 1951 Act,[13] and thus codified the principle that income from property should be taxed to the owner of that property.[14] Section 3797(a)(2) reads in pertinent part: "a person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income producing factor, whether or not such interest was by purchase or gift from any other person." Section 191 of the 1939 Code, also added by the Revenue Act of 1951 reads:

> In the case of any partnership interst created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for service rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner and the earnings of the partnership shall not be diminished because of absence due to military service. For the purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such person.

As previously stated, section 3797(a)(2) and 191 were carried without substantial change into the 1954 Internal Revenue Code as section 704(e).

SECTION 704(e)

Section 704 of the Internal Revenue Code is entitled *Partner's Distributive Share.* Subsection (e) of section 704 is designated "family partnerships" and is the applicable statute. Subsection (e) is divided into three parts:

(1) **Recognition of interest created by purchase of Gift.**
A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income producing factor, whether or not such interest was derived by purchase or gift from any other person.

(2) **Distributive share of donee includible in Gross Income.**
In the case of any partnership created by gift the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance or reasonable compensation for services rendered to the partnership by the donor,

and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(3) **Purchase of interest by member of Family**

For purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

In attempting to understand the statute governing family partnership, a close analysis of the applicable regulation is essential.

EXAMPLE

H & W own a business (which meets the family partnership requirements) that produces an income of $120,000 per year. The business, a farm, is valued at $480,000. For the purpose of this example we assume that the value of the farm, as well as the yearly income, remains constant for the next four years. Presently, H & W, filing a joint return claiming their five children (A, B, C, D, and E), will have a tax liability of the family unit of approximately $54,328 each year. Upon the death of H & W, the entire fair market value of the business (farm) will be included in their estate and subject to federal estate tax and state inheritance tax. They will be taxed on their right to transfer the farm to their children and the children will be taxed on the right to receive the farm. By turning their business into a family partnership, H & W can accomplish two important objectives:

1. H & W can substantially reduce their family unit's income tax liability, and
2. H & W can substantially reduce their estate tax, while transferring ownership of the farm to the children.

Given the fact that the farm, which consist of 400 acres, is valued at $480,000, each acre is worth $1200. Also, all five children are minors and have no other income.

The beginning point is for H & W form a partnership and transfer (deed) the entire farm to the partnership. The division of the partnership should be as follows:

H = 1% general partnership interest
W = 1% general partnership interest
H = 49% limited partnership interest
W = 49% limited partnership interest

Under I.R.C. section 2503(b), both H & W will be allowed to give a $3,000 gift per year to each of the children, without incurring any gift tax or filing a gift tax return (I.R.C. section 6019). Also the total value of these gifts will be excluded from the donor's (H & W) estate upon the donor's death. I.R.C. section 2034 (b)(2) even keeps the value of these gifts from being drawn back into the estate if the gifts are made within three years of the doner's death.

In the first year, H will make a gift of .00625 of his limited partnership (FMV = $3,000) interest of each of the five children. W will do likewise. This will reduce both H & W's limited partnership interest to .45875, and give each child a .01250 limited partnership interest in the partnership. By giving only limited partnership interest H & W, as general partners, retain control in managing the business.

At tax time, H & W's joint return will show taxable income of $112,500 (.93750 of $120,000) instead of $120,000 with a tax liability of approximately $48, 970. Each child will have income of $1500 and have no income tax liability. The total tax liability for the family unit will be $48,970, a tax savings of $5,358. Also a total of .06250 of the partnership has passed to the children without incurring any gift tax or being subject to estate or inheritance tax.

In year two, H & W make exactly the same gifts. This will reduce both H's & W's limited partnership interest in the business to .42750, while increasing each childs' limited partnership interest to .02500. At tax time, H & W's joint return will show taxable income of $105,000 (.8750 of $120,000) a tax liability of approximately $44,948. Each child will have income of $3000 with a tax liability of approximately $98. The total tax liability to the family unit is $45,340, a tax savings of $8,988. Again .06250 of the limited partnership has passed to the children without incurring any estate, gift, or inheritance taxes.

In years three and four, the same procedure is followed, resulting in a tax liability for the family unit of $42,183 ($40,523 for H & W and $332 for each of 5 children) in year three, and a tax liability to the family unit of $39,108 ($36,098 and $602 for each of 5 children) in year four. This represents a tax saving to the family unit of $12,145 in year three and $15,220 in year four.

At the end of year four, the interest in the partnership will be as follows:

H = .01 general partnership interest
W = .01 general partnership interest
H = .365 limited partnership interest
W = .365 limited partnership interest
A = .05 limited partnership interest
B = .05 limited partnership interest
C = .05 limited partnership interest
D = .05 limited partnership interest
E = .05 limited partnership interest

H & W will have retained a large enough portion (.75), (.73 limited partnership interest and .02 general partnership interest), of the business so as to maintain their comfortable lifestyle without becoming dependent on the children. They will have passed .25 of the business to the children without incurring any gift tax or subjecting the gift to estate or inheritance tax. And finally the family unit has saved $41,711 in federal income tax over the four year period.

To illustrate the saving in estate tax, imagine if the partnership (farm) increased in value after the four year period. At the time of H & W's death (died together) the partnership (farm) was valued at $1,000,000. By this simple four year procedure, one fourth ($250,000) of the value of the partnership will escape settling in the estates of H & W. If H & W had continued this for an additional four years, one half ($500,000) of the value of the partnership would have escaped estate taxation.

The use of family partnerships can be an excellent tax and estate planning tool, one that creative tax attorneys should consider in reviewing any substantial estate.

NOTES

1. 327 U.S. 280 (1946)
2. 60 F.2d 252 (6th Cir. 1932)
   19 B.T.A. 577 (1930)
   13 B.T.A. 1248 (1926)
3. 281 U.S. 111 (1930)
4. 281 U.S. 376 (1930)
5. 289 U.S. 670 (1933)
6. 300 U.S. 5 (1937)
7. See note 1. Supra,
8. 6 T.C. 693 (1946)
   10 T.C. 1145 (1948)
9. 337 U.S. 733 (1949)
10. 337 U.S. 733, 742 (1949)
11. Id. at 743
12. Id. at 746, citing *Helvering v. Clifford* 309 U.S. 331 (1940)
13. H.R. Rep. No. 586, 82nd Cong., 1st Sess. 32 (1951) S. Rep. No. 781, 82nd Cong., 1st Sess. 485 (1951)
14. S. Rep. No. 781, 82nd Cong., 1st Sess. 32, 33 (1951)
15. Treas. Reg. §1.704 1(e)(1976)

CITY INCOME TAX ON NONRESIDENTS: AN ENDANGERED SPECIES?

Diane L. Otto

A recent decision by the Washington, D.C., Court of Appeals repealing a commuter tax levied upon nonresidents who work within the District of Columbia may foreshadow the demise of city income taxes on nonresidents. In *Bishop* v *District of Columbia*[1], the District was ordered to refund over forty million dollars in "franchise taxes" collected from nonresidents on personal service income and unincorporated professional businesses. The enabling statute was enacted in 1975 and labelled as a franchise tax levied for the privilege of doing business within the District.[2] Richard A. Bishop, the plaintiff, was a Virginia resident practicing law in the District. A second plaintiff also challenged the tax in a class action on behalf of all nonresident professionals similarly situated. After pursuing their administrative remedies, both filed petitions for refunds with the Tax Division of the Superior Court, where the claims were consolidated to facilitate litigation. The trial court dismissed the petitions.

Plaintiffs appealed on three grounds: first, that the professional tax is an unauthorized exercise of the legislative powers of the District of Columbia Council (hereinafter, the Council) under the Home Rule Act;[3] second, that the tax violates the United States Constitution; and third, that it does not comply with statutory notice requirements. Appellants' challenge, and the Appeals Court opinion, centered on the *ultra vires* nature of the Council's activities in enacting the law. The Home Rule Act provides that the "Council shall have no authority to . . . impose any tax on the whole or any portion of the personal income, with directly or at the source thereof, of any individual not a resident of the District."[4] The conflict arose as to whether the tax imposed by the Council was a tax levied on nonresident personal income, in which case it must be declared invalid, or a tax levied on another permissible area, such as the privilege of doing business in the District. At trial, the D.C. Superior Court held the tax was invalid as a "commuter tax", a tax on the personal income of nonresidents.

The appellate court reviewed the legislative intent in originally exempting the unincorporated business and personal service income, defined as any "trade or business in which more than 80% of the gross income is derived from the personal services actually rendered by the individual or members of the partnership or other entity in the conducting or carrying on of any trade or business and in which capital is not a material income producing factor."[5] That exemption was maintained when the Professional Corporation Act was enacted.[6] The legislative history of the Corporation Act included evidence of objections from various ends of the business spectrum as to the repeal of this exemption. The American Bar Association opposed previous attempts to repeal this exemption on the following grounds:

> Both the states of Maryland and Virginia grant a credit to their residents for income taxes paid to another jurisdiction on income generated in that jurisdiction. The District unincorporated business tax does not qualify for this credit since it is a franchise tax rather than an income tax. Accordingly, the professional who resides in Maryland or Virginia and conducts his practice in the District would, if his present tax exemption were removed, be subject to double tax on the net income for his practice.[7]

Although the legislative history of section 602(a)(5) of the Home Rule Act[8] is slight, it seems clear that by adopting the provision Congress intended to prevent the District from enacting a commuter tax.

