M I C H I G A N

TAX LAWYER

SBM State Bar of Michigan | TAXATION SECTION

Volume XLII
Issue 2
Summer 2017

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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 —October/November (Fall), January/February (Winter), and June/July/August (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 for 2017, please contact Andrew MacLeod, Dickinson Wright PLLC, 500 Woodward, Suite 4000, Detroit, MI 48226 amacleod@dickinsonwright.com; or (313) 223-3187.

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Citation Form

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

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July 15, 2017

Dear Taxation Section Members:

While we are enjoying another warm Michigan summer, I would like to take this opportunity to give you an update on our Section's recent activities and inform you of upcoming events.

In January of this year, the Council of our Section adopted a strategic plan that seeks to advance the mission, goals and objectives of the Section. We have included a copy of the strategic plan in this edition of the *Michigan Tax Lawyer*.

On March 30, 2017, we hosted a Tax Court Luncheon with U.S. Tax Court Judge Ronald Buch at the Westin Book Cadillac Hotel in Detroit. Judge Buch gave a talk on his experience as a Tax Court judge. Judge Buch also took numerous questions from individuals attending the luncheon. It was a terrific event.

On May 25, 2017, we held our 30th Annual Tax Conference at the Inn at St John's in Plymouth. The conference showcased national and local speakers on various topics in the area of tax law. The conference was a huge success.

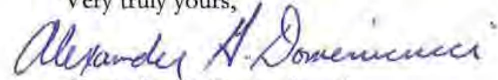
Our State and Local Tax Committee will host its annual SALT Mixer on Wednesday, September 13th. Stay tuned for more details regarding location and time of this event.

Also, please save the date for our Annual Meeting, which we are planning for Thursday, September 28th. Additional information regarding location and time of the meeting will be forthcoming.

Lastly, please consider attending our Fundamentals of Taxation program on Thursday, October 12th. The program is a new initiative by the Section to provide instruction on the basics of taxation and on spotting tax issues that arise in transactional matters and tax controversies. The registration form for the program is included in this edition of the *Michigan Tax Lawyer*.

Enjoy the rest of your summer. I look forward to seeing you at future Section events.

Very truly yours,



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SECTION COMMITTEE REPORTS

Employee Benefits Committee

The Employee Benefits Committee breakout session at the 2017 Annual Tax Conference featured a "Washington Update" presentation by Don Wellington (*Steptoe & Johnson, Washington, D.C.*) on the announced and anticipated benefits initiatives of the new administration.

Please mark your calendars for a couple of upcoming events:

The Committee will be hosting a joint event with the SBM Business Law Section on focusing on employee benefits considerations in mergers and acquisitions. This event is tentatively scheduled for September 19, 2017.

The Committee will be hosting a joint event with ASPPA Benefits Council ("ABC") of Detroit on November 9, 2017, featuring a presentation by Sherry Brackney (*Department of Labor*) focusing on fiduciary responsibilities and DOL investigations of employee benefit plans. This event will be held at the MSU Management Education Center in Troy. Additional information will be provided to you soon. Committee members are also invited to attend ABC Detroit's meeting on August 17; for additional information regarding that meeting, please visit abcdetroit.org.

If you have a topic that you would like covered or are interested in presenting at a Committee event, please contact me at bgallagher@fraserlawfirm.com.

Please ensure that you are properly registered on SBMConnect to receive additional details on future Committee developments.

Estates and Trusts Committee

On November 3, 2016, the Estates & Trusts Committee ("E & T Committee") hosted a morning seminar at the Detroit Athletic Club. The presenters included Gerard P. Charette of Miller Canfield, LLP and Thomas J. Palouski of Bernstein Private Wealth Management. Mr. Charette's presentation addressed the integration of the Canadian and US tax systems with respect to gifts and death from the perspective of a US resident or citizen holding Canadian real estate and personal property. Mr. Palouski's presentation addressed various income tax issues and planning solutions to be considered by professionals, as addressed in his recent publication title "Basis for Comparison: How Income Tax Management Is Changing the Face of Estate Planning." The event was well attended and very informational.

