MICHIGAN TAX LAWYER

Volume XXXIV
Issue 2
Spring 2008

SBM State Bar of Michigan
Taxation Section

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The MICHIGAN TAX LAWYER is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. The MICHIGAN TAX LAWYER is published three times each year - September (Fall), January (Winter) and May (Summer). Features include the Section's Committee Reports, news of Section events, feature articles, and Student Tax Notes.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact Lynn A. Gandhi, LGandhil@honigman.com; 660 Woodward Avenue, 2290 First National Building, Detroit, MI 48226-3506

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CHANGE OF ADDRESS

Individual subscribers should send notification in writing to: MICHIGAN TAX LAWYER, Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend, Lansing, MI 48904.

Citation Form

The MICHIGAN TAX LAWYER may be cited as follows: (Vol.) (Issue) MI Tax L. (Page) (Yr.).

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May 2008

Dear Taxation Section Members:

I would like to take this opportunity to update you on our Section's recent activities and inform you of upcoming events:

Annual Tax Conference

The Annual Tax Conference will be held at the Inn of St. Johns in Plymouth, Michigan on May 28, 2008. Featured speakers include Samuel Starr of PricewaterhouseCoopers in Washington, D.C., who will discuss Choice of Entity issues, and IRA Shepard of the University of Houston Law Center, who will present an annual tax developments update. I'd like to thank this year's co-sponsors, Stout Risius Ross, Fifth Third Bank and Schechter Wealth Strategies for their generous participation in this event. I'd also like to thank Conference Chair Fred Hoops and Taxation Section Facilitator Deb Michaelian for their hard work in putting this program together.

Tax Court Luncheon

The Section will host a Tax Court Luncheon on June 24, 2007 at the Detroit Club. These luncheons give Section members an opportunity to meet with visiting Tax Court Judges. If you have any questions regarding the upcoming luncheon, please feel free to call Warren Widmayer at (734) 662-0222.

Grant Program

The Taxation Section has allocated $12,000 to law school sponsored tax clinics and other organizations providing tax assistance to low income individuals. These grants will be presented at this year's Tax Conference.

Committee Meetings

The five Taxation Section Committees listed below each conduct informative meetings during the year to address practice area issues. Section members can be placed on a committee's mailing list by

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ccontacting the Committee's chairperson. Notice of committee meetings are also placed on our calendar located at the Taxation Section's website. The website address is www.michigantax.org. If you need information about a committee or would like to write an article for the Michigan Tax Lawyer in your specialty area, please contact the appropriate committee chairperson as follows:

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Michigan Business Tax Online Educational Programming

Beginning last fall the Taxation Section has worked with ICLE to provide online education programs dealing with the new Michigan Business Tax. This programming includes a one hour audio summary of the MBT and a more detailed two hour streaming video presentation, both of which are free. These programs may be accessed by going to the Taxation Section website, http://www.michbar.org/tax/. After entering the website, click on "Links", and then click on the "ICLE Education Programs" link.

Michigan Tax Conference

The second annual Michigan Tax Conference, jointly sponsored by the Taxation Section, the Michigan Association of Certified Public Accountants and the Michigan Department of Treasury, will be held on November 5-6 at the Rock Financial Showplace in Novi. At last year's inaugural Conference more than 600 professionals attended presentations focused primarily on the new Michigan Business Tax. Registration and other details will be available on the "Calendar of Events" link on the Section's website.

Annual Meeting

Our Section's annual meeting will be held this year on Thursday, Sept. 25, 2008 at the Meadowbrook Country Club in Northville. The featured speaker at this event will be Michigan lobbyist Tom Hoisington. The annual dinner is a great opportunity to share your knowledge and experience with other tax practitioners and see old friends, and I hope you will consider attending. Please contact Warren Widmayer at 734-662-0222 if you need more information about the annual meeting.

I encourage all members to take advantage of the many services and resources offered by the Taxation Section and to take part in the Section's activities. Please feel free to contact me if you have any comments or concerns regarding the Section.

Very truly yours,

Jay A. Kennedy
Chairperson, Taxation Section

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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Recent Activities

The committee met on February 6th at Thomas M. Cooley Law School in Auburn Hills, with additional attendees participating by video conference from the school's Grand Rapids and Lansing locations. Michael Indembaum of Honigman Miller Schwartz and Cohn LLP spoke on the use of disregarded entities in corporation reorganizations and Section 1031 exchanges.

Upcoming Events

The committee, jointly with the International Committee, will have a panel discussion on creative business entity selection at the annual Tax Section conference in May.

REPORT OF THE EMPLOYEE BENEFIT COMMITTEE

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Recent Activities

The last meeting of the Committee was held on March 13, 2008. The topic of the presentation was "Exploring the Final 403(b) Regulations; Coordinating Guidance under 457(f) and 409A." The moderator was George Whitfield, Esq. of Warner Norcross & Judd LLP (in person) and the speakers were Robert J. Architect, Senior Tax Law Specialist, IRS, Washington, DC (via telephone), Cheryl Press, Esq., Senior Attorney, IRS, Washington, DC (via telephone), Kelli P. Smith, Senior Revenue Agent, IRS, Chicago, IL (in person), and Robert J. Toth, Esq. of Baker & Daniels (in person).

Upcoming Events

Nothing scheduled at this time.

REPORT OF THE STATE AND LOCAL TAX COMMITTEE

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Recent Activities

On February 5, 2008 the Committee held a regular meeting at Dykema Gossett's Bloomfield Hills office. Michael R. Lohmeier of Virchow, Krause & Company, LLP spoke on what attorneys should be aware of when reviewing appraisals.

The State and Local Tax Committee sponsored a networking event hosed by June Haas at Honigman Miller's Lansing, Michigan Office on May 1, 2008. The event was attended by the Chief Deputy Treasurer, as well as the Deputy Treasurer for Tax Administration and several members from the Tax Policy Bureau. Attorneys from the Revenue Section of the Attorney General's office and a number of private practitioners were in attendance.

The Committee continues to work on amendatory language to exclude certain personal investment activity or individual wealth preservation measures from the reach of the MBT. Senate Bill 1038 (substitute) which passed the Senate in February, excludes for an individual, estate or "other person organized for estate or gift planning purposes, or person organized to conduct investment activity (i.e., attempting to exclude investment clubs)." The Bill removes the "exclusively for" language and has retained the reference excluding receipts received outside of the taxpayer's and/or not constituting a "trade or business." Some have expressed the view that the amendatory language is not perfect. Some have expressed the view that the statute should reference specific types or classes of income or analogous provisions in the Internal Revenue Code.

As of this point, however, there is also a sense that "perfect is the evil of good enough." After the experience last year, some members of the legislature have indicated that they are "tired of taxes." Further complicating matters is that there are a number of other interest groups seeking the legislature to address some of the MBT's other, so-called "unintended consequences." See, for example, Senate Bill 1217 (amending the definition of "purchases from other firms" for construction contractors). There are the various other groups seeking additional tax credits or subsidies for their particular industry.

With regard to the exclusion for personal investment activity, the Department of Treasury is concerned that while it was not intended that the MBT reach certain personal investment activity or individual wealth preservation measures, overly broad amendatory language could reach beyond this narrow intent. Treasury is also reluctant to adopt provisions that cross reference to the Internal Revenue Code. The demise of Michigan's estate tax is Treasury's most commonly cited example of the perils of "federal conformity."

Upcoming Events

The next regularly-scheduled meeting of the SALT committee will be held Wednesday, May 28, 2008 from 2:45 p.m. to 4:45 p.m. This meeting will feature Wayne D. Roberts of Dykema Gossett and Jordan Goodman of Horwood Marcus & Berk, Ltd. of Chicago. Mr. Roberts will present a Michigan tax developments update. Mr. Goodman has agreed to speak on the unitary business principal. This meeting will be held in conjunction with the Tax Section's 21st Annual Tax Conference at the Inn at St. John's in Plymouth, Michigan during the SALT break-out session.

The committee is also working with Department of Treasury officials to reschedule Question and Answer session previously scheduled on March 20, 2008

REPORT OF THE TAX PRACTICE AND PROCEDURE COMMITTEE

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As the newly appointed chairperson to the Tax Practice and Procedure Committee I look forward to serving the Tax Section in this role. If you have any suggestions for future speakers or events for the Tax Practice and Procedure Committee, please contact me at the above email or phone number

Recent Activities

The last meeting of the Tax Practice and Procedure Committee was on March 20, 2008 at the Inn at St. Johns. The guest speaker was Leonard Bartold, IRS Appeals Manager, from the Detroit Appeals office. Leonard gave a presentation to us on "Using the IRS Appeals Process to Resolve Tax Controversies". Leonard detailed how the IRS Alternative Dispute Resolution process worked from an IRS perspective and explained ways that tax practitioners could use this procedure effectively. The meeting was webcast and can be accessed for viewing at www.icle.org.

I recently met with the Michigan IRS Practitioner Liaison Group via teleconference. This meeting was attended by the Independent Accountants Association of Michigan, the Michigan Association of Certified Public Accountants, the Michigan Society of Enrolled Agents, the National Association of Tax Professionals and the Michigan Department of Treasury Taxpayer Advocate. The purpose of the group is the provide a forum for the exchange of information of new and emerging issues that will enhance the level of understanding between professional tax organizations and the IRS. If you have any issues that you wish to have addressed at future meetings, please let me know.

Upcoming Events

September 2008 (Meeting to be determined).

REPORT OF THE TRUSTS AND ESTATES, TAXATION SECTION

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Recent Activities

New business, Dennis M. Mitzel will be speaking at the Estates and Trusts breakout session at the 21st Annual Tax Conference. Mr. Mitzel will be speaking on "Naming Trusts as Beneficiaries of Qualified Plans."

MICHIGAN TAX MATTERS: SPRING CLEANING

Paul V. McCord

Even before the Michigan Business tax became effective on January 1, 2008, it had been amended eight times.[1] To be sure, Michigan's former Single Business Tax was frequently amended subsequent to its introduction in 1975. But by way of comparison, at the time this piece went to press, that MBT has been amend more frequently in its first four months than the SBT had been amended in its first eight years. Here are some of the highlights of this year's spring cleaning.

Getting The Business Tas We Want

Throughout the development of the MBT it was clear to all involved that a new business tax regime would result in shifts of the tax burden. As the tulips began to bloom, this reality also become apparent to the owners of Michigan's malls, office buildings and warehouses as they began to determine their tax bills under the state's new business tax. Some commercial-real-estate developers are seeing 200 to 400 percent increases as the result of the switch to the MBT from the SBT.

On April 17, 2008, a bill to fix the MBT for construction contractors moved closer to passing the Michigan Senate. SB 1217 would amend Section 113(6)(e) to include in the definition of "purchases from other firms," for certain builders and contractors, direct material costs for a construction project under a contract specific to that project. Under current law, the definition of "purchases from other firms" includes payments to subcontractors for a construction project under a contract specific to that project. Under the bill, "purchases from other firms" would also include direct material costs for a construction project under a contract specific to that project. "Direct material costs" would mean the amounts paid for materials that are deductible on the taxpayer's Federal income tax return as purchases under the cost of goods sold.

You Couldn't Possibly Have Meant All Recipts?

In its most general form, the base of a gross receipts tax is the dollar value of receipts from the sale of goods and services, with no omission of categories of sales and no allowance for costs incurred by sellers. The MBT's Modified Gross Receipts Tax is not as general, as it omits categories of receipts and make various adjustments for costs. There has been a growing awakening of the implications of this type of taxation among Michigan's business taxpayers, much like the dandelions popping up on my lawn this spring.

In an effort to cut back some of the weeds, SB 1038 would amend the MBT to exclude from the definition of "gross receipts" certain proceeds, interest income, royalties, dividends, taxes, fees, and surcharges, and to include hedging transactions.

Under the bill, "gross receipts" would not include amounts that were only deemed received under the Internal Revenue Code. The bill also would refer to the entire amount received by the taxpayer from "business activity". The bill would exclude from the definition of "gross receipts" interest income and dividends derived from obligations or securities of the United States government and this State in the same amount that was excluded from Federal taxable income; dividends and royalties received from a foreign operating entity or a person other than a U.S. person; any tax, fee, or surcharge required by law, or any deposit required under the bottle deposit law; for a partner, amounts received that are attributable to another entity whose business activities are taxable under the MBT Act or would be subject to the tax if the business activities were in this State.

Under the MBT, "gross receipts" do not the recovery of the adjusted basis of capital assets but includes the gain realized and recognized for Federal income tax purposes.[2] Under the bill, the entire proceeds from the sale, exchange or other disposition of a capital asset including any hedging transaction would be excluded from the definition of "gross receipts." This will effectively result in a 0.8 percent capital gain preference in the MBT, as the gain from these types of transactions will be fully taxable under the Business Income Tax component of the MBT, but will be excluded from the tax base of the modified gross receipts tax base. The bill also clarifies that land that was purchased before January 1, 2008, and that qualifies as property used in the taxpayers trade or business qualifies for this preferred treatment. [3] The bill also specifies that such treatment would be retroactive and effective for taxes levied on and after January 1, 2008.

Tell Your Crazy Cousin From Illinois To Stay Home

Combined reporting is required under the MBT for a unitary group. What has proved difficult for many businesses in preparing their first quarterly estimates under the MBT, is getting comfortable with the subjective nature of the requisite affiliation comprising a unitary business group.