The Court of Appeals then proceeded to interpret the wording used in the congressional prohibitory statute and in the enactment by the Council. It reiterated that a determination of the status of a tax will rest with the characterization of its nature and effect, not its label. But, as the court further pointed out, the designation given the tax by the legislature is heavily weighted. The D.C. legislature had designated this tax on unincorporated businesses and personal service income as a "franchise" tax. But the incidents of taxation may cause the court to reclassify a franchise tax as a property tax, an excise tax, or an income tax. The impact of this judicial reclassification turns up in a gross receipts/net income distinction. A gross receipts tax imposes an annual levy on the taxpayer's total receipts, regardless of the cost of attaining those receipts. A net income tax is derived from the assessment of taxes after certain deductions. In effect, a net income tax is imposed by the jurisdiction to raise revenue by taxing the consumable wealth of its taxpayers. Taxes imposed on gross receipts are collected regardless of one's ability to pay without consideration of legitimate business expenses. Therefore, it is usually levied not on personal wealth but simply for raising revenue, as in a sales tax, for example.

The court then followed the lead of the Virginia court in *Groom v. Forst* holding that the District of Columbia Unincorporated Business Tax is in fact an income tax.[9] Further, since the tax by its very terms is one upon net income and since it falls therefore solely on the right to earn income within the District regardless of the extent of one's business expenses, it must be repealed. The court did limit its decision somewhat by stating that the District could impose a tax on nonresident professionals, but reiterated that it cannot tax the net personal income of nonresidents.[10]

In view of the Michigan Home Rule Act,[11] the City of Detroit Income Tax Ordinance[12] and the decision in *Dooley* v *City of Detroit,*[13] our courts may be in conflict with this decision. On the other hand, the language utilized therein may avoid the confrontation which the District of Columbia tax lost.

Under the Michigan Home Rule Act, each city may in its charter provide: 1) for the laying and collecting of rents, tolls and excises . . . .[14] And the City of Detroit Tax Act requires that the city adopt the Uniform City Income Tax Ordinance before it may impose an excise tax. The City Income Tax Ordinance,[15] enacted in April, 1962, requires every employer

to withhold taxes of all employees whose predominant place of employment is within the city limits. Further, the tax applies to both nonresidents' income or compensation and to a distributive share of the net profits of a nonresident owner of an unincorporated business derived as a result of business activities conducted in the city.

This tax upon nonresidents working within the city limits was challenged on three grounds by nineteen nonresident taxpayers in *Dooley* v. *City of Detroit.*[16] first, the city lacked authority to impose such an income tax; second, assuming that it did have the authority to act, this tax violated statutory rate limits; and finally, plaintiffs were denied due process under both the state and federal Constitutions.

The main focus of the Michigan Supreme Court's opinion centered on the Plaintiffs' *ultra vires* claim. Finding that the state constitution did not specifically authorize cities to impose income taxes, the Court held that under the Home Rule Act, cities may provide in their charter for laying and collecting rents, tolls and excises. The issue then turned on whether the tax in question qualified as an excise tax. The Court gave various definitions of excises, one of which, for example, defined an excise tax as any "tax which does not fall within the classification of a poll tax or a property tax, and embraces every form of burden not laid directly upon persons or property."[17] The Court also relied on *Young* v. *Illinois Athletic Club*[18] to support its holding that "an income tax is not similar to other forms of taxation, since it is not imposed upon property or business . . . An income tax is an assessment upon the income of a person, not upon any particular property from which that income is derived."[19]

The Court then stated that its "decision today that not only are such taxes on income not taxes on property, but that they are excises, is based not alone upon the impressive weight of authority from other jurisdictions, but also upon the persuasive reasoning of the courts which have preceded us . . . ."[20] In categorizing the city income tax as an excise tax, the Michigan Supreme Court utilized a process of elimination to deduce that because this was neither a property tax nor a poll tax, it must be an excise tax. In so doing, it casually discarged arguments that income taxes are, in effect, property taxes imposed on one's personal property interest in compensation for services rendered by the governmental authority.

As to the plaintiffs' claim that imposition of such a tax exceeds the city's authority, the Court held that the Michigan Constitution, as amended in 1908, was intended to give cities and municipalities very broad general powers as those entitities of government would best be able to comprehend and fulfill local needs. This greater degree of home rule was found to be implicit in the general policy underlying the present home rule provisions of the state constitution. The court further stated:

> (E)very power exercised by a city, such as the imposition of a new tax, (need not) be specifically delegated by legislative grant where there is delegated the power to impose taxes of a designated generic kind . . . the legislative choice of such a generic term seems intended to grant cities full authority to seek municipal revenues by whatever excises the fertile minds of municipal officers fairly could devise. . .[21]

Detroit's income tax on nonresidents qualified as an excise tax and, therefore, was within the city's power to levy since the legislature has authorized, through home rule legislation, cities' power to lay and collect excises.

As to plaintiffs' claim under the U.S. Constitution, the Court felt that since ". . . Detroit imposes its excise upon residents and others who earn or receive income in Detroit . . . for the privilege of enjoying the municipal services the city performs for them and the protection it provides to them and their property",[22] and this tax validly reflects the extent to which such individuals benefit from the municipal services, the due process claim was unfounded.[23] It upheld the Detroit income tax applied to nonresidents who work within city limits as a valid exercise of the city's right to lay and collect excises under the Home Rule Act.

Does *Bishop* signify a change in the standards for reviewing the validity of "commuter taxes"? Could the *Bishop* court find sufficient grounds in *Dooley* to repeal the Detroit tax? Does *Bishop* threaten the existence of commuter tax legislation?

Distinguishing issues obviously appear between these two cases. The D.C. Home Rule Act specifically forbids the District from imposing income taxes on nonresidents whereas the Michigan Home Rule Act allowed the cities to lay and collect excises. If one can fit the Michigan tax into the excise category, one may argue authority arising from the Home Rule Act, at least by implication. As to legislative intent, the D.C. legislature clearly prohibited the imposition of commuter taxes. On the other hand, the Michigan legislature was desirous of granting cities a broad spectrum of powers. Further, the D.C. court reviewed the nature and effect of the tax to determine its overall character and the Michigan court preferred to give broad discretion to the city's governmental decisions.

It appears from a review of the foregoing decisions that commuter taxes will undergo stricter scrutiny about the origins of their enacting authority, as well as the nature and effect of the tax and the proper classification therefore. The U.S. Supreme Court's denial of certiorari in the *Bishop* case cannot be interpreted as an affirmance of the reasoning and holding of the D.C. court's decision, but Supreme Court review of commuter taxes can be expected in the future on the grounds suggested in *Bishop*. State courts will look to the origins of the legislative authority to enact the taxing ordinance, the legislative intent behind the enabling statute and the true nature and effect of the tax. Apparently only upon a finding of validity under each of the standards examined above will the decision result in an upholding of the tax.

NOTES

1. *Bishop* v. *District of Columbia,* 411 A2d 997 (1980), cert. denied, ____ US ____ (1981).
2. §47 – 1574, D.C. Code 1978 Supp.
3. §1 – 147(a)(5), D.C. Code 1978 Supp.
4. Id.
5. 411 A2d 997, 998.
6. P.L.No. 92 180, 85 Stat. 576 (1971).
7. H.R.Rep. No. 92 508, 92d Cong., 1st Sess. (1971) at 4.
8. Staff of the Senate Comm. on the District of Columbia, 93rd Cong., 1st Sess. Legislative History of the District of Columbia Self Government and Governmental Reorganization Act. 1469 70 (Comm. Print 1974).
9. *Groom* v. *Forst,* At Law No. 18809 (filed 3 30 78).
10. 411 A2d 997, 999.
11. M.C.L. 117.4
12. M.C.L. 141.50
13. *Dooley* v. *City of Detroit,* 370 Mich 194 (1963).
14. M.C.L. 117.4
15. M.C.L. 141.50
16. 370 Mich 194, 200.
17. Supra, 205.
18. *Young* v. *Illinois Athletic Club,* 310 Ill. 75, 82; 141 NE 369; 30 ALR 985 (1923).
19. 370 Mich 194, 204.
20. Supra, 204 205.
21. Supra, 211.
22. Supra, 218.
23. Supra, 219.

MICHIGAN INCOME TAX AND THE FIFTH AMENDMENT PRIVILEGE

Sydney Rooks Isaacs

The structure created by the Internal Revenue Code for the taxation of individual incomes, and upon which the Michigan system of income tax collection is modeled, is based upon a system of compulsory self reporting. Although legal compulsion is an integral part of both the federal and state schemes, the government essentially depends upon the taxpayer's good faith disclosure of all necessary information. With minor exceptions, this system requires the filing of a return by every individual having a gross income of $750 or more during the taxable year. Section 6011 of the Internal Revenue Code[1] states that "every person required to make a return or statement shall include therein the information required by such forms or regulations."