On March 23, 2017 the E & T Committee, co-hosted the second annual "Building Success as a Tax Practitioner" with the Young Tax Lawyers Committee at the Detroit Beer Company. The event featured a panel of five unique, successful tax practitioners who spoke about their individual career paths. The panelists included:

- **Lowell Scott,** Senior Manager at Ernst and Young
- **Jackie Cook**, Senior Tax Attorney at Consumers Energy Corporation
- **Samantha Snow**, Administrative Law Specialist Manager at the Michigan Tax Tribunal
- **Aaron Feinberg**, General Tax Director at GM Financial
- **Shawn Strand**, Partner at Honigman Miller Schwartz and Cohn LLP

The E & T Committee is planning an event for July, 2017. Not only will this event will provide our committee members with the opportunity to discuss the changes (if any) resulting from the new executive administration. The E & T Committee will release specific details once finalized. As always, the E & T Committee is always accepting new members. For more information, please contact Thomas E.F. Fabbri directly at (248) 988-5856.

Federal Income Tax Committee

The next meeting of the Federal Income Tax Committee (the "FIT Committee") is scheduled for 5pm on August 24 and will be held at the EY Detroit office located at 777 Woodward Ave., Detroit, MI 48226. Our speaker will be Trevor Wetherington, Executive Director in Business Tax Advisory. The meeting will cover frequent adjustments in LB&I with a networking mixer to immediately follow the presentation. To register for this event, please email jon.baloch@ey.com

State and Local Tax Committee

The State and Local Tax Committee (the "SALT Committee"), will be hosting a Mixer to be held September 13, 2017 from 5 to 7:30 pm at the Lansing office of Honigman Miller Schwartz and Cohn LLP, 222 North Washington Square, Suite 400, Lansing, MI 48933. Drinks and hors d'oeuvres will be provided and all Tax Section members are welcome to attend.

If you have any interest in participating or getting more involved in SALT Committee events or programs, please let us know by contacting Dan Stanley at DStanley@honigman.com.

Young Tax Lawyers Committee

On March 23, 2017, the Young Tax Lawyers Committee sponsored an event in Detroit called "How to be a Successful Tax Practitioner." The second annual event featured a panel of experienced tax practitioners from Honigman Miller Schwartz and Cohn, General Motors, Consumers Energy and Ernst & Young who provided committee members tips and secrets for a successful career. In addition, on June 14, 2017, the Young Tax Lawyers Committee co-sponsored a happy hour event in Lansing with Michigan Women's Tax Association. Please note that the Young Tax Lawyers Committee is always looking for new members and new event ideas. Please visit us at one of our many events across the State, on SBM connect, or feel free to email me at RPeruski@honigman.com.

STATE FIDUCIARY INCOME TAX CHECKUP, PART 1: TRUST NEXUS IN MICHIGAN

By Raj A. Malviya

Introduction

State fiduciary income taxation of a non-grantor trust is often an afterthought in the design and administration of a trust.[1] The practitioner tends to focus more on the federal income tax issues, especially since the non-grantor trust rules under Section §641 et. seq. of the Internal Revenue Code are complicated enough to understand and implement.[2] But determining where a Trust "lives" for state income tax purposes or whether a Trust has sufficient contacts to a particular state is equally as important. Effective state income tax compliance and planning will not only allow a Trustee to fulfill fiduciary duties and manage overall tax exposure, but help the practitioner add value to the administration side of the practice.

Given the breadth and complexity of state income tax rules, this author will attempt to tackle the topic in a two-part series. Since Michigan taxes a Trust based on its residency, this first article will focus on the state nexus rules that govern a Trust's residency; e.g. it's "tax home" for state income tax purposes. Michigan specific rules will be addressed. The second article will focus on other nexus criteria and planning opportunities to shift a Trust's state tax nexus.[3]

Overview of Trust State Income Taxation

When addressing state income tax planning, the practitioner should first have a general understanding of the fiduciary income tax rules under Chapter 1, Subchapter J, Subparts A, B and C of the Internal Revenue Code (IRC § 641 et. seq.). These rules are well beyond the scope of this article, but there are several resources written by the author that can provide the reader with an overview on the federal taxation of a non-grantor trust ("Trust").[4]

Because a Trust is a separate taxable entity, with certain exceptions, it will generally need to file a U.S. Income Tax Return for Estate and Trusts (Form 1041) and have a separate taxpayer identification number.[5] The taxable income of a Trust is computed the same way as individual income taxes, but with some modifications.[6] In effect, the federal fiduciary income tax rules bifurcate tax liability, depending on whether income is retained by the Trustee or distributed to the beneficiaries.[7] For taxable income that is accumulated, a Trust will be liable for federal income tax on that income.[8]