The MBTA generally defines a unitary business group as including a group of businesses where one member controls, directly or indirectly, more than 50 percent by vote or ownership of the group members, and that the business activities or operations among the group members result in a flow of value between or among those included in the unitary business group or that are integrated with, are dependent upon, or contribute to each other. This unitary filing concept disregards the business structure of the group and is in marked contrast to the SBT's separate accounting.

SB 1053 would amend the MBT to allow a unitary business group to elect to include another person that would not otherwise be included in the group, as long as that person met the ownership requirements of a unitary business group. The election would have to be for a period of at least five years. Because the losses by one unitary member may be utilized against the income of the other another unitary members, SB 1053 would permit some loss utilization by allowing to include, at the taxpayer's election, an otherwise non-unitary person. [4]

And just in time for the home opener, last month's U.S. Supreme Court decision in *MeadWestvaco Corp v Illinois Dep't of Revenue*,[5] throws a curve ball as to just who and/or what may be within or outside of a unitary business group that is not apparent from either the statute or the published FAQ's. Specifically, members or non-members of a unitary business group do not have to be separate "persons." For example, a Michigan taxpayer who may hold an asset or operate a separate line of business as divisions in another state that asset or division may not be unitary with the larger business.

The question for the Court in *MeadWestvaco* was whether an alternative route existed for states to capture revenue from businesses that were not unitary. The Supreme Court had raised this possibility with a passing reference in a 1992 opinion to tax liability generated by assets that served an "operational rather than an investment function" in a business. That ambiguous reference led some state courts to conclude that the justices had blessed an "operational function" test that paved the way to taxing multistate companies that did not qualify as unitary businesses.

During the tax years at issue in the case, Mead, an Ohio corporation and its Lexis/Nexis division (note not a subsidiary) both did business in Illinois. In 1994, Mead sold its Lexis/Nexus division for $1.5 billion. Mead claimed that its $1 billion gain from the sale could be taxed by Ohio, where the company is headquartered, but not by Illinois. On the other hand if Mead and Lexis/Nexis formed part of a single unitary business, Illinois could tax its apportioned share of the gain.

The Illinois trial court ruled that Lexis was not a unitary part of Mead's business. But the Illinois trial court found Mead's sale of Lexis/Nexis was a liquidation of property essential to Mead's regular trade or operations and therefore taxable because it served an "operational function" in the larger business and that Illinois could therefore tax the capital gain.

In *MeadWestvaco,* a unanimous decision written by Justice Alito, the Court upheld its long line of cases holding that the "unitary business principle" sets limitations on a state's ability to tax. If the value the state wished to tax derived from a "unitary business" operated both within and outside of the state, the state could tax an apportioned share of the value of that business instead of isolating the value attributable to the operation of the business within the state. Conversely, if the value the state wished to tax derived from a "discrete business enterprise," then the state could not tax even an apportioned share of that value.[6]

The Court explained that its references to "operational function" in Container Corp. and Allied-Signal were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be part of a taxpayer's unitary business even if what we may term a "unitary relationship" does not exist between the "payor and payee".[7] For example, the Court explained, a taxpayer is not generally unitary with its banker, but the taxpayer's deposits (which represent working capital and thus operational assets) can be clearly unitary with the taxpayer's business.

The Appellate Court of Illinois agreed with the "operational function" conclusion of the trial court, and therefore expressed no opinion on whether the business was unitary. Vacating that decision, the Supreme Court said the state appeals court should now consider whether the business of Lexis/Nexis division was unitary with the larger business. Only if the answer was yes could the tax be upheld, the court said. While not reaching a conclusion on the unitary question, Justice Alito strongly suggested that the answer should be no. He pointed out that while MeadWestvaco is in the paper business, it did not require Lexis/Nexis to buy Mead paper, "and indeed Lexis purchased most of its paper from other suppliers." Neither company even gave the other a discount on goods or services, indicated Justice Alito.

It's Not Your Father's Blighted Property Anymore

New brownfield legislation contained in 89 PA 2008 creates a tremendous window of opportunity for developers by creating tax incentives of up to 20 percent to help revitalize urban development. To encourage increased urban redevelopment in the state, certain "urban redevelopment area" projects will be eligible for a credit of up to 20 percent of the eligible investment for the project, and, after 3 years, will still be eligible for up to a 15 percent credit. For all other projects, the credit limit has been increased from 10 percent to 12.5 percent of the eligible investment for the project. The 10 percent credit was increased to 12.5 percent to compensate for removing "soft costs" (except architecture, surveying, and similar professional fees engineering) from the eligible-investment calculation.

Many developers who apply for a credit are limited liability companies with little MBT liability. As a result, developers typically sold these credits in the open market for a discount and used the cash proceeds as additional equity in order to satisfy their lenders requirements. The recent legislation gives developers the additional option of electing to have the amount exceeding the developers' tax liability to be refunded at the rate of 85 percent and forego the remaining 15 percent. Given the current tight lending requirements, developers should consult with their lenders before opting to wait for a tax refund from the state as some lenders will not count anticipated tax refunds towards the developer's equity requirements.

Finally, 89 PA 2008 fixes the credit assignment provision. When the brownfield credit program was transferred from the SBT statute to the MBT statute, a mistake in the language caused the simplified assignment provision not to apply to MBT credits. The legislation fixes this mistake, so now the simplified assignment provision applies.[8]

Lights Action Camera

To be sure, Michigan has a lot to offer and greater visibility by the movie business could add jobs, bump up tourism, and perhaps change some negative perceptions. But it won't come cheap. A 15 bill package enacted in April gives film studios a refundable credit of up to 42 percent on production expenses in the Michigan.[9] For example, if an out-of-state studio has no Michigan Business Tax liability and spends $10 million on production in the state, the state will cut it a check for up to $4.2 million. The new laws also provide 25 percent tax credit for film and digital media infrastructure investments for such activities as building studios or purchasing equipment. Film and digital media production companies are now eligible to receive job creation tax credits issued by the Michigan Economic Growth Authority (MEGA) against MBT liability for the creation of jobs; loans from the Michigan Strategic Fund under the 21st Century Jobs Fund program for up to $15 million per qualifying film and digital media productions in Michigan; loans against film production tax incentives; and are eligible to participate in the capital access program established by the Michigan Strategic Fund under the 21st Century Jobs program. In an effort to grow the number of film industry jobs in the state, the new laws establish a Film & Digital Media Worker Job Training Tax Credit of 50 percent for expenditures incurred by a production company providing on-the-job training for Michigan residents. Film and digital media companies are allowed free use of state property for film and digital media productions, an option that local governments are allowed to authorize, as well. The Michigan package also covers commercials, TV shows, documentaries, video games and other film work. Probably the most telling aspect about the film incentive package is not the actual bills themselves but the analysis by the Senate Fiscal Agency that suggests that while the legislation could generate more economic activity in the state and increase some tax revenues, they likely would not offset the costs of the incentives. Skip the popcorn and please pass the pork.

For Whom The Public Service Improvements Toll

Developers can expect to save some money as the result of a February Michigan Supreme Court decision that could change the way some cities and townships assess property values. Specifically, the Michigan Supreme Court held that Mich Comp Laws Ann § 211.34d(1)(b)(viii), which includes public-service improvements as "additions" for purposes of the state's property tax cap, is unconstitutional.

In *Toll Northville Ltd Partnership v Twp of Northville*,[10] a developer challenged Northville Township's dramatic increase in the taxable value of newly-developed lots before any sale. The township premised the increase in taxable value, upon the installation of public service improvements; sewers, roads, lighting, for example. The Court found that public-service improvements consisting of public infrastructure located on utility easements or land that ultimately becomes public do not constitute "additions" to property within the meaning of Mich Constitution § 3, as amended by Proposal A. So, as a result, the township's increase in the taxable value of the property represented an unconstitutional violation of the cap on increases in taxable value imposed by Proposal A.

Similar to the Michigan Supreme Court's decision a few years ago in *WPW Acquisition Co v City of Troy*,[11] the Count's recent decision has the effect of limiting a municipalities ability to increase the taxable value of a property based solely upon the installation of public service improvements. The ruling also comes as many builders are sitting on large tracts of land they can't sell or develop because of the region's economic downturn, potentially offering them some breathing room until they decide to move forward on projects.

Making Lemonds from Lemons

In the face of Michigan's difficult housing market, two tax developments this spring should help home sellers. First, under the General Property Tax Act, owner-occupied residences, known as principal residences, are exempt from the local 18-mill school operating tax and instead pay only the 6-mill state education tax.[12] Before the enactment of 96 PA 2008, a person could only claim one principal residence exemption and there had been some high profile cases of individuals claiming more than one principal residence exemption.

And in an effort to address the impact on homeowners of the slow residential real estate market in Michigan, perhaps especially so here in Southeastern Michigan, 96 PA 2008 amends Mich Comp Laws Ann § 211.7cc by adding new subsection (5) to allow a homeowner to claim an additional principal residence exemption in specified circumstances.

Specifically, in addition to an owner's current principal residence, that individual may now continued to retain the 18-mill "principal residence" exemption on their former home for up to three years, provided that the property is not occupied, is for sale, is not leased and is not used for any business or commercial purpose. Property that is available for lease is eligible for this continued exemption, although as soon as it is leased, this continued exemption no longer applies and would have to be rescinded at that time.
Under prior law, homeowners were required to rescind their claim

of exemption within 90 days after exempted property is no longer used as their principal residence by filing a rescission form with the local unit.

While the law retains the 90-day rescission requirement for property that no longer qualifies for the principal residence exemption, the law now provides that the homeowners seeking relief under this provisions have to file a "conditional rescission" on or before May 1 with the local tax unit in order to continue or retain the previous principal residence exemption on that property. The law further provides that the former homeowner would have to verify annually to the local assessor on or before December 31 that the property is eligible for this special exemption. If the former homeowner does not or fails to provide this annual end of the calendar year verification, the continued principal residence exemption on this property is lost.

Lastly, the Attorney General issued Opinion No. 7214 on April 3, 2008, that clarifies the proper application of an obscure exemption contained in the Michigan Transfer Tax Act. Exemption "t", found in Section 6(t) of the Michigan Transfer Tax Act, [13] provides that a seller may seek an exemption from paying the state transfer tax if the following criteria are met:

1. The property must have been occupied as a principle residence, classified as homestead property;
2. The property's State Equalized Value ("SEV") for the calendar year in which the transfer is made must be less than or equal to the property's SEV for the calendar year in which the transferor acquired the property; and
3. The property cannot be transferred for consideration exceeding its true cash value for the year of the transfer.[14]

The AG opinion uses examples to show how the exemption applies. For example if the SEV of the principle residence when acquired in 2006 is $74,000.00 and the SEV when transferred in 2008 is $72,000.00 then criteria one and two above are satisfied. You can establish the true cash value by doubling the SEV at the time of transfer. In this case the true cash value is $144,000. If the sale price in 2008 is $140,000.00 then the sale does not exceed its true cash value. All three criteria are satisfied and the exemption would apply.

The Attorney General's opinion provides welcome guidance to home sellers already faced with the reality of declining value on their single greatest asset. The opinion also provides a uniform reading of the exemption that is necessary to provide consistent application among the various Registers of Deeds across the state. However, please note that no similar exemption exists in the County Real Estate Transfer Tax Act.

CONCLUSION

At the rate we seem to be cleaning out our tax garage, we should have a "fairer" business tax for some before the summer. I have only hit some of the highlights and in the interest of space skipped over captive insurers, private equity funds and a few others. Besides, the dandelions are beginning to poke up faster than I can pull them. Happy spring weeding.

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ENDNOTES

1. *See, e.g.*, 145 PA 2007, 205 PA 2007, 206 PA 2007, 207 PA 2007, 208 PA 2007, 214 PA 2007, 215 PA 2007 and 216 PA 2007.
2. *See* Mich Comp Laws Ann § 211.111(1)(o).
3. Keep in mind that the exclusion from the definition of "gross receipts" for the adjusted basis recovered on the sale, exchange or other disposition of certain capital assets under the current language of Mich Comp Laws Ann § 208.1111(1)(o) makes specific reference to IRC § 1231(b) definition of "property used in the [taxpayer's] trade or business." Land, which is not a depreciable asset, is not included within IRC § 1231(b).]
4. Had this election existed in Michigan's former corporate income tax, *Holloway Sand & Gravel Co, Inc v Dep't of Treasury*, 152 Mich App 823; 393 NW2d 921 (1986) would have concluded to a different result.
5. MeadWestvaco Corp v Illinois Dep't of Revenue, 553 US ___, No 06-1413 (April 15, 2008).
6. Slip op. at 8-9 (citations omitted).
7. *Id*. at 11-12 (citations omitted).
8. While we are talking about passing candy out to our friends, see also 110 PA 2008 which amends the Michigan Economic Growth Authority (MEGA) Act to include tourism attraction facilities and qualified lodging facilities in the definition of "eligible business", and adds a "qualified high-wage activity" to the definition of "qualified high-technology business". A "qualified high-wage activity" includes a business that has an average wage of 300% or more of the Federal minimum wage, including a business that engages in architecture and design, including architectural design, graphic design, interior design, fashion design, and industrial design; and/or advertising and marketing, including advertising and marketing firms and agencies, public relations agencies, and display advertising.
9. See 74 PA 2008 (gives production companies a worker job training tax credit): 75 PA 2008 (enhances Michigan Film Office and transfers that office to the MEDC);76 PA 2008 (amends Management and Budget Act to provide film production companies free use of state owned property); 77 PA 2008 (amends the MBT to provide a 40% - 42% MBT credit for production companies); 78 PA 2008 (phases out existing motion picture credit); 79 PA 2008 (allowing production companies to claim the 40% - 42% credit against the income tax); 80 PA 2008 (allows for Michigan Strategic Fund to

provide loans for qualified film industry productions); 81 PA 2008 (amends the Michigan Military Act to provide production companies free use of state property); 82 PA 2008 (authorizes DNR to provide free use of state property to production companies); 83 PA 2008 (provides for free use of state transportation property); 84 PA 2008 (creates the "Local Government Filming Location Access Act" to allow production companies free use of local government property); 85 PA 2008 (technical bill - changes History Arts and Libraries Act to reflect the transfer of the Michigan Film Office); 86 PA 2008 (Amends the MBT to provide a tax credit for investment in film production infrastructure); 87 PA 2008 (extends MEGA credits to production companies).