The federal requirement closely parallels MCLA §206.311(1): "The taxpayer on or before the due date set for the filing of a return or the payment of the tax, except as otherwise provided herein, shall make out a return in the form and content as prescribed by the Department of Treasury, verify the same, and transmit it to the Department with his remittance in the amount of the tax." In addition to specifics regarding federal adjusted gross income and dependency and personal exemptions, MCLA §206.315(d) requires the taxpayer to provide "other information for the purposes of carrying out this act as may be prescribed by the Commissioner of Revenue." Therefore, it is not enough to file a blank return. This broad language could require the taxpayer to answer every question posed on the return regardless of its relevance or impact. In addition, criminal sanctions are provided at both the federal and state levels for those who fail to comply with these requirements.[2]

The taxpayer has little choice when preparing for the annual showdown on April 15. Being subject to criminal liability for attempting to evade the tax, refusing to file a return or willfully answering incorrectly, the taxpayer is compelled to respond fully and truthfully to all questions asked. So a taxpayer filing a truthful return citing an illegal source of income confesses to a crime. Conversely, filing an untruthful return in an attempt to hide such an illicit gain triggers subjection to a perjury charge and penalties for income tax evasion.[3] Although the Supreme Court has not questioned the federal government's power to tax unlawful activity,[4] such power is in direct conflict with the taxpayer's fifth amendment right against self incrimination: "No person . . . shall be compelled in any criminal case to be a witness against himself."[5] A balance must therefore be struck between the individual's right to be free from compulsory self incrimination, the government's interest in the operation of an equitable and efficient revenue system and its interest in the enforcement of criminal laws and public policy.

One's Fifth Amendment privilege is more than a procedural rule: It is a fundamental right applicable to the states by the operation of the Fourteenth Amendment.[6] It is not, however, an absolute warrant to refuse to give any testimony at all, but rather is limited to testimony which might lend to incriminate the witness.[7] Because the fifth amendment right may be lost if not timely asserted, any information given freely and voluntarily has not been compelled and falls outside the scope of the privilege. Varying standards have been used by the courts to determine when an assertion of the privilege is valid. These have ranged from a "tendency to incriminate"[8] to "a reasonable cause to apprehend danger" of incrimination.[9] But the Supreme Court has consistently applied a "real and substantial hazard of self incrimination" test in cases involving regulatory statutes requiring registration and reporting.[10] If this standard is met, the privilege has been asserted validly. If not, the answer requested may be compelled by the court through its contempt power.[11]

The leading Supreme Court decision addressing the issue of incriminating answers is *United States* v *Sullivan,*[12] decided in 1927. Writing for the majority, Mr. Justice Holmes found that the taxpayer must answer relevant questions regarding every source of income, legitimate or not. The Fifth Amendment did not entitle one to refuse to answer the questions on a return:

> It would be an extreme if not an extravagant application of the Fifth Amendment to say that it authorized a man to refuse to state the amount of his income because it had been made in a crime.[13]

The Court noted that the defendant could have filed an incomplete return and then raised the privilege: "If the form of return provided called for answers that the defendant was privileged from making he could have raised the objection in the return, but could not on that account refuse to make any return at all."[14] Specifically reserved was the question of "what, if anything, the defendant might have withheld."[15]

In *Garner* v *United States,*[16] the U.S. Supreme Court addressed the issue of the government's use of answers given in a federal tax return as evidence in a nontax conviction. There the defendant challenged the government's action on three grounds: the information contained in his tax returns were essentially coerced confessions made without an intelligent waiver as required by *Miranda* v *Arizona;*[17] a mere assertion of the privilege would have been incriminating following the Court's decisions in *Marchetti* v *United States*[18] and *Grosso* v *United States;*[19] and finally, the possibility of prosecution under Section 7203 of the Internal Revenue Code[20] upon claiming the privilege compels disclosure.

The Court dispensed with the *Miranda* argument by finding that a taxpayer could complete the return free from the pressures of custodial interrogation and with the aid of counsel if desired; a far cry from the compelling psychological pressures and physical restraint central to *Miranda* and its progeny.[21] The *Marchetti* and *Grasso* cases involved statutes imposing occupational and excise taxes along with special registration and reporting provisions on wagering. The *Garner* majority emphasized that it was the singling out of "a highly selective group inherently suspect of criminal

activities" in combination with the fact that these returns could be used in prosecutions at the state and federal levels, which were the determinative factors there and not applicable to Garner's fifth amendment claim.[22] Garner's third argument, that the threat of prosecution under I.R.C. §7203 compelled him to make incriminating statements rather than claim the privilege, was found invalid by the Court's reliance on *United States* v *Murdock.*[23] Under the rule of that case, the "willfulness" requirement of revenue statutes similar to I.R.C. §7203 precluded a conviction for failure to file a complete return where that failure was predicated upon a good faith claim of privilege, rather than the actual validity of the claim. Thereby the Court removed from consideration the specific intent required by the statute.[24] Under *Garner*, coercion compulsion and threat of prosecution for failure to answer as evasion, on the one hand, and for perjury or other criminal liability on the other, are not available as defenses for the hapless taxpayer relying on fifth amendment privilege.

Statutory grants of immunity from criminal prosecutions arising from statements made by a witness may be used to compel otherwise privileged testimony if that grant is fully coextensive with the privilege supplanted.[25] Two distinct types of immunity are available to the legislatures in two contexts: immunity from prosecution (transactional immunity) and use immunity. Immunity from prosecution grants complete exemption from prosecution for any offense related to the compelled disclosure.[26] Use immunity, proffered in the *Garner* decision, prohibits the use in subsequent prosecutions of the information elicited *unless* the government can prove that its evidence is not tainted by or traceable to the incriminatory nature of the information so compelled.[27] Neither type of immunity is favored at the federal level by congressional enactment.

Such is not the case in Michigan. Under MCLA §205.3, it is clear that immunity from prosecution is granted before one's Fifth Amendment privilege can be invoked in the tax arena:

> No person shall be excused from testifying or from producing any books, papers, records or memoranda in any investigation, or upon any hearing when ordered to do so by the commissioner, upon the ground that the testimony or evidence, documentary or otherwise, may tend to incriminate or subject him to any criminal penalty for or on account of any transaction made or thing concerning which he may testify or produce evidence, documentary or otherwise, before the board or its agent. No person so testifying shall be exempt from prosecution and punishment for perjury committed in so testifying . . . .

In addition to being freed from the hazards usually incumbent in a tax investigation, the Michigan taxpayer finds his or her cooperation is compelled by a parallel exposure to criminal sanctions for perjury should that testimony be less than candid and for contempt should the taxpayer balk when ordered to testify or produce documentation.

This statute, originally enacted in 1941, apparently went unchallenged by Michigan taxpayers until the recent Court of Claims decision in *Walter Gene Schroeder, M.D.* v *Department of Treasury.*[28] Squarely addressing the

issue of the assertion of Fifth Amendment privilege in relation to compulsory self reporting in state income tax returns, the Court of Claims held that "a taxpayer answering questions on the Michigan income tax return with the words '5th Amendment' has not provided the information requested and has failed to comply with the taxpayer's statutory duty under Michigan income tax law of filing a proper return."[29] The Revenue Department's assessment of an income tax, plus penalty and interest, against the taxpayer as authorized by MCLA §205.21 "is presumed *prima facie* correct, and the taxpayer has the burden of refuting the assessment."[30] A taxpayer failing to file an income tax return, according to the *Schroeder* court, is in default and has not refuted the tax assessment.[31] So in that case, the assessment was held to be neither arbitrary nor capricious, conforming with the statutory scheme.[32]

Case law conditions a taxpayer's privilege to raise a Fifth Amendment claim against compelled testimony regarding information requested in a federal tax return upon finely drawn distinctions such as the degree of "willfullness" of abuse of privilege required by a particular statute or the application of a special level of scrutiny to a distinct group of taxpayers. Often bereft of the cloak of fifth amendment privilege, the federal taxpayer remains exposed to criminal sanctions triggered by the Internal Revenue Code's system of self reporting. But Michigan's statutory grant of immunity from prosecution, while arguably denying one's right to exercise a fundamental constitutional warrant, serves to clarify the rules of the game to which every taxpayer in this state is subject. In this area, Michigan law is clear.