Additionally, a Trust is liable for state fiduciary income tax where it "lives", unless the state does not impose a state-level income tax. Currently, 43 states and the District of Columbia impose a state fiduciary income tax. The seven states that do not impose a state-level income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.[9] The issue governing whether a state can justify imposing a tax on a Trust with continued entitlement to income tax regardless of reduced state contacts has become an important and developing issue in fiduciary income taxation over the past decade. Several seminal cases have been decided in this area that have a significant influence on state income tax planning.[10]

State fiduciary income taxation is generally based on residency within a state, and more broadly, contacts within the state. If a trust is determined to be a "resident" of a particular state, that state will tax *all* of the trust's income, wherever located; but there may be adjustments for income tax paid to other states, depending on state law. The determination of whether the trust will be treated as a resident trust, and thereby subject a trust to full state taxation, is based on the level of contacts that exist with the state.[11]

Five common criteria for finding a Trust income tax nexus within a particular state include: (1) contacts with the decedent or decedent's estate that gave rise to the testamentary trust, (2) contacts with the state by the grantor who created an inter vivos trust, (3) contact through the ongoing administration of the trust, (4) contacts with the trustee of the trust, (5) contacts with the beneficiary of the trust. Under one or more of these factors, a trust may be deemed a statutory resident.[12] Practitioners often mistakenly think that including provisions in a Trust "declaring" the situs of the administration will control; however, as will be addressed in this article series, such a provision is not necessarily dispositive in a state's determination of a Trust's tax residency.

Where Does a Trust Live? Founder Rules

States that tax a Trust based on the first two criteria mentioned above are commonly referred to as "Founder" states, since the founder of a Trust was a resident of the applicable state when such Trust created, or became irrevocable, and is the basis for taxation.[13] The two criteria can be summarized as follows:

1. The state has contacts with the *decedent or decedent's estate.* This refers to the decedent's state of domicile at the time of death. If a probate estate is commenced in the state of domicile, then a Founder state will tax a testamentary trust created under the decedent's Will or a revocable living trust that became irrevocable at the decedent's death if a probate estate has been commenced that is connected to such a trust (e.g. the need to probate a pour-over Will to send assets to a Trust).[14]

2. The state has contacts with the *Settlor who created an inter vivos trust.* This refers to a Trust to which the Settlor was domiciled in the state at the time of creation of the Trust.[15]

As mentioned above, a state that taxes the income of a Trust under the Founder rules will generally tax all the income of a Trust, wherever located. There may be adjustments to taxable income based on tax paid to other jurisdictions, but that will be determined under the Founder state's law. If a state taxes all the income of a Trust based on its residency, it is critical for the practitioner to carefully review the applicable statute defining the requirements that control residency in the state. The factors by which the residency of a Trust is determined is not uniform among the states.[16] An overview of Michigan's state fiduciary income tax and residency rules are outlined more fully below.

MICHIGAN RESIDENCY TAX RULES FOR TRUSTS

Michigan imposes income tax on estates and trusts.[17] *Michigan is a "Founder" state for income for fiduciary income tax nexus.* This is because a Trust is a resident trust if it was created by will of a Michigan domiciliary at time of death (testamentary trust) or if it was created by a Michigan domiciliary at the time the trust becomes irrevocable ("resident trust").[18]

A resident trust is subject to Michigan income tax on all income from any source, except those properly attributable to another state under Michigan Income Tax Act sourcing rules.[19] Taxable income of a resident trust is federal taxable income subject to Michigan adjustments.[20] As of October 1, 2012, the Michigan income tax rate is a flat rate of 4.25 percent.[21]

A nonresident trust is one that does not meet the definition of a resident trust. Importantly, a trust that initially constitutes a resident trust under Michigan statute may nonetheless "convert" into a nonresident trust if *all* the following are true:

1. The trustee is not a Michigan resident;
2. the trust assets are not held, located or administered in Michigan, and;
3. all of the beneficiaries are nonresidents.[22]

It is important for the practitioner to identify the basis for a Trust being taxed in Michigan and do this exercise annually. Being able to distinguish between a "resident" trust and a "nonresident" trust will enable the practitioners to perform this task properly. The Michigan residency rules can be best understood through a review of the seminal Michigan published opinion, *Blue v. Michigan Dept. of Treasury* (the "Blue case").[23] The *Blue* case involved an inter vivos trust established by a Michigan resident that became irrevocable at her death. After some time, many of the trust's connections with Michigan evaporated, with the exception of the Settlor's Michigan domicile, measured at a snapshot in time when the trust became irrevocable. The trust's residency in Michigan was challenged; the Court analyzed the following non-Michigan contacts:

1. The only income beneficiary moved to Florida 16 years after the trust was established;
2. All residuary beneficiaries were Florida residents;
3. The Trustee was a Florida resident;
4. All income-producing assets (the trust held Michigan non-income producing real estate) were located in Florida;
5. The administration was conducted in Florida;
6. The Trust was registered in Florida;

Yet, despite all these non-Michigan contacts, the Michigan Treasury still sought to tax the trust under MCL §206.18(c), arguing the trust was a "resident trust" and its continued residency in Michigan gave it the benefits and protections in Michigan which resulted in necessary nexus to impose tax.[24]

In a win for the taxpayer, the Michigan Court of Appeals focused on the following in holding that the trust was <u>*not*</u> a resident trust in Michigan:

1. There were "insufficient connections between the trust and the State of Michigan to justify the imposition of an income tax";
2. The Court looked to other state law in reaching its decision ((*In re Swift*, 727 S.W. 2d 880, 882 (Mo, 1987) and *Mercantile-Safe Deposit & Trust Co v. Murphy*, 19 A.D.2d 765; 242 N.Y.S. 2d 26 (1963), aff'd 15 N.Y.2d 579; 255 N.Y.S. 2d 96; 203 N.E. 2d 490 (1964));
3. There was a lack of ongoing protection and benefit of Michigan law that resulted in an unconstitutional

taxation (violation of due process clause), as applied to the trust (i.e. MCL §206.18 was not held unconstitutional on its face); and

4. The trust was registered and administered in Florida.

In its opinion, the Court made the following powerful statement: "We analogize the present case to a hypothetical statute authorizing that any person born in Michigan to resident parents is deemed a resident and taxable as such, no matter where they reside or earn their income. We believe this would be clearly outside of the state's power to impose taxes."

Due Process and State Income Taxation

As outlined in the *Blue* case, the Court held that there was a lack of ongoing protection and benefit of Michigan law that resulted in an unconstitutional taxation of the trust at issue under the due process clause of the Constitution. Generally, the Due Process Clause is one of two bases that taxpayers have used to attack state taxation of a Trust in a Founder state. The other is under the Commerce Clause. A discussion of these constitutional bases is beyond the scope of this Article, but it is important that the practitioner understand the consistent and reoccurring arguments taxpayers are making to rid a Trust of unconstitutional state taxation.

The Constitution provides that no one shall be "deprived of life, liberty or property without due process of law."[25] The Due Process clause provides assurance that all levels of government operate legally and fairly. As applied to states, it empowers states to tax the income of its residents, regardless of the origination of which state the income was derived.[26] A tax allowed under the Due Process clause must still satisfy the requirements of the Commerce Clause to be constitutional.[27] However, to satisfy the Due Process Clause, there must be minimum contacts with the taxing jurisdiction.[28]

In analyzing the Due Process issue, the *Blue* Court looked to *In re Swift*, 727 SW2d 880, 892 (Mo. 1987) in order to properly analyze whether the trust at issue had sufficient minimum contacts to satisfy Michigan's power to tax. The *Swift* Court held that an income tax was justified only when there are benefits and protections provided during the relevant taxing period.[29] The *Swift* Court considered the following "six points of contact" in determining whether a state had sufficient nexus to tax trust income: (i) the domicile of the settlor; (ii) the state in which the trust is created; (iii) the location of the trust property; (iv) the domicile of the beneficiaries; (v) the domicile of the trustees; and (vi) the location of the administration of the trust.[30]
In reaching its holding, the *Swift* Court acknowledged that the first point of contact was satisfied because the trusts at issue were testamentary trusts created by the will of decedent domiciled in Missouri. However, the Court opined that Missouri provided "no present benefit" to the trusts, where none of the beneficiaries or trustees were Missouri residents, the trust property was held, managed, and administered in Illinois, and all trust income-generating business was conducted in Illinois.[31] The Court then held that, since Missouri law provided no present benefits or protections to the subject trust, beneficiaries, trustees or property, the State of Missouri did not have sufficient connections to impose an income tax; therefore, the tax violated the Due Process Clause.[32]

Blue Case Takeaways

Probably the biggest takeaway from the *Blue* case is that even if a Trust begins its home in Michigan as a resident trust, it is possible for that trust to shift its home to another, perhaps more tax friendly, jurisdiction. As long as the three general criteria outlined in the *Blue* case are met for a Trust (Trustee is not a Michigan resident, the income producing trust assets are not in Michigan, and all beneficiaries are not Michigan residents), there should be no basis for Michigan to tax it as a resident trust. Setting aside non-tax reasons to stay in Michigan; the practitioner should analyze whether there are sufficient contacts (or could be) in another state that would provide a more palatable or beneficial state income tax regime for the Michigan resident trust; i.e. one with no state income tax. As previously mentioned, there are currently seven states that do not impose an income tax.