10. Toll Northville Ltd Partnership v Twp of Northville, ____ Mich ___; ___ NW2d ___, 2008 WL 307829 (Mich 2008).
11. WPW Acquisition Co v City of Troy, 466 Mich 117; 643 NW2d 564 (2002).
12. See, generally Mich Comp Laws Ann § 211.7cc.
13. Mich Comp Laws Ann § 207.521 et seq.
14. Mich Comp Laws Ann § 207.526(t).

EIGHT THOUGHTS ON PREPARER PENALTIES; AND THEN SOME MORE

Lorraine F. New
Douglas W. Stein

EIGHT THOUGHTS ON THE NEW PREPARER PENALTIES:

o Penalties for tax preparers are now $1000 to up to one-half of the preparer's fee or claim for refund for unreasonable positions taken on the return to $5000 to up to one-half of the preparer's fee for understatement due to willful or reckless conduct. Does that get your attention?

o You don't have to sign a return to be a tax preparer; oral advice that leads to a substantial tax item on a return or claim for refund is enough.

o Penalties for preparers now apply to more than income tax returns, even estate and gift tax returns.

o A head's up from the IRS- Permanent regulations may be more stringent than those proposed. IRS has publicly espoused "appropriate" penalties and is less likely to remove them during the appeals and trial negotiations. Even the Tax Court is getting into the act.

o Smart moves- Advise your client of audit hazards, potential penalties and make contemporaneous notes.

o IRS professes not to want a disclosure form with every return but use of Form 8275 provides a lower reporting standard- reasonable basis for the position. You would be safer if you included one.

o If you end up testifying about your advice/opinion, are you representing yourself or the client? Hint- Your client doesn't care.

o You might need an independent opinion that states that your position is a reasonable belief that the position you took would more likely than not be sustained on the merits to protect you. It is important that the opinion be independent, researched and by a qualified source.

The Small Business and Work Opportunity Act of 2007 ("2007 Act") significantly and unexpectedly broadened the tax return preparer penalties of Code Sec. 6694[1]. Generally, preparer penalties apply to any practitioner who signs a return or claim for refund or to a practitioner who does not sign a return but gives advice about a position on a tax return.[2] In addition to expanding the reach of the preparer penalties, Code Sec. 6694 also increased the penalties. Notably, at roughly the same time, the Treasury also proposed amendments to Circular 230 to conform the professional standards with the civil penalty standards for return preparers in Code Sec. 6694.

Prior Law

Under prior law, penalties were imposed against a return preparer if the return did not have a realistic possibility of being sustained on its merits.[3] However, if the signing practitioner[4] made adequate disclosure of the position penalties were imposed only if the position was frivolous.[5] A non-signing practitioner qualified for the lower "non-frivolous" standard only if the practitioner advised the client about the opportunity to avoid penalties through disclosure.[6] The standard was applied to a signing preparer on the date the return was signed, and to a non-signing preparer on the date that the preparer provided advice. [7]

New Law

The 2007 Act amended Code Sec. 6694 to elevate the general rule from a realistic possibility of success standard (i.e., a 1 in 3 standard) to a "more likely than not" (greater than 50% likelihood of success) standard to avoid penalties.[8] If adequate disclosure of the issue is made on the return (or for a non-signing practitioner, if advice about disclosure is given), the non-frivolous standard is lowered to a reasonable basis standard.[9]

In order to take advantage of the lower reporting standard (i.e., reasonable basis standard), disclosure must be made on Form 8275 (or Form 8275-R if the position is contrary to a regulation.).[10] However, advice by a non-signing preparer may be adequate if the advisor notifies the taxpayer that the advice does not meet the "more likely than not" standard and advises that the taxpayer may be subject to penalty unless adequately disclosed.[11]

Code Sec. 6694 still applies to both signing and non-signing return preparers.[12] In either case, a preparer refers only to someone who prepares or gives advice as to "all or a substantial portion" of the return.[13] Thus, it is clear that an attorney can be, and often may be, a return preparer. The example in the regulations suggests that giving advice regarding the treatment of a "significant" item on the return constitutes preparation of a "substantial portion" of the return. [14]

The definition of a non-signing return preparer is an individual who only gives advice on specific issues of law.[15] (Notably, the language of the regulation appears to be directly aimed at attorneys.) An important limitation is that a non-signing preparer is limited to someone who gives advice "with respect to events which have occurred at the time the advice is rendered and is not given with respect to the consequences of contemplated actions."[16]

Interplay with Circular 230

Circular 230 also applies to practitioners who sign returns or give advice regarding a position on a return. These positions can be as obvious as opining whether a gift has been made or as unexpected as the value of an item included on a Federal Gift Tax Return. Notably, the Circular 230 provisions do not contain the limitation that advice about a position on a return is limited to advice about transactions that have already occurred and not just contemplated transactions. Thus, a practitioner can safely avoid the preparer penalty provisions of Code Sec. 6694 but violate their obligations under Circular 230.

Notice 2008-13 provides interim guidance, pending the revision of regulations, regarding implementation of the preparer penalty provisions of Code Sec. 6694 and the related definitional provisions of Code Sec. 7701(a)(36). Return preparers may rely on the Notice until further guidance is issued. The guidance clarifies that "any determination as to whether a person has prepared a substantial portion of a tax return, and thus is considered a tax return preparer, will depend on the relative size of the deficiency attributable to the schedule, entry, or other portion."

It is important to be cognizant of the interplay of Circular 230 and Code Sec. 6694. Section 10.34 of Circular 230 addresses the standards for advising taxpayers with respect to tax return positions and for preparing or signing returns. Prior to an amendment effective on September 25, 2007, §10.34(a) applied a realistic possibility standard to practitioners signing a tax return or giving advice about a position on a tax return. "Realistic possibility" was defined as being "approximately a one in three, or greater, likelihood of being sustained on it merits."[17]

Section 10.34 was amended, as of September 25, 2007, to eliminate the provisions regarding standards (leaving the sections dealing with documents and affidavits, and regarding advising clients on potential penalties), and the IRS proposed amended sections dealing with the standards. The proposed amendment to Circular 230 conforms the professional standards of practitioners to the same general requirements of Code Sec. 6694. Under the §10.34 amendment, a practitioner may not sign a tax return as a preparer or advise a client to take a position on a return unless (1) "the practitioner has a reasonable belief that the tax treatment of each position on the return would more likely than not be sustained on its merits;"[18] or (2) "there is a reasonable basis for each position and each position is adequately disclosed."

In addition to conforming to the "more likely than not" and "reasonable basis if there is disclosure" standards of Code Sec. 6694, this amendment makes two important changes. First, the amendment removes the statement that the reasonable basis standard is satisfied if the position has a one-in-three chance of being sustained. Instead, the amendment provides that "[r]easonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or has a colorable claim. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account."

Second, Circular 230 previously provided that a practitioner who gives advice about a position taken on a return can avoid the realistic possibility standard and qualify for a lower "not-frivolous" standard by specifically advising the taxpayer about the opportunity to avoid penalties through disclosure. Merely advising a taxpayer about avoiding penalties through disclosure is no longer sufficient under the proposed amendment. Rather, the taxpayer must actually disclose the position to the IRS in order for the practitioner to qualify for the lower "reasonable basis" standard. This is an important change as it now places the tax preparer (e.g., attorney) on the hook even if the tax preparer advised the client, in writing, merely because the client did not adequately disclose.

The Circular 230 amendment will be effective for returns filed or advice provided on or after the amendment is finalized, but no earlier than January 1, 2008.

Notice 2008-13

Notice 2008-13, provides interim guidance regarding the return preparer penalties and reiterates that the standard is applied as of the date the return is signed (for a signing preparer) or the date advice is given (for a non-signing preparer). The Notice makes clear that the regulations are expected to be finalized in 2008 and may be substantially different from the rules described in this notice. Ominously, the Notice states that in some cases the regulations may be more stringent.

Highlights of the interim notice regarding the reporting standards include:

More Likely than Not Standard

The more likely than not standard is met if the preparer analyzes the pertinent facts and authorities in the manner described in the current regulations[19] and reasonably concludes that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged. The preparer may rely in good faith without verification on information furnished by the taxpayer as provided in Treas. Reg. §1.6694-1(e) and on information furnished by another advisor, tax return preparer or other third party. The tax return preparer also must make reasonable inquiries if the information furnished by another tax return preparer (e.g., accountant) or a third party (e.g., appraiser) appears to be incorrect or incomplete.[20]

Reasonable cause and good faith

The reasonable cause exception in the statute was not changed (i.e., "reasonable cause for the understatement and such person acted in good faith"). Notice 2008-13 changes the "reliance on advice" rules in Treas. Reg. §1.6694-2(d)(5). A preparer acts in good faith "when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice." The advice may be written or oral (but the burden of establishing the advice is on the return preparer). However, the advisor's reliance is not in good faith if (i) the advice is unreasonable on its face; (ii) the preparer knew or should have known that the third party was not aware of all relevant facts; or (iii) the preparer knew or should have known that the advice was no longer reliable due to developments in the law since the time the advice was given.

Disclosure for Signing Preparers

The interim guidance gives some additional exceptions (in addition to disclosure on a Form 8275 or 8275-R) to satisfy the disclosure requirement in order to lower the standard to the reasonable basis standard:

> (1) providing the taxpayer with the prepared return that includes the appropriate disclosure (presumably even if the taxpayer does not actually include the disclosure with the return that the taxpayer actually files);
>
> (2) "If the position would otherwise meet the requirement for non-disclosure under section 6662(d)(2)(B)(i) (i.e., if there is "substantial authority," which is the standard for the taxpayer to avoid penalty without disclosure), the tax return preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 and the penalty standards applicable to the tax return preparer under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided;" or
>
> (3) "If section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C) (i.e., "tax shelters"), the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between these standards and the standards under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided."

The last requirement appears to be the IRS's response to the ethical problem that professionals have raised in light of the inherent conflict that preparers have in representing clients because the standard for the preparer to avoid penalties is higher than the standard for the taxpayer to avoid penalties. If the "substantial authority" standard is satisfied, so that the taxpayer does not have to disclose to avoid penalties, the preparer can avoid penalties by merely advising the taxpayer of the difference between the penalty standards applicable to taxpayers and preparers (i.e., the substantial authority and more likely than not standards). Stated differently, if the preparer advises the taxpayer of the difference between the taxpayer and preparer penalty standards, the standard for the preparer effectively is reduced from a "more likely than not" standard to a "substantial authority" standard. The safest course of action appears to be to routinely give clients this notice.[21]

Disclosure for Non-signing Preparers

The non-signing return preparer can use the lower reasonable basis standard if the advice to the taxpayer includes a statement informing the taxpayer of any opportunity to avoid penalties under Code Sec. 6662.

This appears to be the most helpful aspect of this Notice because the advisor otherwise would have to assume that the higher "more likely than not" standard always applies. It is unlikely that a non-signing preparer has any way of guaranteeing that the return, as actually filed, includes the proper disclosure. However, it is interesting that this option was effectively removed from the analogous Circular 230 rules under the amendments proposed last fall. Hopefully, the IRS will add this provision back into the revisions of §10.34(a) of Circular 230 and remove the requirement that the taxpayer actually disclose in order to reap the benefit of the lower reasonable basis standard.

If a non-signing preparer gives advice to another preparer, the non-signing preparer can use the lower standard "if the advice to the tax return preparer includes a statement that disclosure under section 6694(a) may be required." If the advice is in writing, the statement must also be in writing, but the advice and statement may both be oral. "Contemporaneously prepared documentation in the non-signing tax return preparer's files is sufficient to establish that the statement was given to the taxpayer or other tax return preparer."

Applicable to All Practitioners

Code Sec. 6694 has also been broadened to apply to all matters and not just income tax matters. While Code Sec. 6694 under prior law applied only to income tax returns, Circular 230, §10.34 imposed a similar obligation on all tax advisors.