NOTES

1. 26 U.S.C. §6011.
2. *See* I.R.C. §§6065, 6676(a), 6687(a), 7201, 7203 and 7207; and MCLA §§205.3a, 206.455 and 206.461.
3. I.R.C. §7206(1); 26 U.S.C. §7206.
4. *See, e.g., Marchetti* v *United States,* 390 US 39 (1968).
5. US Const, Am V.
6. *Malloy* v *Hogan,* 378 US 1 (1964)
7. *United States* v *Malnik,* 489 F2d 682 (5th Cir 1974), *cert. denied,* 419 US 826 (1974).
8. *Emspak* v *United States,* 341 US 190, 201 (1955).
9. *Hoffman* v *United States,* 341 US 479, 486 (1951).
10. *California* v *Byers,* 402 US 424, 429 (1971).
11. *Lefkowitz* v *Turley,* 414 US 70, 78 (1973).
12. *United States* v *Sullivan,* 274 US 259 (1927).
13. Id., at 263 264.
14. Id., at 264.
15. Id., at 264.
16. *Garner* v *United States,* 424 US 648, 662 (1976).
17. *Miranda* v *Arizona,* 384 US 436 (1966).
18. *Marchetti* v *United States,* 390 US 39 (1968).
19. *Grosso* v *United States,* 390 US 62 (1968).
20. 26 U.S.C. §7203.
21. 424 US 657 658.
22. Id., at 660.
23. *United States* v *Murdock,* 290 US 389 (1933).
24. Id., at 396.
25. *Counselman* v *Hitchcock,* 142 US 547 (1892).
26. Id., at 586.
27. 424 US 648, 661 665.
28. *Walter Gene Schroeder, M.D.* v *Department of Treasury,* 1980 Mich. Tax Cas. Rep. (CCH) ¶200 845 (Ct. Cl./May 12, 1980).
29. Id.
30. Id.
31. Id.
32. MCLA §205.21.

INDEXING THE TAX LAWS FOR INFLATION

Patrick Michael Higdon

In recent years there has been a growing concern with the effect of inflation on individual income taxation. As both our federal and state income tax laws were designed in periods of low inflation, the mechanics of these laws simply fail to address the problem of inflation in a progressive system. Inherent in these systems are the notions of maintaining tax equity through the use of the fixed dollar provisons of the codes such as the standard deduction (or zero bracket amount), personal exemptions, and income brackets. However, these fixed dollar provisions have been severely affected by rising and continuous inflation in such a way as to water down their positive value to the taxpayer. The net effect of such occurrance is the raising of the tax burden disproportionate to inflation. This increased tax burden has been labeled "inflation tax:"

> To understand the problem more clearly, consider a family of four whose money income increases from $15,000 to $16,500 to keep pace with one year of 10% inflation. Although its purchasing power (its "real income," in economists terms) is the same, the family has jumped from the 18% tax bracket to the 21% bracket, the value of its $4,000 in personal exemptions has diminished by 10%, and its federal income tax bill has increased more than 23% while its money income has grown only 10% and its real income has not changed. While 8.3% of family income was paid in taxes before the increase in money income, afterward the effective tax rate stood at 9.3% simply because of the natural infraction of inflation with the tax structure.
>
> If the family's tax bill had increased only by the rate of inflation (i.e., remained constant in real terms), its liability would have been $1,366, meaning that an extra "inflation tax" of $164 ($1,530 minus $1,366) has been imposed without legislative enactment of a tax increase. In economists language, the family has suffered a real tax increase even though its real income remained constant.[2]
>
> As reported by the Tax Foundation, recent estimates by the Joint Committee on Taxation demonstrate the magnitude of the problem. Based on inflation rates assumed in the First Concurrant Budget Resolution for fiscal 1981 (13.3%), and extending to 1985 (8.3%), an individual tax windfall to the U.S. Treasury of over $20 billion is projected for 1981. Assuming no changes in present tax brackets, exemption levels and the like, by 1985, the inflation windfall will approximate $140 billion for that year alone. For the five year period from 1981 through 1985, the total inflation windfall could exceed $380 billion.[3]

THE IDEA BEHIND INDEXATION

One proposal to remedy the inflation tax problem has been to index the tax system for inflation by raising the fixed dollar provisions of the code in relation to the rate of inflation as measured by indices such as the U.S. Consumer Price Index (C.P.I.). By adjusting the fixed dollar provisions of the code to an accurate inflation index, the "real value of the exemptions and deductions is preserved" and incomes which increase with inflation are no longer automatically subject to higher tax rates.[4] At the same time, the government does not automatically receive the inflation tax windfall. Ideally, this should mandate greater political accountability and budgeting in that any rise in taxes would have to occur through public legislation, thus leaving elected officials open to greater public scrutiny. "Conversely, tax cuts under an indexed system can be clearly identified as such because they must cause a real reduction in tax burdens. In short, indexation allows the electorate clearly to fix responsibility for their tax bills and to hold elected officials accountable."[5]

> Using the earlier example, indexing the tax code for 10% inflation would keep the family's $16,500 income in the 18% bracket and increase personal exemptions to $4,400. Tax liability would increase by only 10% to $1,366 rather than to $1,530, and the effective tax rate would remain at 8.3%. Indexing would in effect reduce the family's tax burden by 10.7% compared to the liability without indexation. Federal revenues, in this instance, would also be limited to a 10% increase rather than the 23% jump that occurred without indexation.[6]

Indexation would be of particular benefit to lower income families who seem to be the hardest hit by inflation's effect on the progressive tax system.[7] As the personal exemption is weighted much more heavily in the outcome of low income tax liability, any watering down of its effect proves to be devastating to this income group which tends not to make use of the itemized deduction (which by its nature is self-indexing).

Although both state and federal governments have attempted to mitigate the effect of inflation through discretionary adjustments to the tax system in the form of ad hoc tax cuts and changes in the fixed dollar provisions of the code, the actual effect of inflation has been to substantially shift upward the federal income tax rate structure since the 1960's.[8] In fact, many of the tax cuts in effect do not reduce taxes at all:

> They often accomplish little more than undoing one or two years of inflation and leave taxpayers in roughly the same position they would have been had the tax code been indexed for inflation only a year or two later. These actions do however, allow elected officials to campaign on a record of "cutting taxes," often without acknowledging that they are only compensating for the inflation tax, or that inflation is likely to diminish any actual tax reduction in the near future.[9]

Although these periodic reductions are politically popular, they are quite misleading and act only to placate the electorate while failing to address the problem at hand: continuing and unchecked inflation.

INDEXATION PRACTICALLY APPLIED

Due to their extremely high rates of inflation, indexation has been applied in varying degrees in several European nations. But indexation is a relatively new experience to the United States. Since 1978, nine[10] states have enacted some sort of inflation indexing. In a report entitled "State Experimentation with Indexed Income Taxes: Early Results" presented to the National Tax Association and Tax Institute of America, on November 28, 1980, John Shannon and Robert Lucke of the U.S. Advisory Commission on Intergovernmental Relations, Taxation and Finance Section, have presented an excellent analysis of indexing for inflation on those states which have so legislated. Shannon and Lucke conclude that "the initial results indicate that the various state indexation plans performed as expected — income tax receipts did not rise as fast as would have been the case under a non indexed arrangement.[11] Also that "indexation does not prevent state income tax growth — but it does prevent the reaping of a revenue windfall due to inflation."[12]

The authors further conclude that:

> The impact of the indexation laws in each of the states has been to improve the correspondence between tax receipts and personal income. In all cases the percentage change in tax receipts after indexation has exceeded the increase in personal income, but it was much smaller than if the tax laws had remained unchanged. The initial results suggest that although indexation moderates the rate of growth in income tax collections, it still allows collections to rise at least as fast as the increase in resident income.[13]

Indexation has also improved the maintenance of tax equity in a progressive system in that with indexation there is a preservation in value, especially to low income groups, of personal exemptions and standard deductions ("the shields for protecting subsistence income from the income tax collectors reach").[14]1

The major prohibition upon either state or federal use of indexation is loss of revenue in states such as those in the Midwest, which are hard hit by the current recession. There, losses of large sums of revenue coupled with existing budgetary deficits could be disastrous. Ideally, any loss in revenue would force legislators to first tighten the fiscal belt and then obtain additional necessary revenue by regulating tax increases under the auspices of their constituency. Practically, however, this is not an attractive scenario for the elected official.

CONCLUSION

Clearly, inflation's impact on the tax structure of both state and federal government is a major policy issue that must be reckoned with. Obviously, periods of low inflation can be adequately counteracted by ad hoc tax cuts and adjustments. But with the prospect of double digit inflation continuing well into the eighties, we must question the validity of the ad hoc tax cut system of dealing with inflation.

Indexation looks at first blush to be a viable remedy to the harsh effects of inflation on a progressive tax system. In recessionary periods politicians seem unlikely to cut revenues generated by inflation tax if the only substitute for these lost revenues must come through openly legislated tax increases.