Increased Penalty Amounts

The penalty for unreasonable positions is increased from $250 to the greater of $1,000 or one-half (1/2) of the preparer's fee for the return (or a claim for refund).[22] The penalty for an understatement due to willful or reckless conduct is increased from $1,000 to the greater of $5,000 or one-half (1/2) of the preparer's fee for the return.[23]

Reasonable Cause Exception

Unless the understatement is due to willful or reckless conduct, there is a reasonable cause exception to the penalty if the practitioner acted in good faith.[24]

Unrealistic Standard

The major concern is that a "more likely than not" standard is unrealistic in the tax world where there are so many factual and legal uncertainties. This is particularly a problem for factual issues. Since many factual issues may reasonably be viewed in more than one way, as long as the position taken by the return preparer was solidly grounded in the facts, there was little risk that the preparer would by subject to a penalty even if the IRS ultimately determined that there was an understatement of liability."[25]

Presumption of Preparer Penalty

If the IRS wants to get ugly with preparers,[26] in effect there would seem to be an initial presumption that a preparer penalty could be imposed whenever the IRS disagrees with a position taken on a return (that is sustained).[27] How will the preparer rebut the return position was more likely than not correct when a determination has already been made that the position was, in fact, not correct?

Reaction of Professionals; Either Extreme Conservatism or "Over disclosure"[28]

There has been a strong adverse reaction to these new rules by the tax professional community. One complaint is that substantial preparer penalties may apply even though there is only a very small tax deficiency. Another complaint is that tax professionals are put in an inherent conflict situation with their clients and may lead to extreme conservatism.[29]

"The new Section 6694 makes practitioners the insurer of the accuracy of their clients' returns. Practitioners likely will react very cautiously to this change in the law. Indeed, some practitioners may conclude that they are better off disclosing every position taken on a return on Form 8275 of 8275-R rather than risk the penalty, and the IRS will be flooded with returns disclosing, on a line-by-line basis, that there is no certainty that each number reflected on the return is more likely than not correct. The Service would be swamped by disclosures, effectively eliminating some of the benefit of the amendment to Section 6694 by offsetting administrative costs. Other practitioners may become more circumspect in the advice they give their clients, which ultimately may lead to less compliance."[30]

The concern of respectable professional tax advisors goes far beyond the monetary penalties that may apply. Well respected professionals point out that the effect with the most impact may be the stigma attached to having preparer penalties being assessed rather than the direct money penalty. Another fear is that an attorney may be censured, possibly publicly, by the IRS or, even worse, have their license to practice before the IRS revoked.

Conclusion

To minimize the impact of the preparer penalties, we should advise our clients of their opportunities to avoid penalties under Code Sec. 6694. In the gift and estate tax context, this can be done by advising our clients about full disclosure or filing Form 8275, or 8275-R as the case may be, whenever there is a valuation issue. Although Notice 2008-13 permits non-written disclosure, the better practice is to reduce the disclosure to writing. Remember to stay tuned for final IRS guidance and "be careful out there."

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ENDNOTES

1. Code Sec. 6694.
2 Code Sec. 6694; circular 230, §10.34(a).
3 Generally, this means a 1 in 3 or greater likelihood of prevailing on the merits. Code Sec. 6694; Treas. Reg. § 1.6694-2(b)(1); ABA Formal Opinion 85-352 also used a one-in three standard.
4. Described in Cod Sec. 6662(d)(2)(B)(ii).
5. Code Sec. 6694(a)(3).
6. Circular 230, § 10.34(a)(2).
7. Treas. Reg. § 1.6694-2(b)(5).
8. Code Sec. 6694(a)(2)(B).
9. Code Sec. 6694(a)(2)(C).
10. Treas. Reg. § 1.6694-2(c)(3).
11. Treas. Reg. § 1.6694-2(c)(3)(ii)
12. Treas. Reg. § 1.6694-1(b)(2).
13. Code Sec. 7701(a)(36)(A); Treas. Reg. § 301-7701-15(a).
14. Treas. Reg. § 1.6694-1(b)(3). Notably, the IRS does not describe what is a "substantial portion."; but see examples in IRS Notice 2008-13,2008-3 I.R.B. 282.
15. Treas. Reg. § 301.7701-15(a)(2).
16. Id. Emphasis added.
17. Circular 230, § 10.34(d)(1).
18. Note the more likely than not standard.
19. Treas. reg. §1.6662-4(d)(3)(iii).
20. Note, Circular 230 requires "the relying practitioner's opinion must identify the other opinion and set forth the conclusions reached in the other opinion." In addition, "the practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements of this section." Circular 230, 10.35(d).
21. Keep in mind, however, that the IRS warned that the final regulations may adopt rules more stringent than the rules described in the Notice.
22. Code Sec. 6694(a)(1).
23. Code Sec. 6694(b)(1).
24. Code Sec. 6694(a)(3).
25. What Hath Congress Wrought? Amended 6694 Will Cause Problems for Everyone, Lipton, Journal of Taxation(August 2007)
26. It should be noted that the IRS has been getting ugly in other contexts. Some practitioners have been criminally charged in close situations, some accounting firms have been required to pay significant penalties and at least one law firm

was forced out of business. In one well publicized case the government was excoriated for using strong hand tactics and threatened to dismiss a criminal case. "White shoe" firms like Sidley, Austin, Brown, & Wood have not been immune from the IRS's heavy hand. In informal conversations with Cono Namorato, formerly Director, IRS Office of Professional Responsibility, the IRS believes that attorneys have been one of the root causes of aggressive tax planning. The IRS's "trust me" position is not comforting.

27. Based on personal conversations with Jonathon Blattmachr of Milbank, Tweed, Hadley & McCoy LLP, one California attorney who had a history of winning FLP audits, was charged with a Circular 230 violation during an audit simply to silence the attorney.

28. The majority of this section is based upon personal conversations of one of the authors with attorneys at large firms while at University of Miami's 2008 Heckerling Institute of Estate Planning.

29. The Changing Face of Compliance, Adams, Trusts and Estates (January 2008).

30. What Hath Congress Wrought? Amended 6694 Will Cause Problems for Everyone, Lipton, Journal of Taxation (August 2007)

MICHIGAN'S SHORT STATUTE OF LIMITATIONS FOR REFUND CLAIMS BASED ON CONSTITUTIONAL CHALLENGES: HARMING THE PERCEPTION OF MICHIGAN'S TAX SYSTEM

Drew M. Taylor, J.D.

I. Introduction

In April 2007, the Council On State Taxation[1](COST) released *The Best and Worst of State Tax Administration: Scorecard on Tax Appeals and Procedural Requirements*.[2] COST regularly publishes the *Scorecard* which "rank[s] the states on their treatment of significant issues which impact the perceived fairness of the rules and requirements for administration and appeal of state tax matters."[3]

The *COST Scorecard*, authored by Douglas L. Lindholm and Stephen P. Kranz, examined a number of different procedural elements, and states were ranked on each.

The *COST Scorecard* considered whether the state has:

- even-handed statutes of limitations,
- equalized interest rates,
- adequate time to file a protest,
- a due date for corporate income tax returns at least 30 days beyond the federal due date, and
- an automatic extension of the state return due date based on the federal extension.[4]

The *Scorecard* uses a points system to rank the states, and a state's ranking decreases the more points it has. COST assessed Michigan two points on the even-handed statutes of limitations issue "for attempting to curtail taxpayers' rights to challenge unconstitutional deprivations."[5]

This article will review Michigan's statute of limitations on assessments and refunds, and analyze the reason for COST's two point assessment, with a brief comparison with Kentucky's similar statute.

II. Ninety-Day Statute of Limitations for Refund Claims Based on Constitutional Challenges

In Michigan, there is a four-year statute of limitations for assessments and a four-year statute of limitations for most (but not all) types of refund claims.[6] MCL 205.27a(6) provides:

> A deficiency, interest, or penalty shall not be assessed after the expiration of 4 years after the date set for the filing of the required return or after the date the return was filed, whichever is later. The taxpayer shall not claim a refund of any amount paid to the department after the expiration of 4 years after the date set for the filing of the original return…

However, where the taxpayer's challenge is constitutional in nature, MCL 205.27a(6) provides a shorter statute of limitations.[7] Only four states have a similar provision. In addition to Michigan, the three other states are Kentucky,[8] New Hampshire,[9] and North Dakota.[10]

Pursuant to MCL 205.27a(6), a taxpayer only has ninety days to file a claim for a refund based upon a constitutional challenge. MCL 205.27a(6) provides: "Notwithstanding the provisions of subsection (2), *a claim for refund based upon the validity of a tax law based on the laws or constitution of the United States or the state constitution of 1963 shall not be paid unless the claim is filed within 90 days* after the date set for filing a return." (Emphasis added.)

Kentucky, New Hampshire, and North Dakota also were assessed points in the *COST Scorecard*. But of the four states, Michigan's ninety-day statute of limitations for refund claims is the shortest.

COST has this to say about uneven statutes of limitations: "[r]equiring taxpayers to meet one statute while the tax administrator is granted additional time is unfair and should not be tolerated in a voluntary tax system."[12] From a policy standpoint, COST certainly is right; uneven statute of limitations obviously do not promote "fair, efficient, and customer-focused tax administration." But beyond the policy question of whether a shortened statute of limitations is fair, what, if anything, can a taxpayer do about it.

III. Judicial Treatment

Taxpayers seeking a judicial remedy will be disappointed. Courts across the country have held that states are free to set "[d]iffering time limits for different refund claims."[13]

The principle question before the courts has been whether the shortened statute of limitations violates the Due Process Clause and the Equal Protection Clause of the state Constitution and United States Constitution. The Equal Protection Clause generally requires that similar persons or objects subject to taxation be treated in a similar manner.[14] The Due Process Clause requires that a state provide a meaningful tax remedy either before the tax is paid (allowing the taxpayer to avoid paying the contested tax) or after it is paid (allowing the taxpayer the opportunity to contest the tax after it is paid).[15]

A. Michigan

The Michigan Court of Appeals considered the constitutionality of MCL 205.27a(6) in the 1996 case

American States Ins Co v State Dept of Treasury.[16] The taxpayers in *American States* were thirty-five out-of-state insurance companies. The taxpayers were seeking refunds based on the recalculation of their retaliatory tax liability, when section 134(6)(g) of the Insurance Code was held unconstitutional.[17] The Michigan Department of Treasury denied the claims as untimely under MCL 205.27a(6). The Court of Claims upheld the department's decision. The taxpayers appealed to the Michigan Court of Appeals. The taxpayers argued that MCL 205.27a(6) violated the Due Process Clause and Equal Protection Clause of the United States and Michigan Constitutions. In both regards, the Court of Appeals disagreed and held MCL 205.27a(6) valid. On March 31, 1998, the Michigan Supreme Court denied leave to appeal.

On the issue of Due Process, the Michigan Court of Appeals held "the ninety-day limitation period found in [MCL 205.27a(6)] is a constitutionally valid limitation on plaintiffs' postdeprivation remedy"[18] and "passes due process muster…."[19]

The taxpayers in *American States* also argued that MCL 205.27a(6), "which treats preemption claimants differently than others seeking a tax refund, violates the Equal Protection Clauses of the United States and Michigan Constitutions."[20] The taxpayer's agreement here was that the Court of Claims erroneously applied the rational basis standard, and should have instead reviewed the statute through the lens of "strict scrutiny."[21]

The Michigan Court of Appeals disagreed. The taxpayers did not constitute a "suspect class," and the operation of the statute of limitations by denying the plaintiffs a tax refund did not impinge upon a "fundamental right."[22] Therefore, the statute was not subject to "strict scrutiny," and the court applied the rational basis standard. Under this deferential standard, the court held MCL 205.27a(6) was constitutional, even though it treated claimants who claimed a refund because a state statute has been pre-empted by federal law or the state constitution differently than other claimants. The court held that "[p]rotection of the state treasury certainly qualifies as a legitimate state interest"[23]and agreed with Treasury's "common-sense reasoning"[24] that MCL 205.27a(6) "helps protect the state treasury from devastating claims"[25] that could have an "enormous effect on the state treasury."[26] Even though MCL 205.27a(6) may not "perfectly fulfill its purpose,"[27] it still bears a "rational relationship to that purpose sufficient to satisfy equal protection guarantees."[28]

B. KENTUCKY

Kentucky also has a different statute of limitations for refund claims based on constitutional challenges. Kentucky provides a two-year limitation for such claims, and a four-year limitation period for all other refund claims.

In the 1994 case *Revenue Cabinet v Gossum*,[29] decided two years before *American States*,[30] the Kentucky Supreme Court affirmed the lower court's decision that a two-year statute of limitations for refund claims based on constitutional challenges withstood equal protection scrutiny. The Kentucky Supreme Court held that Ky. Rev. Stat. Ann. § 134.590(2) was rationally related to the furthering of a legitimate state interest, namely Kentucky's interest in fiscal security. The Court noted that "refunds under an unconstitutional statute will involve multitudes of taxpayers and millions of dollars."[31]

It is apparent that courts are not going to strike down uneven statutes of limitations.

Therefore, the taxpayer's remedy lies in the legislature.

IV. CONCLUSION

In the words of the *COST Scorecard* authors, "the *Scorecard* gives states the opportunity to enact corrective legislation as a means of improving business climates."[32] I suggest Michigan legislators take COST's hint. Even though MCL 205.27a(6) is constitutional does not mean it is good tax policy. Michigan does not need to perpetuate the complexity of its tax system with a restriction like MCL 205.27a(6), and only serves to increase taxpayer perception of unfairness. While in the eyes of the courts, shortened statutes of limitations for refund claims based on constitutional challenges may be rationally related to the protection of the state's treasury, they certainly do not appear to be necessary. If shortening the statute of limitations for refund claims based on constitutional challenges is so effective in preventing "financial chaos,"[33] why then have only three other states adopted a similar provision?

It is incumbent upon Michigan legislators to strike MCL 205.27a(6) from the Revenue Act.

And maybe Michigan can recoup those 2 points in COST's next scorecard.

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ENDNOTES

This article is provided for general information purposes only and should not be relied upon as legal advice or opinion.

1. Council On State Taxation (COST), *COST Policy Statements, COST Public Policy Objectives, available at* http://www.statetax.org/uploadedFiles/About_COST/Policy_Statement/COSTPublicPolicyObjectives.pdf (last visited March 11, 2008). COST's policy mission is "to preserve and promote equitable and nondiscriminatory taxation of multijurisdictional business entities."
2. Douglas L. Lindholm and Stephen P. Kranz, *The Best and Worst of State Tax Administration: Scorecard on Tax Appeals and Procedural Requirement*, Council On State Taxation (COST) (April 2007). In the Executive Summary, the authors write: "The Council On State Taxation (COST) has long monitored and commented on state tax administrative practices."

3. *COST Scorecard*, page 1.
4. *COST Scorecard*, page 2.
5. *Id.* COST assessed Michigan eight points, earning it a B- The A range is zero to four points; the B range five to eight points. Michigan was assessed one point on the issue of interest rates, two points for its protest period, and three points for other key issues. COST notes that in Michigan: "Refunds must be requested explicitly on the face of a return or in a separate request or correspondence in order to commence the refund payment process. Interest on a refund begins to run forty-five days after the refund is requested."
6. MCL 211.27a(2). The only state where the statute of limitations for refunds and assessments do not mirror each other is Pennsylvania. 72 Pa. Cons. Stat. § 7407; 72 Pa. Cons. Stat. § 10003.1(a).
7. The Revenue Act was amended by PA 58 of 1986, effective May 1, 1986.
8. Ky. Rev. Stat. Ann. § 134.590(2). Ky. Rev. Stat. Ann. § 134.590(2) states: "No state government agency shall authorize a refund unless each taxpayer individually applies for a refund within two (2) years from the date the taxpayer paid the tax."
9. N.H. Rev. Stat. Ann. § 21-J:29.I.(c) provides:
   Notwithstanding subparagraph I(b), any claim for a refund or credit of taxes, penalties or interest paid as a result of an assessment or demand for payment shall be made within 3 years of the due date of the tax upon which such refund is claimed.

   > Notwithstanding subparagraphs I(b) and (c), any claim for a refund or credit of taxes based upon a claim that the tax or any provision thereof is unconstitutional under the federal or state constitution shall be made *within 120 days* of the due date of the tax upon which such refund is claimed. (Emphasis added.)
10. Of the four states discussed, North Dakota is the latest to have restricted the statute of limitations for refund claims based on constitutional challenges. During the 2005 Legislative Session, the 59th Legislative Assembly of North Dakota enacted Senate Bill 2132. This Act created N.D. Cent. Code § 57-01-19, which provides:

    > Notwithstanding any provision relating to claims for refund or credit of state taxes paid contained in title 57, any claim for a refund or credit of taxes paid based upon a claim that the tax or any provision thereof is unconstitutional under the federal or state constitution must be made within *one hundred eighty days* of the due date of the return or payment of the tax, whichever occurs first, for which the refund or credit is claimed. A claim for refund or credit of taxes paid before January 1, 2005, based upon a claim that the tax or any provision thereof is unconstitutional that is not filed with the commissioner before July 1, 2005, must be denied. This section does not apply to ad valorem property taxes. (Emphasis added.)
11. Michigan Revenue Administrative Bulletin 1996-4, 05/13/1996 states: "[t]he legislature has waived this 90-day limitation period for refund claims involving pension income received from the United States government for tax years 1984-1988. [See MCL 205.27a(7)]."
12. *COST Scorecard*, page 8.
13. Dale Joseph Gilsinger, *Annotation, Validity and Applicability of Statutory Time Limit Concerning Taxpayer's Claim for State Tax Refund*, 1 A.L.R. 6th 1 (2005). Mr. Gilsinger's article examined the issue of "[d]iffering time limits for different refund claims."
14. U.S. Const., art XIV. In general, Equal Protection requires that all persons be treated equally under the law. In *Santa Clara County v Southern Pac R Co*, 118 U.S. 394 (1886), the Court determined that the term "person" included corporations.
15. *McKesson Corp v Division of Alcoholic Beverages & Tobacco*, 496 US 18, 36-39 (1990).
16. *American States Ins Co v State Dept of Treasury*, 220 Mich App 586, 560 NW2d 644 (1996); lv den 456 Mich 952, 577 NW2d 683 (1998).
17. MCL 500.134(6)(g); MSA 24.1134(6)(g).
18. *Id.* at 591, 560 NW2d at 647.
19. *Id.*
20. *Id.*, citing U.S. Const. Amend. XIV; MI Const., art 1, § 2 (1963).
21. *Id.* at 592, 560 NW2d at 648. The discussion in *American States* on the application of the rational basis standard:

    > When legislation is challenged as being in violation of the equal protection guarantee, it is subjected to judicial scrutiny to determine whether the goals of the legislation justify the differential treatment it authorizes. *Doe v Dep't of Social Services,* 439 Mich 650, 661-662, 487 NW 2d 166 (1992). Different review standards apply to different kinds of cases. A rational basis standard is used for the review of most legislation, meaning that "a statute will not be struck down if the classification scheme it creates is rationally related to a legitimate governmental purpose." Id. at 662, 487 NW 2d 166.
22. *Id.* at 592-593, 560 NW2d at 648, citing *Doe v Dep't of Social Services*, 439 Mich 650, 662, 487 NW2d 166 (1992). The Court of Appeals' discussion of strict scrutiny: "If a suspect class is being treated differentially by a statute or if the statute impinges upon the exercise of a fundamental right, 'strict scrutiny' is applied, and the statute will be upheld only if its classification scheme has been precisely tailored to serve a compelling governmental interest."
23. *Id.* at 597-598, 560 NW2d at 650, citing *McKesson Corp v Division of Alcoholic Beverages & Tobacco*, 496 US 18, 36-39 (1990). "Protection of the state treasury is certainly a legitimate state purpose."
24. *Id.* at 598, 560 NW2d at 650.
25. *Id.*
26. *Id.* at 597, 560 NW2d at 650.
27. *Id.* at 598, 560 NW2d at 650.
28. *Id.*
29. *Revenue Cabinet v Gossum*, 887 SW2d 329 (Ky.1994).
30. *American States*, 220 Mich App at 596, 560 NW2d at 649. The Michigan Court of Appeals cited *Gossum* in *American States* for the proposition that MCL 205.27a(6) did not impinge on any fundamental right of the taxpayers.

31. *Gossum*, 887 SW2d at 335.
32. *COST Scorecard*, page 2.
33 Mitchell Bean and Marjorie Bilyeu, Michigan's *Short Statute of Limitations: Applying to Tax Laws A Constitutional Controversy, Fiscal Forum*, Volume 3, Number 2, October 1, 1997, available at http://house.michigan.gov/hfa/PDFs/ninetyday.pdf (last visited March 13, 2008). This article was published while the application for leave to appeal at the Michigan Supreme Court was pending in *American States*. The authors contend that MCL 205.27a(6) "has limited the state's exposure to fiscal chaos resulting from tax refunds."

A MALPRACTICE TRAP FOR UNWARY TAXPAYER ADVISORS "SETTLING" STATE TAX DISPUTES WITH THE MICHIGAN DEPARTMENT OF TREASURY

Samuel J. McKim, III
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A recent published decision of the Court of Appeals will have perhaps the unintended, but likely result of placing Michigan taxpayers and those who represent and advise them in serious jeopardy whenever a Michigan Department of Treasury ("Department") tax audit or request for refund could be settled short of litigation. That decision, handed down in *Tyson Foods, Inc. v. Department of Treasury*, ___ Mich ___; ___ NW2d ___ (COA Docket No. 272929) (2007), reversing a Court of Claims' decision, held that the Department can issue successive assessments against the same taxpayer with respect to the same tax issues for the same years. This means that (i) any taxpayer which negotiates an acceptable audit or refund result with the Department's auditors and/or audit supervisors, (ii) any taxpayer which negotiates a settlement with the Department during the informal conference preceding the issuance of the Department's final assessment, and (iii) any taxpayer which accepts the result of a Department audit and/or Department decision and order of determination, cannot now do so with the assurance that the agreements reached for those tax years are final and binding on the Department.

As a result of this construction of the Michigan Department of Revenue Act[1] by the *Tyson Foods* decision, the Department is now free in many situations to initiate new audits and issue assessments, notwithstanding having settled an earlier audit and/or intent to assess[2] which the taxpayer understood would, and which was intended to resolve the issues involved for the tax periods at issue. Additionally, there is the risk that any person advising a taxpayer in such a proceeding who does not clarify to the taxpayer that the Department may be free, so long as the statute of limitations has not run,[3] to issue a second or even a third assessment under the same tax involving the same issues and tax years, may be at risk of a malpractice claim.

This possibility should effectively eliminate negotiated settlements between taxpayers and the Department where the taxpayer believes the Department may have the ability to issue subsequent assessments for additional deficiencies. While some might assume that it is not in the Department's interest to attempt to assess the same taxpayer twice, on the same issues, for the period, that is precisely the situation that was involved in the same *Tyson Foods* case.[4]

In *Tyson Foods*, the taxpayer, believing as had literally thousands of other out-of-state businesses, that it could rely upon the Department's published assurances in RAB 1989-46 that the Department would apply the cases decided under Public Law 86-272[5] in determining whether it would assert jurisdiction under the Michigan Single Business Tax Act, had not filed SBT returns for the years 1988 through 1996. In 1998, the Department ignored its still-outstanding RAB 1989-46, and issued an Intent to Assess, without attempting to avail itself of readily available information upon which it could have produced an informed assessment. The taxpayer, now alerted that notwithstanding its published assurances to the contrary the Department intended to follow the Court of Appeals' decision in *Gillette v. Department of Treasury*,[6] did not request an informal conference,[7] and upon receiving the Department's Final Assessment, which included a 50% non-filing penalty, paid the same in full and immediately began filing SBT returns and the respective taxes due. The Department later audited these subsequent year returns and came to the conclusion that its assessment for the earlier years was too low. The Department then audited the earlier years for which it had already issued the 1998 first Final Assessment, which had been paid in full, and issued a second Intent to Assess, plus another 50% penalty and interest, in the millions of dollars.[8] At the informal comference, the Department refused at the to address the issue as to whether under the Revenue Act it had the power to assess the same taxpayer a second time under the same tax act for the same tax years asserting later in discovery that "the Department… is not required to respond to all legal challenges…regarding its administration of various tax laws."[9]

The Department's 1998 first Final Assessment covering the 1988-1996 years, was limited to an assessment of $25,000 for each year, this being the maximum amount an unpublished policy of the Department permitted it to issue when the assessment involved was arbitrary and not founded on an informed belief as to the amount of taxes due. During oral arguments in the Court of Claims, counsel for the Department stated that he assumed that the Department had a rational factual basis for the amount being assessed for each year, but later admitted in its Court of Appeals brief[10] there was no such basis other than the Department's unpublished policy limit applicable to unauthorized arbitrary assessments.[11]

The Court of Claims granted the taxpayer's Motion for Summary Disposition, concluding that the Revenue Act did not permit the Department to issue a second assessment in such circumstances, there having been no allegations as to taxpayer fraudulent concealment and/or taxpayer failure to inform the Department as to changes in its federal taxable income, for which statutory power to issue a second assessment was specifically granted.[12]

The Court of Appeals reversed, in what can only be characterized as a "result-oriented decision,"[13] concluding, *inter alia*, that the second "final" assessment was permitted under Revenue Act Section 21(1), which permitted the Department to audit and subsequently issue an assessment where "…the Department has reason to believe that a return made or payment does not supply sufficient information for an accurate determination of the amount of tax due." The fact that the taxpayer paid in full the Department's 1998 first Final Assessment without filing at the same time SBT tax returns for those years, was illogically held to have given the

Department "reason to believe that a…payment does not supply sufficient information for an accurate determination of the amount of tax due." How this could possibly be true where the taxpayer had just paid in full the Department's final tax assessment which is statutorily required to reflect the Department's informed "belief" of the "accurate" amount of tax due was not explained.[14] The Court of Appeals ignored the fact that the Revenue Act anticipated but a single assessment, because that was all that was necessary based on the Department's informed position as to what "the Department believes the taxpayer owed."[15] It ignored the fact, relied upon by the Court of Claims, that a second assessment was specifically provided for, but only where there had been fraudulent concealment or failure to report a change in federal taxable income, establishing that otherwise no other assessment was permitted.[16] The Court of Appeals further concluded that the "finality provisions" found in Sections 21 and 22 of the Revenue Act apply only with respect to appeals from a Department final assessment, and therefore did not merit the Court of Appeals analysis.[17]

Interestingly, the Court of Appeals' Opinion concluded with a footnote which seemed to recognize the problems which its Opinion would create, at the expense of attempting to garner additional revenue for the State. The Court of Appeals acknowledged,

> "We recognize that it is neither good government nor good policy to permit the Department of Treasury to have a seemingly unlimited power to issue multiple tax assessments to a taxpayer for the same tax period. At some point a taxpayer is entitled to the security of knowing that its tax liability for a tax period has been discharged or satisfied. In this regard, we note that the defendant should have audited plaintiff before issuing the first intent to assess and final assessment in order to insure that the assessment was based on plaintiff's actual tax liability and no merely speculation. If defendant had made the effort to ascertain a true and accurate assessment of plaintiff's tax liability at the outset, the second intent to assess and final assessment would have been unnecessary. …Ultimately, while we acknowledge the possibility of an unfair result under different facts, we believe this result was the intention of the Legislature as articulated in the relevant provisions of the revenue act. If we are incorrect, we urge the Legislature to specifically clarify this issue in the revenue act or the SBTA."