Perhaps Scott R. Schmedel, Tax Editor for the Wall Street Journal, summed it up best in saying "Tax Indexing works, but politics may slow its spread."[15]

NOTES

1. Advisory Commission for Intergovernmental Relations, "The Inflation Tax: The Case For Indexing Federal And State Income Taxes," M 117, Washington, D.C., GPO, (January 1980), p. 1.
2. Id.
3. Arthur Anderson and Company, "Impact Of Inflation On Taxes And Capital Formation," A statement before the Commission on Finance of the United States Senate, (submitted July 31, 1980), p. 14.
4. Id. ACIR, "The Inflation Tax: The Case For Indexing Federal And State Income Taxes," at 2.
5. Id., at 18.
6. Id., at 2.
7. George M. Von Furstenberg, "Individual Income Taxation and Inflation," National Tax Journal, Vol. 28, (1975), p. 122.
8. Charles J. Goetz and Warren E. Webber, "Intertemporal Changes In Real Federal Income Tax Rates," National Tax Journal, Vol. 24, (1971), p. 52.
9. Id. ACIR, "The Inflation Tax: The Case For Indexing Federal And State Income Taxes," at 7.
10. 1978 Arizona, California and Colorado; 1979 Iowa, Minnesota, Oregon and Wisconsin; 1980 Montana and South Carolina.
11. John Shannon and Robert Lucke, "State Experimentation With Indexed Income Taxes Early Results," Presented to the National Tax Association Tax Institute of America, New Orleans, Louisiana, (November 17, 1980), p. 10.
12. Id.
13. Id., at 11.
14. Id., at 12.
15. Scott Schmedal, Tax Report, Wall St. J., January 14, 1981, §1 at 1.

RECENT DEVELOPMENTS IN MICHIGAN TAX LAW

By Scott R. Torpey

In 1980, the Michigan Legislature enacted thirty-nine new tax laws. Some tax reform proposals, such as The Tisch Amendment, (proposal D) and The Smith-Bullard Proposal, (proposal A), were made subject to approval by voters in the November 1980 elections. Consequently, these acts received a great deal of media attention and became widely known. Other important proposals were not subject to voter approval and passed into law with very little or no notoriety. But lack of notoriety should not be mistaken for unimportance. This article will briefly highlight, by subject matter, the most important of these little publicized yet important new Michigan tax laws.

ADMINISTRATION

Perhaps the single most important new legislation passed in 1980 is HB 4718 et. seq., 1980 P.A. 162 et. seq. This act established a uniform series of procedures under which the Revenue Division of the Treasury Department will collect money, provided for appeals, and set up a schedule of penalties for failure to pay taxes. Also, as of Sept. 19, 1980, all new appeals must thereafter be brought before the Tax Tribunal. Finally, the statute of limitations for all taxes is now set at four years. As an extensive analysis of 1980 P.A. 162 et. seq. is contained in the preceding issue of the *Tax Journal,*[1] an analysis herein is omitted.

INCOME TAX

The Farmland and Open Spaces Preservation Act,[2] allows farmers who sign agreements with the state preserving their land from development to claim credits for the amount by which property taxes exceed seven percent of income. Owners of family farms claim the credits through the income tax; corporate farmers claim the credits through the single business tax. Credits not used to offset income tax or single business tax liability are returned to the farmers. According to the Department of Natural Resources, some farmers have complained that they have not received these payments within the normal 45 days after submitting their returns, and have had to borrow money to make up for the delayed cash. They say that since the state requires taxpayers to pay interest on late returns, the Treasury Department should pay farmers interest on delayed tax credits. However, the Open Space Preservation Act says that credits shall be paid without interest.[3] Newly enacted SB 376, 1980 P.A. 133 now makes credit payments under the Farmlands and Open Spaces Preservation Act conform to the provisions of the Income Tax Act, which requires the state to pay annual interest of nine percent on credits delayed past 45 days.

PROPERTY TAX

In order to foster growth in downtown Detroit's economic development district, the Legislature in 1976 enacted a law permitting the city to exempt new rental housing in the district from property tax for a period of twelve years, by issuing commercial housing certificates. In the belief that other municipalities would benefit from the program, some supporters urge that the population limitation specified by the act (one million or more) be removed so that any city, village or township that establishes a downtown development district under 1975 P.A. 197 and levies an income tax could grant property tax relief to commercial housing. Others argue that the program could be made even more attractive if an eligible local government had the choice of either forgiving half the property taxes or granting an exemption, and could issue certificates for various periods not to exceed twelve years.[4] ¶SB 209, 1980 P.A. 42, removes the requirement that a local unit have at least a million people before commercial housing certificates may be issued forgiving partial tax or exempting all new rental units from the property tax. The statute removes the requirement that a local unit levy at least thirty mills in order to qualify to issue certificates. It institutes a program under which a local government levying an income tax could require the owner of a new rental housing development to pay, instead of property taxes, a "commercial housing facilities tax" to be figured at fifty percent of the property taxes levied by all jurisdictions in the district. The local unit could also waive the entire housing facilities tax, in effect granting an exemption from all property taxes. Proceeds from the housing facilities tax would be distributed to local taxing units (schools, the county, etc.) in the same manner that revenue from the commercial facilities tax is paid out, i.e., in proportion to their authorized mills.

The statute also permits a local government to issue certificates of varying duration but for no more than twelve years. Finally, the life of the program is limited by the requirement that eligible housing must be under construction no later than January 1, 1987. Proponents contend the act will encourage downtown revitalization in the following Michigan cities: Albion, Battle Creek, Big Rapids, Flint, Grand Rapids, Grayling, Hamtramck, Highland Park, Hudson, Lansing, Lapeer, Pontiac, Port Huron, Portland, Jackson, and Saginaw. By offering property tax breaks, these cities feel they, like Detroit, will inspire the building of new shopping and entertainment facilities, thereby providing new jobs and increased municipal income tax revenues. Proponents contend that this increased income tax revenue will more than offset losses from abated property taxes.

Opponents contend that SB 376, 1980 P.A. 133 will place a heavy burden on the state's school budget. Because Michigan schools are supported by property taxes and not the income tax, the Treasury Department and the Department of Management and Budget believe that municipal schools will lose approximately $2,000,000 dollars yearly.[5] This will necessitate increased support from the state school aid fund to compensate for lost municipal property taxes. Consequently, as state funds are used to support local schools, the residents of the entire state must absorb the cost of revitalization of these seventeen cities through higher state taxes.

Another new property tax act is 1980 P.A. 180. Approximately two years ago the Legislative Service Bureau requested nineteen state departments to review forty eight laws which it felt had become obsolete or were superseded. Responding to the conclusions reached by those departments S.B. 978, 1980 P.A. 180 was passed into law. The act repealed all but one of the statutes examined, involving several areas of Michigan law. Of those, two dealt with the state's tax laws.

1848 P.A. 64 provides that the state shall have a lien on the property of corporations for the purpose of collecting state taxes. The act is obsolete as most of the tax laws administered by the Revenue Division contain individual tax lien provisions.

1913 P.A. 208 provides a five year tax exemption on all cut over or wild (swamp) lands purchased by an individual for the purpose of making a home. Although no specific explanation is given, the Michigan Department of Natural Resources believes the act to be obsolete. Apparently, in this day of urban prefabricated housing, such a pioneering incentive has outlived its purpose.

These are but a few of the thirty nine new tax laws passed by the Michigan Legislature during the 1980 session. Most of them have received little or no attention until now. In response, this article and similar future articles will strive to keep Section members informed of important new Michigan tax legislation.

NOTES

1. Vol. 6 *MI TAX L. J.*, No. 4 at 15 (1980).
2. 1974 P.A. 116; MCLA 554.701 et. seq.
3. Id.
4. Analysis of Senate Bill 209, Senate Legislative Service.
5. Id.

CASE DIGESTS

CRIMINAL PROCEDURE – GUILTY PLEAS – INCOME TAX

When substantial, serious occurrences alter the nature of a plea agreement, Defendant must be allowed to withdraw his guilty plea and respond to these new occurrences. *United States* v *Coure,* 632 F.2d 665; Docket No. 80 5078. (6th Cir., Oct. 10, 1980).

FACTS:

Defendant was indicted on two charges of willful failure to pay income taxes. The first charge was failure to pay taxes withheld from an employee's wages; the second, willful failure to pay his own income taxes from 1973 to 1975. Defendant made an agreement with the U.S. Attorney to plead guilty to one count in the first indictment and one count in the second relating to his 1975 taxes. In exchange, all other charges would be dismissed. Defendant then entered his guilty plea. At a subsequent plea hearing, an IRS special agent testified in support of Defendant's guilty pleas that determinations as to Defendant's net worth were based upon a possible source of income being the distribution of heroin.

At the sentencing hearing, Defendant entered a plea for leniency and the government recommended a substantial sentence because of the seriousness of the alleged drug involvement. The court then ordered an evidentiary hearing to determine the validity of the government's charges regarding Defendant's drug dealing. At this point, Defendant attempted to withdraw his guilty plea, which motion the court denied. The court again refused to allow Defendant to withdraw his guilty plea at the subsequent evidentiary hearing. The court found that the government had not proved any portion of the charges relating to Defendant's drug dealing and sentenced Defendant to thirty days in jail and $10,000 fine.

HELD:

Defendant should have been allowed to withdraw his guilty plea in light of the fact that the plea agreement did not involve the drug charges. The government's action in attempting to prove the drug charges negated the plea agreement.