The taxpayer applied for leave to appeal to the Michigan Supreme Court in January of 2008. If leave to appeal is granted, the COA Opinion should be, and probably will be, reversed. If leave is not granted, then it will be up to the Legislature. Either approach to correcting this troublesome ruling will likely take some time. In the meanwhile, tax consultants and advisors should be aware that settling with the Department at any stage short of litigation can provide a trap for the unwary.

There is no other Michigan legislation which could ameliorate or expand the pertinent provisions of the Revenue Act. Since the Revenue Act did not contemplate the issuance by the Department of an arbitrary assessment, authorizing only the issuance of an assessment which reflected the Department's informed "belief" as to the "accurate" amount of taxes due,[18] the plain language of the Revenue Act would suggest that only a single assessment is authorized, absent taxpayer fraud and/or failure to report a change in federal taxable income. This is because these two circumstances are the basis for the specific statutory grant of authority for an additional assessment in Section 27a(2).[19] These provisions dovetail with the provision in Section 22(5) which provides that, "An assessment is final, conclusive, and not subject to further challenge after 90 days after the issuance of the assessment, decision, or order of the Department, and a person is not entitled to a refund of any tax, interest, or penalty paid pursuant to an assessment unless the aggrieved person has appealed the assessment in a manner provided by this section." This latter provision does not apply only in the context of appeals from the Department's final decision, or even as to the result of a taxpayer having not taken such an appeal, which circumstances are specifically dealt with in the two preceding "finality" provisions in Section 21 and Section 22. [20] While it would mean the Department may collect fewer dollars from taxpayers than the amount of taxes to which it would have been entitled had it not "guessed" too low on its first arbitrary Final Assessment, which under the language of Section 22(4) became final and "not reviewable in any court by mandamus, appeal, or other method of direct or collateral attack," the Court of Appeals' emphasis on collecting all revenues possibly due the State, at the expense of depriving taxpayers of the assurance of finality they would otherwise have had under the language of the Revenue Act, is ill-advised.[21]

The problem this decision creates in Michigan is one not frequently encountered in Federal tax practice or under the laws of most other states. This is because Section 28(1)(e) of the Revenue Act provides, except in circumstances not here relevant, that "the state treasurer or an employee of the department shall not compromise or reduce in any manner the taxes due or claimed by this state… This subdivision does permit a compromise of interest or penalties, or both." Non-compliance with this provision is in Section 28(2) established as a felony, also requiring termination of Department employment.[22] The Department of Treasury has, accordingly, repeatedly concluded that it has no power to compromise any taxes (as opposed to penalties and interest) which may be or may become due the State.[23]

The normal "closure letter" executed by the taxing entity in connection with an administrative settlement would, in Michigan, therefore not only probably be void as against public policy, but could submit the Department employee to felony prosecution and termination of employment. The Department cannot, in connection with an audit or refund "settlement," agree that it will not later pursue the taxpayer under the same act for the same years if it later believes additional taxes may be due, since the Court of Appeals has now concluded that such a second assessment may be permitted by the Revenue Act. It is also now admitted by the Department that it does issue assessments with the (non-disclosed) intent it may issue a second assessment later should it believe additional taxes are due. Thus, taxpayers and their advisors who wish to accomplish a truly final and conclusive settlement must appeal Department assessments and decisions to the Tax Tribunal and/or Court of Claims.[24]

Section 22 of the Revenue Act permits a taxpayer to appeal the "contested portion of the assessment, decision, or order" of the Department to the Tax Tribunal within 35 days, or within 90 days after paying under written protest, to the Court of Claims.[25] It is the practice in Michigan that once the Department is made a party to a Tax Tribunal or Court of Claims appeal, the Attorney General's Office will appear to represent the Department. The Attorney General is empowered to consider the hazards of litigation and to settle or compromise such tax appeals. Therefore, taxpayers appealing to the Tax Tribunal or Court of Claims can, should settlement be agreed to with the Assistant Attorney General representing the Department, enter into a consent judgment which if properly structured and worded, should permit the taxpayer to later argue that the taxpayer's tax liability under that tax act, for the years on those issues, had been finally resolved, under the principles of *res judicata and/or collateral estoppel*.[26]

Careful taxpayers and their advisors will, should the Supreme Court not grant leave in and reverse the Tyson Foods case and until the Legislature chooses to act, not settle with the Department until an appeal has been filed from the Department's Final Assessment or refund request decision and the settlement agreement has been incorporated in a final order of the Court of Claims or Tax Tribunal. While this may bring hundreds if not thousands of additional cases to the courts each year, the possibility of such a multiplicity of litigation was called to the attention of the Court of Appeals on brief, but was ignored by its decision which, acknowledging that it may lead to "unfair results," seemed more oriented toward making certain that the State's revenues were maximized.

There is an additional potential problem in Section 21(3) of the Revenue Act, which provides,

> "(3) If a protest of the notice of intent to assess the tax is determined by the department to be a frivolous protest or a desire by the taxpayer to delay or impede the administration of taxes administered under this act, a penalty of $25.00 or 25% of the amount of tax under protest, whichever is greater, shall be added to the tax."

Taxpayers reaching tentative agreements with the Department's auditors and/or audit supervisors on audit, accordingly, must keep this provision in mind. The Section 21(3) 25% penalty does not apparently apply, however, if the taxpayer does not request an Informal Conference and permits the Notice of Intent to Assess to automatically become a "Final Assessment."[27] There is no similar specific penalty provided when an appeal without payment of the tax is taken to the Tax Tribunal or after payment under protest to the Court of Claims, where the taxpayer believes that it and the Department have reached an accord but is taking the appeal so that the accord can be reflected in a judgment according the taxpayer the protection of *res judicata and collateral estoppel*. Query whether an appeal to the Tax Tribunal or Court of Claims would be deemed to be a frivolous protest if the reason for that appeal was that the taxpayer wished to be able to formally establish the settlement agreement it had tentatively reached with the Department. Because the settlement would not otherwise have been agreed to the appeal should not be protested by the Department as "frivolous."

While an appeal can be taken to the Tax Tribunal without paying a contested assessment, section 22(1) provides "The uncontested portion of an assessment, order, or decision shall be paid as a prerequisite to appeal."[28] While not involving a "penalty," this provision could arguably relate to the subject matter jurisdiction of the tribunal. However, if the amount agreed to be paid in settlement was required to be the "final and conclusive amount of taxes due," for example, since the Department cannot agree to such an assurance there would arguably not be an uncontested amount which had been agreed to. To appeal to the Court of Claims the tax must be paid in full under protest in advance.[29]

SUMMARY

The Court of Appeals' recent published opinion in *Tyson Foods, Inc. v. Dep't. of Treasury* has opened a Pandora's Box. On an issue of first impression, this decision construed the Revenue Act as permitting, "multiple tax assessments to a taxpayer for the same tax period", even where there is no allegation of fraudulent concealment or failure to report a change in federal taxable income. Because of other provisions in the Revenue Act criminalizing any attempt by the Department to compromise taxes which may be due to the State, the Department cannot, and will not, sign closure letters when settling an assessment or refund request short of litigation. Because the Revenue Act has now been construed as permitting multiple successive assessments in many circumstances, the Department may now be permitted to reassess, and indeed, may be required to reassess, if the period of limitations has not run, whenever it becomes aware of a reason to believe additional taxes may be due. A taxpayer cannot assume that a prior assessment settlement short of litigation, will preclude the Department from "reopening" the years involved with a new assessment.

A Department "letter ruling" may not act as such a closure letter and, because it would be required to be published would most likely not be available. A Department agreement by way of settlement, short of litigation, cannot be relied upon to preclude the issuance later of a new assessment relating to the same tax and tax years, essentially ignoring the earlier "settlement."

That the Department has been willing to assess a second time when it realized that additional taxes may be due was established in the *Tyson Foods* case. That the Department will retroactively apply new constructions of tax and constitutional law notwithstanding having earlier published "binding" assurances to the contrary, was established by the *Gillette* case and its progeny.[30] Taxpayers and its advisors cannot now assume that a settlement with the Department will be binding and conclusive without appealing to the Tax Tribunal or Court of Claims and incorporating the settlement in an appropriately worded "court" order, permitting the taxpayer to assert the principles of *res judicata and collateral estoppel*.

Such a procedure could involve other potential problems under the Revenue Act, but should not be precluded if carefully thought out and structured. It could possibly eliminate the use of the Informal Conference procedure to avoid a potential 25% penalty for appealing "uncontested" assessed taxes to the Informal Conference.

Hopefully, the Supreme Court will grant leave to appeal and reverse *Tyson Foods* or, the Legislature will act to clarify the Revenue Act which the Court of Appeals found to be ambiguous. Until then, taxpayers, if they are unwilling to base their Michigan administrative tax assessments settlements with the Department on simple "trust," knowing that the Department may believe it may be beyond its power to decline to assess a second time, must appeal every assessment or refund decision of the Department to the Tax Tribunal or Court of Claims to avail of the assurance of finality accorded by the principles of res judicata and collateral estoppel under a carefully worded "court" approved settlement.

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ENDNOTES

1. MCL 205.1 et seq (the "Revenue Act") (Hereinafter Revenue Act provisions will be referenced by section numbers only.)
2. Department audits can be negotiated and settled between the taxpayer and the auditor before or at the audit exit conference. Likewise, a settlement can be reached prior to the issuance of the Department's final assessment. See, e.g., RAB 1994-1
3. Section 205.27a(3)(a) provides that the running of the four-year statute of limitations on the Department's right to assess is suspended pending the final determination of tax under an audit, conference, hearing, or litigation and for one year after. Section 27a(4) limits the suspension to "…those items that were the subject of the audit, conference, hearing, or litigation…" The term "items" has not been defined. Accordingly, if a taxpayer was assessed in year two, and the audit informal conference and issuance of the "final assessment" consumed four years, it would be open to reassessment under the statute of limitations long after the expiration of the original 4-year period of limitation.
4. The Department has also been willing to retroactively pursue taxpayers for additional taxes due under new theories and constructions ordered by the courts, even where they contradict the Department's earlier published assurances as to the correct tax theory and/or construction. (See, e.g., *Gillette Co. v. Dep't. of Treasury*, 198 Mich App 303; 479 NW2d 595 (1993), lv. den. 445 Mich 860 (1994), *cert. den*. 513 U.S. 1103; 1155 S. Ct. 779 (1995) and *J. W. Hobbs Corp. v. Dep't. of Treasury*, 368 Mich App 38, 43-51; 706 NW2d 460 (2005), *lv den* 478 Mich 865; 731 NW2d 734 (2007).
5. 15 U.S.C. §382.
6. The Department also ignored its RAB 1989-34 published assurance that it would be bound by its non-rescinded RABs. RAB 1989-34, replacing RAB 1987-2, provided, *inter alia*, "A Revenue Administrative Bulletin states the official position of the Department, has the status of precedent in the disposition of cases unless and until resolved or modified, and may be relied upon by taxpayers…" (See *J.W. Hobbs Corp. v. Dep't. of Treasury*, 268 Mich App 38, 47; 706 NW2d 460 (2005), where the Court noted the *Gillette* decision did not mandate that the Department retroactively abandon the assurances given in its then-extant RAB, calling the Department's doing so a reprehensible "bait and switch" tactic. .
7. The administrative review procedure for assessments is outlined in Section 21 of the Revenue Act. The Department is authorized to obtain "information on which to base an assessment of the tax," by examinations and audit, where a "taxpayer fails or refuses to make a return or payment" or "if the department has reason to believe that a return made or payment does not supply sufficient information for an accurate determination of the amount of tax due." The taxpayer is notified of the Department's concerns, and ultimately receives a "notice of intent" to levy the tax. The taxpayer can, within 60 days, after paying any uncontested amounts, request an "informal conference" following which the Department will issue its "final assessment." A final assessment will automatically follow if the taxpayer receiving a notice of intent to assess and does not request the informal conference. See also, Rules 205.1008-205.1010.
8. Section 24(1) provides a penalty for failure or refusal to file a return or pay a tax of 4% per month up to 50%.
9. Defendant's Answers to Plaintiff's 2nd Request for Admissions, ¶18, Court of Brief Claims No. 05-159-MT.
10. Department's Brief on Appeal in Court of Appeals, p. 14. (COA Docket No. 272929)
11. There is no statutory authority which permits the Department to issue an arbitrary tax assessment where the taxpayer has maintained and would produce appropriate books and records from which the Department can meet the Section 21 statutory requirement that it assess based on an informed belief as to the accurate amount of taxes due.
12. Section 27a(2) provides, *inter alia*, "If a person subject to tax fraudulently conceals any liability for the tax or a part of the tax, or fails to notify the department of any alternation in or modification of federal tax liability, the department within 2 years after discovery…shall assess the tax with penalties and interest as provided by this act…"
13. See, e.g., *Mayor of City of Lansing v. P.S.C.*, 470 Mich. 159, 164; 680 NW2d 846 (2004).
14. Section 21(2)(b) requires that the Department's intent to assess state "the amount of tax the department <u>believes</u> the taxpayer owes" (emphasis added). Section 21(1) empowers the Department to obtain information necessary "for an <u>accurate</u> determination of the amount of tax due." (Emphasis added.) Section 21(2)(e) only permits the Department to assess, if no informal conference is timely requested, "… the tax that the department <u>believes</u> are due and payable." (Emphasis added.)

15. See preceding footnote.
16. See note 13, *supra*.
17. Section 21(2)(f) provides that the Department's assessment after an informal conference or if no conference was requested "…is final and subject to appeal as provided in Section 22." Section 22 provides, "(4) The assessment, decision, or order of the department, if not appealed in accordance with this section, if final and is not reviewable in any court by mandamus, appeal, or other method of direct or collateral attack," and "(5) An assessment is final, conclusive, and not subject to further challenge after 90 days after the issuance of the assessment, decision, or order of the department, and a person is not entitled to a refund of any tax, interest, or penalty paid pursuant to an assessment unless the aggrieved person has appealed the assessment in the manner provided by this section." (See also, 1994 RAB No. 1.)
18. See notes 8 and 15, *supra*.
19. See note 11, *supra*.
20. See note 15, *supra*.
21. The Court of Appeals' decision presumed the Revenue Act was ambiguous although it did not point to any specific ambiguous language. It determined that because the taxpayer had not filed returns, even though it had promptly paid the Department's first Final Assessment in full, the legislative purpose and intent that all possibly due taxes be collected required the Act to be construed (misconstrued?) to permit successive assessments. The Court correctly acknowledged that this approach and construction could lead to "…an unfair result under different facts…"
22. Section 28(2) provides, "(2) A person who violates subsection (1)(e), (1)(f), or (4) is guilty of a felony, punishable by a fine of not more than $5,000.00, or imprisonment for not more than 5 years, or both, together with the costs of prosecution. In addition, if the offense is committed by an employee of this state, the person shall be dismissed from office or discharged from employment upon conviction." (See generally, *Galperin v. Dep't of Revenue*, 327 Mich 556, 42 Nw2d 823 (1950).)
23. See, e.g., 1994 RAB No. 1.
24. Section 6a of the Revenue Act was recently added by PA 2006 No. 12, effective February 3, 2006. This provision would possibly permit a taxpayer to settle with the Department short of an appeal to the Tax Tribunal or Court of Claims if the Department were to issue a "letter ruling." However, the definition of "letter ruling" relates only to "a specific tax matter related to a future transaction." Even if the settlement were deemed to involve such a "future transaction," a questionable assertion, the statute only provides the taxpayer will not be "penalized" if the Department reneges, without defining what "penalize" means. Further, Section 3(f) requires all letter rulings to be published, effectively (given the Department's reluctance to issue and publish letter rulings) eliminating such letter rulings as "closing letters" in pre-litigation settlements.
25. See, Nowak, G., *A Tale of Two Forums – Litigating State Taxes*, 69 MICH. B. J. 826 (1990).
26. See, e.g., *Nummer v Dep't of Treasury*, 448 Mich 534; 533 Mich 250 (1995); *Schwartz v Flint*, 187 Mich App 191, 194; 466 NW2d 367 (1991); *Jones v State Farm Ins Co*, 202 Mich App 393, 401; 509 NW2d 829 (1993); *Zantop Int'l Airlines, Inc v Dep't of Treasury*, 12 MTT 460, 465 (2003) and *County of Wayne v. City of Detroit*, 9 MTT 765 (1997). The factual issue would not be whether the particular assessment settlement was correct, but rather that the decision established would establish the full amount of taxes due.
27. See note 8, *supra*. See also, Section 21(2)(c) which provides, "(c) If the taxpayer serves written notice upon the department within 60 days after the taxpayer receives a notice of intent to assess, remits the uncontested portion of the liability, and provides a statement of the contested amounts and an explanation of the dispute, the taxpayer is entitled to an informal conference on the question of liability for the assessment."
28. "Section 21(1) A taxpayer aggrieved by an assessment, decision, or order of the department may appeal the contested portion of the assessment, decision, or order to the tax tribunal within 35 days, or to the court of claims within 90 days after the assessment, decision, or order. The uncontested portion of an assessment, order, or decision shall be paid as a prerequisite to appeal…. (2)….In an appeal to the Court of Claims, the appellant shall first pay the tax, including any applicable penalties and interest under protest and claim a refund as part of the appeal."
29. Id.
30. See, Gandhi, L., *International Home Foods, Inc., a Final Determination of the Retroactive Application of Michigan's Single Business Tax Nexus Standards*, 33 MICH TAX LAWYER, p. 18 (Winter 2007).

STUDENT TAX NOTES

THE TAX TREATMENT OF TRANSFERABLE DEVELOPMENT RIGHTS

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I. Introduction

Michigan's economic redevelopment is an ongoing struggle aided by various state sponsored methods including development programs and tax incentives. For example, Michigan's Renaissance Zones program waives state taxes for businesses and individuals located in specified areas.[1] Recently, groups within the state have proposed that the state adopt a transfer of development rights (TDR) program[2] to complement existing redevelopment programs.[3] TDRs may provide a less expensive means of reducing undesirable development than traditional zoning restrictions while simultaneously encouraging development where it is needed.

Numerous states have adopted TDR programs to promote urban development and preservation of historical properties and open spaces, but the tax consequences of the receipt or transfer of TDRs have received little attention.[4] This is unfortunate because excluding or reducing state taxes could encourage voluntary participation in a TDR program and mollify landowners who are granted TDRs as compensation for regulatory takings.[5] Since a TDR is a separate property right, a landowner must determine his basis in a TDR and any taxable gain incurred upon its receipt and subsequent sale. As discussed herein, the author has concluded that the receipt and subsequent sale of a TDR will cause an original landowner to incur little or no federal and state income tax liability. The state should consider codifying this situation for state tax purposes to provide greater assurances to landowners and to exclude any small amount of state income taxes that might be incurred under current law. Since a TDR is generally freely transferable[6] and can be held as investment property, the state should also consider tax waivers to subsequent transferors to encourage voluntary participation in a TDR program.

II. What is a TDR program and how is it implemented?

A TDR program is a low-cost method to reduce development in fragile or historic areas and redirect development to urban cores.[7] Cities or counties create and implement TDR programs pursuant to their zoning power.[8] The development right itself is severed from a landowner's fee simple and may be transferred to another party who can use the right to override zoning limitations or hold it as an investment. A local government may grant a TDR as compensation for a regulatory taking, e.g., restrictive zoning amendments, or at the landowner's request.

The basic components of a TDR program are a sending area and a receiving area. Landowners in the sending area may sever from their property certain development rights allowed by existing zoning standards; the landowner is permitted to transfer those development rights and thereby capture their economic value. After the development right is severed, the underlying property is perpetually restricted to the remaining development rights; the restriction is usually implemented by a deed modification or a conservation easement. Landowners in the receiving area may purchase a severed development right and use it to override zoning restrictions. While the sending area could be any place within a local government's jurisdiction, the receiving areas are usually discrete redevelopment zones. For example, a landowner in a sending area who is currently allowed to build up to 5,000 square feet of residential property could sell 2,000 square feet of that right to a landowner in a receiving zone who will add that capacity to a development project in order to exceed zoning limits, subject to maximums set in the TDR ordinance. Unused development rights may also be traded as investment property.

TDR programs can take many different forms. For example, legislators may specify either mandatory or voluntary landowner participation, or leave the choice to local governments.[9] Sending and receiving areas could be designated to fulfill certain goals of the local jurisdiction. State tax provisions could be left untouched or could be modified. If modified, the legislature could choose to do so generally, or it could provide different tax treatment for specific circumstances. For example, the legislature could abate, in whole or in part, sales use taxes, property taxes, determination of tax basis, and/or the amount of taxable gain associated with the sending and receiving of interests under a TDR program.

III. Current Income Tax Treatment of TDRs

There are three separate events that occur in a TDR that generate federal and state income taxes. First is a landowner's receipt of the TDR; second, is the sale or other transfer of the TDR by the original landowner; and third, is the sale or other transfer of the TDR by a subsequent owner. While other state taxes may also apply to the transfer of development rights, e.g., property and transfer taxes, this article focuses solely on the federal and state income tax consequences.

A. Federal Income Tax Consequences

Receipt of a TDR. When a local government grants a TDR to a landowner for any reason, the transaction constitutes an exchange: the landowner's right to develop his land is exchanged for a marketable right to permit others to develop their land. While both sides of the exchange involve the same development right, they represent a change in the location where that right can be exercised. That difference is of sufficient significance to require the landowner to realize any gain or loss on the exchange.[10] One question is whether any gain or loss that the landowner realized is not recognized under the like-kind exchange provision of Section 1031 of the Internal Revenue Code. It is plausible that Section 1031(a) is applicable since both properties in the exchange are interests in realty and presumably held by the landowner as an investment.[11]

If Section 1031 applies to the exchange, the landowner's basis is equal to the basis that the landowner had in the development right that he surrendered.[12] The basis in the surrendered development right is a portion of the basis that the landowner has in the underlying realty allocated according to the relative value that the surrendered development right had to the value of the rest of the property at the time that the landowner acquired the realty.[13] However, it is likely that the landowner has no reasonable means to determine the value of the development right at the time of acquisition. Therefore, there is no reasonable method to determine how much of the landowner's basis in the realty is properly attributable to the surrendered development right. In the Inaja case, where a landowner received compensation for the taking of a riparian right, the Tax Court held that the landowner could utilize his entire basis in the realty to determine his gain (but not to allow a loss).[14] Consequently, the landowner in that case had no gain or loss from receiving the compensation for the taking of his riparian rights. By comparison, on a landowner's sale of the TDR, the landowner should also be allowed to use his entire basis in the realty to determine if there was a gain on the sale, but would not be allowed to recognize a loss on the sale.

If federal tax authorities determine that Section 1031(a) does not apply to a local government's grant of a TDR, the Inaja principle will likely still apply in circumstances where it is impractical to separate the TDR's basis from that of the entire realty. In Revenue Ruling 77-414, the Commissioner applied Inaja where a taxpayer sold development rights on agricultural land to the state, but retained the remaining fee simple.[15] The Commissioner held that the landowner must use his entire basis in the underlying realty to determine his gain.[16] Thus, it is likely that the federal authorities will apply Inaja in TDR transfers so long as it is impractical to separate the TDR's basis from that of the underlying realty.

Landowner sale or other transfer of a TDR. The tax treatment of a TDR may vary depending upon how the landowner transfers the TDR. Based on *Inaja*, a landowner will typically have little or no gain upon sale of a TDR (and will not be permitted to recognize a loss). Establishing the landowner's basis in non-sale transactions will be more difficult. The *Inaja* principle is fundamentally a non-recognition principle and may only apply when determining a landowner's taxable gain on receipt (as in *Inaja*) or on subsequent sale (as in Revenue Ruling 77-414). Therefore, it will be more difficult to determine a landowner's basis in a TDR if the right is transferred (without the underlying realty) in a non-recognition transaction, e.g., as a gift or as a contribution to a partnership. Although the landowner certainly should not use the basis of the entire property as the basis of the TDR, it is not clear that basis should be set at zero either. This will be an ongoing, but infrequent problem with TDR programs.

Subsequent owner sale or other transfer of a TDR. As noted above, subsequent owners of a TDR may buy a TDR for use or investment. These subsequent owners are an integral part of a TDR program because they help develop a market for TDRs. If the subsequent owner purchased the TDR he or she will have a cost basis[17] in the right and realize tax gain or loss based on cost.[18] However, as previously discussed, if the subsequent owner received the TDR from the original landowner through a non-recognition transaction, basis and gain or loss will be difficult to calculate. While this is not an issue for tax-exempt charitable organizations, it is problematic for non-exempt taxpayers.

B. State income tax consequences.

Since most state income tax systems piggyback on the federal income tax, the state income tax consequences are likely to follow the federal income tax consequences. Like many states, Michigan uses an individual's adjusted gross income as the starting point for applying the Michigan income tax. An individual's adjusted gross income would reflect the nonrecognition provision and basis allocation rules described above in connection with the federal system. If the federal income tax law should fail to apply either Section 1031(a) or the Inaja principle, there would be state income tax consequences as well. Additionally, as subsequent owners will almost always have federal tax consequences on disposition of a TDR, a waiver of state income taxes would not be a meaningless gesture to encourage redevelopment through TDR programs.

IV. Why Waive State Taxes on TDRs?

Although the receipt or sale of a property right can invoke a number of state tax affects, land use policies and political considerations suggest that waiving all or some associated state taxes could be beneficial in certain circumstances. A reduction or elimination of certain state taxes will encourage voluntary citizen participation in TDR programs. Additionally, tax exclusions may reduce political opposition to the use of TDRs (instead of cash) as compensation for regulatory takings. If federal income tax authorities apply the *Inaja* principle (or Section 1031(a) of the Code), the state's exclusion of income tax to the original landowners would merely codify existing law, but would assure landowners as to the state income tax treatment. Tax waivers for subsequent owners, or for other state taxes, e.g., property and transfer taxes, will have a greater cost to the state, but could be a significant incentive for the public to participate in the program. Nonetheless, while statutory tax incentives are sensible in some circumstances, they should be implemented judiciously to serve the goals of the program and to avoid generating tax shelters or sham transactions.