Although withdrawal of a guilty plea is not an absolute right, *United States* v *Kirkland,* 578 F.2d 170, 172 (6th Cir. 1978), it falls within the discretion of the District Court. This court felt that the District Court had abused its discretion in refusing to allow Defendant to withdraw his guilty plea in view of the serious nature of these drug charges and the adverse effect they had on sentencing.

INCOME TAX – CONTRIBUTION OF CAPITAL

Transfer of real estate by partner to partnership in which he had a 50 percent interest was a contribution of capital rather than a sale.

John H. Otey v. *Commissioner of Internal Revenue,* 634 F2d 1046, No. 79 1183 (6th Cir., Nov. 26, 1980).

FACTS:

Petitioner, the Commissioner, appeals from a decision by the tax court which refused to adopt a rule that an agreement for preferential distribution out of borrowed funds to restore capital accounts to equality, after non pro rata partnership contributions, necessarily leads to the conclusion that such contributions in reality are sales. The sole issue is whether a transfer of real property to a partnership by a 50 percent partner was contribution to capital or a sale.

HELD:

The transfer of real property by a partner to a partnership in which he owned 50 percent was a contribution to capital and not a sale. The court affirmed the tax court's holding that the form of the transaction was a contribution to capital and that there were no elements of artificiality in the form selected. The court further followed the tax court's finding that the partnership would have had no assets and no business without the transfer. Therefore, the property had to be in the partnership to make any borrowing possible. The court also considered that respondent remained liable for the entire borrowing of the partnership.

STATUTE OF LIMITATIONS – CONSTITUTIONAL LAW

A state claim for medical treatment against the estate of Plaintiff is not barred by a six year statute of limitations nor is the exception to the statute of limitations, MCL 600.5821(4); MSA 28 A. 5821(4), which provides that the state's claim for treatment is not barred by any statute of limitations, unconstitutional.

Department of Treasury, Revenue Division v *Sylvia Hart, Executrix of the Estate of Mary Konke, a/k/a Marie Konke,* 98 Mich App 249, Docket No. 44122, (June 16, 1980).

FACTS:

Mary Konke was declared mentally incompetent and admitted to the Northville State Hospital on September 29, 1965, under an order providing that her guardian was to pay the state for her care and maintenance. She left the facility on September 19, 1968, owing $3,803. On February 15, 1977, Plaintiff filed a claim against the decedent's estate for the above

amount. The only assets of the estate were social security benefits, which are exempt from process until death. The Probate Court held that MCL 600.5821 (4); MSA 28A.5821 (4), under which the state may bring an action to recover the cost of maintenance, care and treatment for persons in any state hospital, home, school or institution without being subject to a statute of limitations, violated the due process and equal protection clauses of the United States and Michigan Constitutions. This decision was affirmed on appeal to the Wayne County Circuit Court. Plaintiff appealed.

HELD:

Reversed and remanded. The government's delayed claims are not barred by the statute of limitations, and the statute as applied in the present case does not deprive Defendant of a fair hearing. The facts establishing liability were undisputed and were provable by public record, and thus the ten year delay in bringing the action did not seriously prejudice the defendant. A reasonable relationship exists between the classification of private or governmental creditors in the statute and the legitimate state interest protected. The state has an obligation to provide treatment regardless of ability to pay, whereas private institutions have no such obligation. Thus, many patients in state institutions may be unable to pay for long periods of time because the only benefits they receive, such as social security, are exempt from process. Therefore, there is no denial of equal protection in the instant case. MCL 600.5821 (4); MSA 28A. 5821(4), as applied here does not violate the due process and equal protection clauses of the United States or Michigan Constitutions.

INCOME TAX – DETERMINATION OF ORIGINAL INCOME

Whether property is held "primarily for sale" depends entirely upon a judicial determination of the taxpayer's intent.

Case, etc., et al. v. *United States,* 633 F.2d 1240; No. 78 3330, (6th Cir., Oct. 30, 1980).

FACTS:

Taxpayers formed a partnership to acquire real estate. Long range plans included transfer of the purchased properties to a corporation, which the taxpayers would form to develop and sell residential units and a recreational complex. An alternative possibility was resale of the properties in bulk to another, larger developer. Before the corporation was formed, taxpayers were notified of the state of Ohio's intention to condemn and purchase the properties. The taxpayers, over a series of sales, sold the properties to the state for $1,213,000. Since their cost was $712,257, taxpayers received a gross profit of $500,743. Taxpayers reported this as capital gain. The Internal Revenue Service, claiming that the property was being held primarily for sale in the course of original business, required the taxpayers to claim the profit as original income. Each taxpayer paid their deficiency and filed this action in District Court.

HELD:

The profit was capital gain. Eight elements were considered in determining whether the property was held "primarily for sale": 1) the purpose for which the property was acquired; 2) the purpose for which the property was held; 3) the extent of improvements made to the property; 4) the frequency, number, and continuity of sales; 5) the nature and substantiality of the transactions; 6) the nature and extent of the taxpayer's dealing in similar property; 7) the extent of advertising to promote sales; and 8) whether the property was listed for sale directly or through brokers. The taxpayers' plan for the acquired property was sound tax planning. The property was not held "primarily for sale." The profit was capital gain.

PROPERTY TAX – EXEMPTIONS

An organization's social and cultural programs must sufficiently relieve the state's educational burden to warrant the educational institutional exemption it claims.

Ladies Literary Club v *City of Grand Rapids,* 92 Mich App 567 (1979), *rev'd,* 409 Mich 748 (1980).

FACTS:

Plaintiff claimed its clubhouse, which houses a library, auditorium and a nursery, was exempt from real property taxes assessed by Defendant on the ground that it is a non profit theatre, library, benevolent, charitable, educational or scientific institution under MCLA 211.7; MSA 7.7. Defendant appealed from a decision of the Court of Appeals overturning a ruling by the Tax Tribunal that Plaintiff did not qualify for the exemption because it also engages in cultural and social activities.

HELD:

An organization may be involved in two or more tax exempt activities and need not fit neatly into only one. But if the organization engages in activities which are not tax exempt, it does not satisfy the statutory requirements. An organization must make a substantial contribution to the relief of the government's educational burden to fit into the scheme of education provided by public taxation in order to claim an exemption. Here, Plaintiff's social and cultural programs fail to do so. 92 Mich App 567, Reversed.

LEGISLATIVE UPDATE

Type of Tax	Act/Bill No. and Date	Explanation
Property	P.A. #427 1/13/81	Increases interest rates on late tax payments from 3/4 of 1% to 1%. Strikes obsolete language in section dealing with information which must be included on property tax notices.
Inheritance	P.A. #474 1/17/81	The tax and interest on the tax levied under this Act may be deferred for up to 10 years without penalty, if the decedent was a professional artist. Probate Judge to determine if deferral shall be granted, etc.
Income	P.A. #475 1/17/81	Provides for a taxpayer to claim a tax credit for up to 50% of the fair market value of pieces of art created by the taxpayer which are donated to qualified organizations, as defined.
S.B.T.	P.A. #468 1/17/81	Provides a tax credit for taxpayer who provides child care services for their employees. Effective for tax years beginning after Dec. 31, 1980 and before Jan. 1, 1983.
Income	H.B. #4018 1/27/81	Excludes alimony or child support payments made pursuant to an order of divorce from the definition of "income". (Beginning with the 1981 tax year).
Intangibles	S.B. #7 1/27/81	Repeals the intangible tax.
Property	S.B. #21 1/27/81	The homestead of a person 65 years of age or older whose gross income, combined with the income of a spouse or co-occupant, for the preceding calendar year is not more than $15,000 is exempt from property taxation. Provides for filing for exemption with the local assessing officer, etc. State to reimburse local governments for lost revenues.
Income	S.B. #26 1/27/81	Provides for a taxpayer to receive a tax credit equal to 50% of the aggregate cost of prescription drugs over $100 purchased during the year.
Income	P.A. #517 1/26/81	Provides for a taxpayer to deduct any retirement or pension benefits received from a public retirement system of another state.
Sales	H.B. #4039 1/29/81	A contractor or builder directly involved in the sale to and installation of materials in an institution or agency which is exempt from taxation under this Act shall also be exempt from taxation with regard to materials for the tax exempt institution.
Use	H.B. #4040 1/29/81	Exempts property sold to contractors for installation in tax exempt institutions, from taxation under this Act.

Type of Tax	Act/Bill No. and Date	Explanation
Income	S.B. #61 1/29/81	Provides for city income taxpayer to claim up to $25 credit for contribution to a neighborhood association. Taxpayer may also designate that $5.00 ($10.00 for joint return) be distributed to a neighborhood organization. Above provisions must be adopted by the local governing body, etc.
Income	H.B. #4031 1/29/81	Excludes credits granted under the Farmland and Open Space Preservation Act from the definition of "income" for purposes of this Act.
Use	H.B. #4056 2/2/81	Prescription drugs prescribed by a veterinarian are exempt from taxes levied under this Act.
Sales	H.B. #4057 2/2/81	Exempts prescription drugs prescribed by a veterinarian from the sales tax.
S.B.T.	H.B. #4068 2/4/81	Revised the qualifying restrictions for affiliated groups so that one corporation must own or control 75% (vs. 80%) or more of the capital stock of the other corporation. Also provides certain exemptions for commission payments of independent insurance agencies.
Income	S.B. #69 2/4/81	Excludes payments made to person over 60 years of age who is acting as a foster grandparent under the Foster Grandparent Program, from the definition of income for purposes of this Act.
Income	H.B. #4072 2/5/81	Prescribes conditions under which a taxpayer may obtain an advance payment of expected property tax credit for a tax year. This section of the Act to be known as the Michigan Income and Property Tax Rebate Act.
S.B.T.	H.B. #4083 2/5/81	Increases the total exemptions allowed under this Act to $70,000 (up from $48,000) to be indexed to the Detroit Consumer Price Index. Also allows tax credit for compensation to new employees.
Sales	H.B. #4101 2/5/81	Exempts the sale of a motor vehicle to a person employed as a minister of a regularly organized church or house of religious worship from taxation under this Act.
Income	H.B. #4103 2/5/81	Allows a taxpayer to claim a tax credit for 2.5% of the purchase price of a vehicle if the vehicle is powered exclusively by electricity. Effective January 1, 1982.
Use	H.B. #4171 2/17/81	Increases the use tax rate by 1%. Collections from this add'l. 1% shall be deposited in the General Fund and shall be distributed according to the Homestead Property Tax Reduction Reimbursement Act. Effective July 1, 1981.

Type of Tax	Act/Bill No. and Date	Explanation
General Sales	H.B. #4172 2/17/81	Increases the Sales Tax rate from 4% to 5%. Revenues from the add'l. 1% levy shall be deposited in the General Fund and shall be distributed pursuant to the Homestead Property Tax Reduction Reimbursement Act. Effective July 1, 1981.
Property	H.B. #4174 2/17/81	Provides exemption for property taxpayers of 35% (100% for senior citizens and totally and permanently disabled persons) of the taxes imposed for the operating purposes, upon the taxpayers homestead, as defined (maximum exemption of $1,400). Prescribes exemption application filing procedures and revised information which must be contained on tax notices.
Income	H.B. #4175 2/17/81	Revises formula used to compute homestead and renters tax credits.
S.B.T.	H.B. #4191 2/19/81	Allows a taxpayer to claim a tax credit ($300 for first year, decreasing to $100 for third year) for the employment of handicapped persons, as defined.
S.B.T.	H.B. #4198 2/19/81	During the first 3 years of a person's business activity, a person shall not have a tax liability greater than the net profit of the business for the tax year, or less than zero if the person had a net loss for the tax year.
S.B.T.	H.B. #4193 2/19/81	Provides for employers in areas of economic distress, as defined, to claim a tax credit for the employment of new employees, as prescribed. Dept. of Commerce to annually certify a list of qualified economically distressed areas, etc. Effective for tax years beginning on or after Jan. 1, 1982.
Property	H.B. #4216 2/19/81	Exempts real and personal property used solely in the production of ethanol or menthanol of greater than 99% purity derived from sources other than petroleum or natural gas from taxation under this Act.
Income	S.B. #117 2/19/81	Provides for a taxpayer to claim a credit for the installation of a woodburning apparatus, as defined, in the taxpayer's domicile.
Income	H.B. #4226 2/24/81	Revises the amount of tax credit allowed for the installation of energy conversion devises by increasing the allowable percentage and lowering the maximum credit. Also provides for taxpayers to be eligible for a tax credit equal to the amount of sales and use taxes paid on the purchase price of certain solar, wind, or water energy conversion devices.

Type of Tax	Act/Bill No. and Date	Explanation
S.B.T.	H.B. #4227 2/24/81	Provides for taxpayers to be allowed a tax credit for the purchase and installation (including finance charges) for solar, wind, wood or water energy conversion devices. Effective Jan. 1, 1982. Expires Dec. 31, 1990.
Property	H.B. #4228 2/24/81	Provides for the Department of Commerce to certify the installation of energy conversion devices as eligible for tax exemptions under this Act. Prescribes formula for determining exemption for certified taxpayers, et al.

(Editors Note: The following is the complete text of Joint Resolution G, the Milliken Tax Shift proposal, which will appear on the May 19, 1981 ballot.)

Filed with the Secretary of State
March 19, 1981

STATE OF MICHIGAN
81ST LEGISLATURE
REGULAR SESSION OF 1981

Introduced by Reps. Thomas H. Brown, Roy Smith, Trim, Buth, Cropsey, Stacey, Van Singel, Hillegonds, Willoughby, Welborn, Binsfeld, Dutko, Bennett, Sietsema, Bullard, Scott, Spaniola, Lincoln, Griffin, McCollough, Fessler, Gnodtke, Ogonowski, Brotherton, Owen, Anderson, Fitzpatrick, Armbruster, Mueller, Maynard, Ballantine, Dillingham, Cruce, Harrington and Mahalak
Rep. Vanek named co-sponsor

ENROLLED HOUSE JOINT RESOLUTION G

A JOINT RESOLUTION proposing amendments to section 41 of article 4 and sections 3, 8, 30, and 31 of article 9 of the state constitution of 1963, to provide for the deposit of net lottery revenues in the state school aid fund; to provide for the allowance of basing the assessment of agricultural and forestry property on its use as agricultural and forestry property; to provide for an exemption from collection of 50% of ad valorem property taxes levied on a homestead for operating purposes, but not to exceed a maximum of not less than $1,400.00, and for an exemption from collection of 50% of resident and nonresident local individual income taxes, but not to exceed a maximum of not less than $100.00 for each 1/2% levy of local income taxes; to provide for adjustment of the maximum ad valorem property tax exemptions; to provide for reimbursement of local units for revenue not collectible because of these exemptions; to provide for the imposition of an additional 1.5% sales and use taxes for the purpose of providing required local unit reimbursement; to provide for certain adjustments to state revenue and expenditure limitations and to the calculation of state spending paid to local units of government; to eliminate the required reduction in the maximum authorized millage rate due to increases in the assessed valuation of property over the change in the general price level; and to provide that a certain percentage of ad valorem property tax levy for operating purposes be exempt from collection from each class of property; to require approval of a majority of the qualified electors of the local unit thereon to increase the millage rate above the rate levied in the previous year.

Resolved by the Senate and House of Representatives of the state of Michigan, That the following amendments to section 41 of article 4 and sections 3, 8, 30, and 31 of article 9 of the state constitution of 1963, to provide for the deposit of net lottery revenues in the state school aid fund; to provide for the allowance of basing the assessment of agricultural and forestry property on its use as agricultural and forestry property; to provide for an exemption from collection of 50% of ad valorem property taxes levied on a homestead for operating purposes, but not to exceed a maximum of not less than $1,400.00, and for an exemption from collection of 50% of resident and nonresident local individual income taxes, but not to exceed a maximum of not less than $100.00 for each 1/2% levy of local income taxes; to provide for adjustment of the maximum ad valorem property tax exemptions; to provide for reimbursement of local units for revenue not collectible because of these exemptions; to provide for the imposition of an additional 1.5% sales and use taxes for the purpose of providing required local unit reimbursement; to provide for certain adjustments to state revenue and expenditure limitations and to the calculation of state spending paid to local units of government; to eliminate the required reduction in the maximum authorized millage rate due to increases in the assessed valuation of property over the change in the general price level; and to provide that a certain percentage of ad valorem property tax levy for operating purposes be exempt from

(4)

collection from each class of property; to require approval of a majority of the qualified electors of the local unit voting thereon to increase the millage rate above the rate levied in the previous year, are proposed, agreed to, and submitted to the people of the state:

ARTICLE 4

Sec. 41. The legislature may authorize lotteries and permit the sale of lottery tickets in the manner provided by law. Net revenues received by the state from the operation of lotteries shall be deposited in the state school aid fund.

ARTICLE 9

Sec. 3. (1) The legislature shall provide for the uniform general ad valorem taxation of real and tangible personal property not exempt by law. The legislature shall provide for the determination of true cash value of such property; the proportion of true cash value at which such property shall be uniformly assessed, which shall not, after January 1, 1966, exceed 50%, and for a system of equalization of assessments. For purposes of assessing agricultural and forestry property, true cash value may be based, as provided by law, on its use as agricultural and forestry property.

Effective for taxes levied after December 31, 1980, 50% of the ad valorem property tax levy for operating purposes but not to exceed a maximum of not less than $1,400.00, as this maximum shall be adjusted in accordance with this section, shall be exempt from collection on the homestead of an individual who is a resident of this state. This exemption shall be applied after the exemption provided in section 31 of this article is applied. Effective for the 1981 tax year and each tax year thereafter, 50% of the resident and nonresident local individual income taxes shall be exempt from collection. However, the legislature shall establish a maximum amount of local individual income taxes which shall be exempt from collection which maximum shall not be less than $100.00 for each 1/2% levy of local income taxes. The maximum amount of ad valorem property taxes that may be exempt from collection under this section shall be adjusted annually for ad valorem property tax levies in the 1982 calendar year and for ad valorem property tax levies in each calendar year thereafter pursuant to law by the same percentage as the percentage increase or decrease in the state equalized value of residential and agricultural real property in this state, excluding new construction and improvements. The legislature may provide for alternative means of taxation of designated real and tangible personal property in lieu of general ad valorem taxation. Every tax other than the general ad valorem property tax shall be uniform upon the class or classes on which it operates.