V. Tax Waiver Methods.

As noted above, determining basis and taxable gain or loss are the two basic income tax issues regarding TDRs.[19] To consider possible tax waiver provisions, we again look at the three stages of TDR's: a receipt of a TDR from a local government, a landowner's subsequent transfer of the TDR, and a subsequent owner's transfer of the TDR.

A. Receipt of a TDR from a Local Government Agency.

The state could explicitly provide for nonrecognition of gain or loss on a landowner's receipt of a TDR. This would effectively apply Section 1031(a) treatment for state income tax purposes regardless of whether or not the federal tax authorities adopt that position. A state exclusion will be significant only if federal tax authorities do not apply Section 1031(a) to the transaction; and, even then, it will have little impact if federal tax authorities adopt the Inaja principle.

Alternatively, instead of adopting nonrecognition treatment, the state could codify the Inaja principle by explicitly providing that a landowner can utilize its basis in the entirety of its land in measuring the gain, if any, on the receipt of the TDR. The effect of this provision is to prevent the landowner from recognizing a gain on the receipt of a TDR unless the TDR's value is determined to be greater than the landowner's basis in the realty (a relatively unlikely scenario). The statute should also prohibit any loss recognition.

B. Landowner's Transfer of the TDR.

On a sale or disposition of a TDR, a landowner must also determine its basis in the TDR so that gain or loss can be measured. If either the Section 1031(a) nonrecognition approach or the Inaja approach is adopted, the landowner should be allowed to use its basis in the entire realty to measure gain. Consequently, the landowner will recognize gain only if the amount realized on the sale exceeds its basis in the realty. The landowner should not be allowed to recognize a loss. Upon sale, the landowner's basis in the realty will be reduced by the amount the landowner received from the sale of the TDR. The state should legislate these results by statute to avoid confusion. Alternatively, the state could provide that the landowner does not recognize gain or loss on the disposition of the TDR, and that the landowner's basis is reduced (but not below zero) by the amount realized on the sale of the TDR.

Alternatively, rather than codifying the Section 1031(a) approach or the Inaja principle for all TDR transactions, the legislature could create tax incentives for transferring a TDR under specified conditions. Since these approaches apply equally to subsequent owners, they are discussed below.

C. Sale or other transfer by subsequent owners

While determining basis for subsequent owners may be problematic at times, most subsequent owners will likely have a cost basis, which simplifies calculating gain and loss. For those subsequent owners who have a transferred basis from a non-recognition transaction, there is no easy way to determine basis. However, since most subsequent owners will likely realize some gain on the sale of a TDR, it is meaningful to waive some of that tax associated with that sale in order to encourage participation in a TDR program. Tax incentives for subsequent owners, including investors, may also help create a viable market so that landowners can realize the full value of TDRs.

Tax incentives for subsequent owners (or, in the absence of Section 1031(a) or *Inaja* treatment, original landowners) should be designed to encourage participation without creating abusive situations. One way to achieve this goal is to target certain qualities in transferred rights. Aside from a general exclusion of state taxes,[20] targeted exclusions could include property-focused waivers, transferor-focused waivers, and transferee-focused waivers. Depending on policy goals, each of these methods could be implemented singly or in combination using exclusions, deductions or credits, as discussed below.

Property-focused waivers. The legislature could limit income tax waivers to sales of TDRs that are derived from certain types of property, e.g., historical landmarks or natural features. For example, New York grants municipalities the right to restrict development of historical properties and remit taxes as part of compensation (which may include transferable development rights).[21] Although the New York legislature authorized municipalities to waive only local property taxes, Michigan's legislature could go one step further by waiving state income taxes on the gain realized by selling TDRs severed from historical properties. Similarly, the state could waive income taxes to a taxpayer who sells development rights to entities that will use the TDR in certified redevelopment areas.

A property-focused waiver could be accomplished by using an exclusion provision with or without a ceiling on the amount of gain that can be excluded. Although implementation could be difficult, it could be tied to a Renaissance Zone project to minimize costs.

Transferor-focused waiver. Tax provisions that focus on both who the transferor is and why the development rights were severed are the most politically attractive and least damaging to the state fisc. Regarding gain, it is arguably politically hazardous to levy tax on gain realized upon sale of a TDR that was granted as compensation for a regulatory taking. Waiving tax on gain for an investor may also encourage participation in a TDR program without the costing the state too much revenue or creating tax shelters. Regarding loss, even in the absence of the Inaja principle, it is arguably just to not allow a loss deduction to a TDR owner whose basis in the TDR is tied to its basis in the underlying property. Although transferor-focused waivers would reduce tax revenue, trading political benefits for less revenue may be a worthwhile investment in order to redirect development toward urban cores and away from protected areas.

A transferor-focused waiver could be implemented by several methods, depending on whether the transferor is the original landowner or an investor. For original landowners, in the absence of Section 1031(a) or Inaja treatment, the legislature could set basis at fair market value at the time of transfer or grant a deduction for part of the taxable gain from transfer of a TDR. A provision that sets basis at fair market value would also benefit subsequent owners who have transferred basis. For investors, it would be a minor revenue impact for the state to implement deductions for some of the gain from sale of a TDR.

Transferee-focused waivers. Waiving tax on gain when TDRs are transferred to certain transferees, e.g., preservation organizations or large employers, could facilitate the preservation goals of many TDR programs and investment in Michigan. While a landowner could donate the TDR to a charitable organization,[22] it may be deterred from doing so because of federal deduction limitations[23] or because it prefers to cash out the property right. A statutory waiver of taxable gain on a sale would likely encourage landowners to voluntarily sell TDRs, and the increase in TDRs on the market could in turn, reduce the price to buyers and thereby encourage more development where needed.

A deduction or exclusion provision is likely the best method to implement a transferee-focused waiver. However, while this type of waiver has great potential for focused economic development, it may be the most difficult and costly to implement. The class of transferees could be as narrow as state-sanctioned development corporations[24] or as broad as qualified charitable organizations or approved employers. If limited to charitable organizations or development corporations, approving recipients would require proof of qualification as a state development corporation or as a federal 501(c)(3) or 170(c) organization. However, if the waiver were extended to approved employers or other businesses, the state would have to approve each company, potentially using valuable resources for small gains.

VI. Conclusion.

Undertaken judiciously, strategic tax incentives for transfers of development rights would not harm the state fisc and could be instrumental in moving Michigan towards a better future. While it is not the dispositive answer to the state's economic dilemma, coupled with existing development programs, a TDR program could move Michigan closer to economic prosperity while also facilitating preservation of the state's historic and natural features. With focused tax incentives, a TDR program would also be more palatable politically.

Of all the possible incentives, the simplest is tying the original landowner's basis in the TDR to the basis of the underlying property by codifying the Inaja principle. However, the legislature should also consider provisions excluding a transferor's taxable gain upon sale to a landowner in Renaissance Zones or other redevelopment areas and a partial deduction for gain on sale of a TDR. These three incentives would encourage participation, help develop a robust TDR market, and, if designed carefully, will not cause substantial impact to the state.

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ENDNOTES

1. The Renaissance Zone project is designed to facilitate economic redevelopment by creating "enterprise zones". Businesses and individuals located within the zones are exempt from many state taxes, including income taxes. Mich. Comp. Laws. §§ 125.2681-125.2696 (2008); c.f., *John T. Schuring, Detroit's Renaissance Zones: The Economics of Tax Incentives in Metropolitan Location Decisions, the Results of the Zones to Date, and Thoughts on the Future*, 83 U. DET. MERCY L. REV. 329 (2006).
2. *See, e.g.*, *Elizabeth Riggs, Potential Impacts of Transfer of Development Rights for Michigan Communities*, Huron River Watershed Council Report of Dec. 2007, available at http://www.hrwc.org/program/land_tdr.htm (last visited March 29, 2008). The term TDR is used herein to refer to a transfer of development rights program or the transferable development right itself.
3. *See, e.g.*, Riggs, *supra* note 2. Michigan has several redevelopment programs. The planned unit development statute allows transfers of development rights, but only within a planned unit development. Mich. Comp. Laws § 125.3503 (2008). The Village at Grand Traverse Commons is a good example. Traverse City Ord. § 1352.06; c.f. Michigan Economic Development Corporation, *Renaissance Zones – Grand Traverse County*, available at http://ref.michigan.org/medc/services/sitedevelopment/renzone/GrandTraverseCounty (last visited March 30, 2008). Local governments may also purchase development rights from willing landowners, but must use local funds. Mich. Comp. Laws §§ 125.3507-125.3509 (2008).
4. Many states have TDR legislation. See e.g., Conn. Gen. Stat. §8-2(a) (2008), Md. Code Ann., [66B] § 11.01(2008), Wash. Rev. Code § 36.70A.090 (2008). Only two states have tax provisions in TDR legislation. Tenn Code Ann. §§ 13-77-201, 13-7-101 (2008); N.Y. Gen. Mun. Law §§ 96-a, 119-dd (2008).
5. This document concerns only possible state tax incentives; absent federal provisions, TDR owners must report taxable gain from a sale or receipt of TDRs at the federal level. However, as noted in Part III of this article, it is likely that a landowner who receives a TDR will incur little or no federal income taxes on receipt or sale. *Subsequent owners* will typically incur federal income taxes upon sale.
6. Many state enabling statutes grant local governments broad (and unspecified) authority, but some explicitly recognize TDRs as freely alienable. See, e.g., Ga. Code Ann. § 36-66A-2 (2007), N.C. Gen. Stat. § 136-66.11 (2007), 53 Penn. Stat. 10619.1(a) (2007). Treating TDRs as real property for tax purposes depends on state or local determination of the TDR as a property right. PLR 200805012, p. 6 (citing Rev. Rul. 77-414, 1977-2 C.B. 299).

7. See generally, John J. Costonis, Development Rights Transfer: An Exploratory Essay, 83 YALE LAW J. 75 (1973); Richard L. Barrows and Bruce A. Prenguber, Transfer of Development Rights: An Analysis of a New Land Use Policy Tool, 57 AMER. J. AGRIC. ECON. 549 (1975). The United States Supreme Court famously addressed the constitutional nature of TDRs as compensation in Penn Central, where the owners of the historic Penn Central railway terminal sued the City of New York for a regulatory taking of the development capacity in the air space above the terminal. Penn Central Transp. Co. v. City of New York, 438 U.S. 104 (1978).
8. Although TDR programs are arguably within the zoning power, states typically have TDR enabling statutes within the general body of zoning legislation. For examples of state enabling statutes see note 4, above.
9. Some states authorize only voluntary participation by landowners in the sending zone. See, e.g., Ky. Rev. Stat. Ann. § 100.208; Ga. Code. Ann. § 36-66A-2; Idaho Code § 67-6515A(3). A few statutes imply that local governments may require severance of development rights, e.g., to promote "orderly growth and development," a clear example of the police power. Md. Ann. Code. art. 66B § 11.01 (2008); see also, N.H. Rev. Stat. Ann. §§ 674:16, 674:21 (2008); N.C. Gen. Stat. § 136-66.11 (2007). Yet, many statutes grant local governments broad authority to create TDR programs without further detail regarding voluntary or mandatory participation. See, e.g., 53 Penn. Stat. 10619.1 (2007); Rev. Code Wash. § 36.70A.090.
10. *See Cottage Savings Assoc. v. Comm'r*, 499 U.S. 554 (1991).
11. 26 C.F.R. § 1.1031(a)-1(b) (2008).
12. 26 U.S.C.S. § 1031(d) (2008).
13. 26 C.F.R. § 1.61-6(a) (2008).
14. *Inaja* Land Co. v. Comm'r, 9 T.C. 727 (1947).
15. Rev. Rul. 77-414, 1977-2 C.B. 299. But see Rev. Rul. 77-413, 1977-2 C.B. 298 (holding that a landowner who sold property and retained a 20-year possessory and use interest could separate the basis in the possessory interest from the basis of the entire realty and thus calculate gain from the sale of the property).
16. As with other sales of realty, if the realty consists of both land and improvements, the selling price must be allocated between the land and the improvement. The basis of each is used to measure gain from that portion of the amount realized on a sale. Even in this circumstance, it may be impractical to separate the basis of the TDR from the basis of the remaining interests. See Rev. Rul. 77-414, 1977-2 C.B. 299.
17. 26 U.S.C.S. § 1012 (2008).
18. 26 U.S.C.S. § 61(a)(3) (2008) (including "gains derived from dealings in property" in gross income).
19. Timing and characterization issues may arise but should align with normal property transactions.
20. Tennessee uses a less extreme, yet generally applicable, method: a sales tax exemption on TDRs. Tenn. Code §§ 13-7-201, 13-7-101.
21. N.Y. Gen. Mun. Law §§ 96-a, 119-dd.
22. The Internal Revenue Service has recognized development rights as qualified charitable contributions under Section 170 of the Internal Revenue Code. 26 C.F.R. § 1.170A-14(f), Example 5 (2008).
23. 26 U.S.C.S. § 170(b) (2008). Michigan does not have a gift tax, only an estate tax. Mich. Comp. Laws § 205.201 (2008).
24. See Mich. Comp. Laws § 125.1604 (2008).