(2) The state shall reimburse units of local government in the manner provided by law for not less than 100% of the revenues not collectible for ad valorem property tax levies in 1981 and each year thereafter because of the exemption from collection of ad valorem taxes for operating purposes on the homestead of a resident of this state as provided by this section. The legislature shall reimburse a unit of local government for 100% of the amount of revenues not collectible by a unit of local government because of the exemption for local income taxes provided in this section. Reimbursements for the exemptions provided in this section which are returned to units of local government shall be excluded from computations to determine the proportion of total state spending paid to all units of local government as annually required by section 30 of this article. Reimbursements to units of local government for the exemptions provided in this section shall not be considered a transfer of responsibility for funding a program as defined in section 26 of this article. An amount equal to the payments made to units of local government for reimbursement of the exemptions provided in this section shall be excluded from the annual determination of total state revenues for purposes of section 26 of this article, and shall not be considered an expense of state government for purposes of section 28 of this article.

Sec. 8. Except as provided in this section, the Legislature shall not impose a sales tax on retailers at a rate of more than 4% of their gross taxable sales of tangible personal property.

Beginning July 1, 1981, the Legislature shall impose additional sales and use taxes at a rate of 1.5% on the sale or use of tangible personal property, the revenue from which shall be used exclusively for purposes of reimbursing units of local government for the revenues not collectible because of the exemptions provided in section 3 of this article. The revenue from this additional sales tax shall not be included within the allocation made pursuant to sections 10 and 11 of this article.

No sales tax or use tax shall be charged or collected from and after January 1, 1975 on the sale or use of prescription drugs for human use, or on the sale or use of food for human consumption except in the case of prepared food intended for immediate consumption as defined by law.

This provision shall not apply to alcoholic beverages.

To compensate units of government other than the state for loss of revenue resulting from repeal of the sales tax on food and prescription drugs, each present allocation of sales tax revenue to such units shall be increased by one fifth.

Sec. 30. The proportion of total state spending paid to all units of Local Government, taken as a group, shall not be reduced below that proportion in effect in fiscal year 1978-79. As used in this section, total state spending shall not include transfers to or from a counter-cyclical budget and economic stabilization fund created pursuant to law.

Sec. 31. Units of Local Government are hereby prohibited from levying any tax not authorized by law or charter when this section is ratified or from increasing the rate of an existing tax above that rate authorized by law or charter when this section is ratified, without the approval of a majority of the qualified electors of that unit of Local Government voting thereon. If the definition of the base of an existing tax is broadened, the maximum authorized rate of taxation on the new base in each unit of Local Government shall be reduced to yield the same estimated gross revenue as on the prior base.

Effective for taxes levied after December 31, 1980, a percentage of the ad valorem property tax levy for operating purposes shall be exempt from collection on each class of property. The percentage exemption shall be separately calculated and applied for the levy of each unit of Local Government on each class of property, but shall not apply to revenue generated by the class of property from the levy of an increased number of mills over the millage rate levied by the unit of Local Government in the previous year. This exemption shall limit the annual increase in revenues generated from ad valorem property tax levies by the unit of Local Government on the class of property of the unit of Local Government, excluding new construction and improvement, to 6%. as if the current year's millage rate, excluding the increased number of mills over the millage rate levied in the previous year, had been levied in the previous year. A millage rate shall not be increased above the rate levied in the previous year without approval of a majority of the qualified electors of the unit of Local Government voting thereon. The 6% limit may be increased or waived by approval of a majority of the qualified electors of the unit of Local Government voting thereon.

The limitations of this section shall not apply to taxes imposed for the payment of principal and interest on bonds or other evidence of indebtedness or for the payment of assessments or contract obligations in anticipation of which bonds are issued which were authorized prior to December 23, 1978.

Resolved further, That the foregoing amendments shall be submitted to the people of the state at a special statewide election on May 19, 1981 which shall be held in the manner provided by law.

I hereby certify that on the seventeenth day of March, nineteen hundred eighty-one, the foregoing joint resolution was agreed to by the House of Representatives, by a two-thirds vote of all the Representatives-elect.

Thomas S. Kushend

Clerk of the House of Representatives.

I hereby certify that on the eighteenth day of March, nineteen hundred eighty-one, the foregoing joint resolution was agreed to by the Senate, by a two-thirds vote of all the Senators-elect.

William C. Lander

Secretary of the Senate.

(Editors Note: The following instruction sheet was given to persons who last February sought review of their 1981 property tax assessment in the City of Detcoit. It is reprinted without additional comments and with only a passing reference to Amendment XIV of the United States Constitution.)

INFORMATION FOR PERSONS APPEARING BEFORE THE 1981 BOARD OF REVIEW

In order to hear all taxpayers within the time allowed by law, the Board cannot spend more than about 3 minutes per appeal. We ask for your understanding and cooperation.

1. When your number is called, come to the table quickly.
2. The Clerk will read into the record information about your property.
3. The Board may ask the appraiser about sale prices of properties in your neighborhood
4. The Board will ask you to state why you do not agree with the proposed assessment. Please be brief. *Limit your remarks to about 1-1/3 minutes.*
5. Don't waste time by talking about items such as shown below. You *cannot* expect to receive a lower assessment from the Board solely because:
   A. You are assessed today $10,000 more than you paid for the house many years ago. (Inflation has hit the housing market too. The higher assessment reflects the fact that you can sell the house today for more than you paid for it.)
   B. Your house badly needs paint, the carpet is threadbare, there is water in the basement, two storm windows are broken, etc. (You are expected to maintain your house in reasonable condition, and are not assessed lower because you fail to do so. On the other hand, your assessment will not be increased if you correct the deficiencies.)
   C. Your property taxes are up, but your income is fixed. (Michigan, however, provides tax relief through Public Act 20 of 1973 which is normally claimed through the Michigan State Income Tax form. Check with the Assessor's Office for help in claiming a refund.)
   D. Neighboring renters have too many cars in the drive, too many people living in the house, dogs loose, and noisy parties which lower the value of your property. (Please report the excess renters and cars to the city building department, the dogs to animal control, and the noisy parties to the police; and report *all* to your neighborhood association if one is organized.
   E. Your neighbor's home, of same size, style, and age as yours, is completely carpeted and elaborately landscaped. You have neither carpeting nor landscaping and are assessed the same as your neighbor. (Neither carpeting nor landscaping is considered to be a permanent feature of the property and therefore is not specifically assessed by the assessor.)
   F. Some property in your neighborhood was sold at a significantly lower price (unless it is a truly bona fide sale). (Sometimes property is sold at a reduced rate to a relative, or is sold on an "as is" basis (such as HUD properties) and the buyer assumes the cost of required repairs.)
   G. Your assessments have been increased every year in the last 3 years. (State law requires that assessments be set at 50% of true cash value, and are therefore adjusted annually in accordance with the change in market values.)
   H. The Board of Review reduced your assessment last year. This year your neighbor's assessments were increased about 7% while your assessment has been increased 20%. (The Board of Review reduction was for one year only. Assessors set the current assessment at what they consider to be 50% of December 31, 1980 cash value, regardless of Board of Review action last year.)
6. After hearing from you, the Board may ask you questions. Be brief in your response.
7. A reduction in your assessment will be granted only on motion made, seconded and passed by the Board. If there is no motion, the assessment will remain as set by the Board of Assessors.
8. Hardship cases are considered by a special committee of the Board. If you believe you qualify for a reduction because of your *financial situation,* please go to Room 804 for an application.

LETTER TO THE EDITOR

800 First National Building
Detroit, Michigan 48226

March 3, 1981

Editors, MI Tax L.J.
University of Detroit Law School
651 E. Jefferson Avenue
Detroit, Michigan 48226

RE: Michigan Tax Law Journal
October – December 1980

Ladies and Gentlemen:

Scott R. Torpey's article "State Legislature Brings Uniformity to the Enforcement of Michigan's Tax Laws" is well done. His general language in the second paragraph on page 17 may be misleading if the variation in respect to the single business tax is omitted.

MCLA 208.88 provides that the Court of Claims refund action shall be commenced within 6 months after the payment of the tax or the adverse determination on the refund claim, whichever occurs later.

MCLA 205.20 provides: "Unless otherwise provided by specific authority in a taxing statute administered by the department, all taxes shall be subject to the procedures of administration, audit, assessment, interest, penalty, and appeal provided in sections 21 to 30".

My construction of these two sections is that the generality of the MCLA 205.22 language yields to the specificity of the MCLA 208.88 language. Perhaps someday the uniformity in procedures stated in the first paragraph of Mr. Torpey's article will be realized.

Cordially,

/s/
Ernest Getz