Finally, if contacts have seemed to evaporate from a Michigan resident trust over time, as they often do when families evolve, fiduciaries move and assets change situs, it is critical that the practitioner assess whether there are still sufficient contacts for Michigan to tax the trust. If not, the Trustee may be unnecessarily paying income tax when a "break" from residency has already happened, perhaps years ago.

Conclusion

Multiple layers of taxation warrant carefully analyzing the applicability of the income tax laws of Michigan and other states that have or could have a connection or nexus to a Trust. Although a Trust typically contains a provision that designates which state's laws govern administration, such a provision is not necessarily dispositive in the determination of state tax residency. As discussed in this article, sometimes courts are called upon to decide whether a state taxing authority has pushed the constitutional limits too far in asserting its ability to tax a trust based on the contacts existing between the subject trust and the state. The *Blue* case is a perfect example, and its holding remains relevant to trusts taxed as Michigan resident trusts today. Knowing Michigan's general

stance on what constitutes sufficient nexus to be a resident trust is a good starting point to better understand potential strategies for managing (and perhaps shifting) state income tax residency if warranted. But state income tax management is not without complexity. The next article in this two-phase series will explore the other criteria for state income taxation and planning opportunities available to shift nexus.

About the Author

Raj A. Malviya *practices in the areas of domestic and foreign estate planning, fiduciary income taxation and fiduciary administration at Miller Johnson. He holds an LL.M. in Taxation from Northwestern University School of Law and practices in the firm's Grand Rapids, Michigan office.* *The author would like to thank fellow Tax Section Member, George W. Gregory, for his helpful review and insight in preparing this article.*

Endnotes

1 The planning considerations discussed in this article apply to non-grantor trusts taxed under IRC §641 et. seq. This article will not address planning involved with the special rules in subchapter J (known as the "grantor trust rules") that provide that if a grantor (or another person) of a trust holds an interest or a power described in Code §§ 671 through 679, then such grantor (or other person) is deemed to be the owner of the trust for federal income tax purposes.

2 All references and citations to the Internal Revenue Code throughout this article shall be to the "Code" or "IRC."

3 Much of the substance of this two-part article series will be addressed in the following presentation: Malviya, Raj A., Berek, David A., "State Fiduciary Income Tax Checkup and Planning: Does Your Trust Have A Tax Nexus?" The 25th Annual Probate and Estate Planning Institute, Michigan Continuing Legal Education, University of Michigan Press (May 18, 2017).

4 Malviya, Raj A., Strohmeyer, John R., "Fundamentals of Trust Administration and Fiduciary Income Taxation", American Bar Association Section of Real Property, Trust and Estate Law Fundamentals of the Modern Estate Planning Practice Series, air date May 25, 2017; Malviya, Raj, Beer, Jonathan K., "New Year's Resolutions for Trustees and Beneficiaries: Ten Fiduciary Income Tax Planning Considerations. The Michigan Probate and Estate Planning Journal, Vol. 36, No. 1. (January, 2017); Malviya, Raj, Gregory, George. "Drafting Trusts for the Net Investment Income Tax." Presentation for 25th Annual Drafting Estate Planning Documents Seminar, Michigan Continuing Legal Education, University of Michigan Press (January, 2016); Malviya, Raj, Nicholson, Sara N., Puhek, Richard J., "Fiduciary Income Tax Planning: Including Capital Gains in Distributable Net Income (DNI)." The Michigan Tax Lawyer, Vol. XL, Issue 2, Summer 2014).

5 IRC § 6072(a).

6 IRC § 643(b). Estates/trusts are also subject to the same alternative minimum tax liability as individuals. IRC § 55.

7 IRC §§ 641, 651 and 661.

8 IRC § 641(a).

9 See Nenno, Richard W. "Let My Trustees Go! Planning to Minimize or Avoid State Income Taxes on Trusts", 46th Heckerling Inst. on Est. Pl., ch. 15 (2012) for a thorough review of various states with detailed charts addressing state-by-state application (the "Nenno Chart").

10 The issue of resident state taxation was most recently considered in *Kaestner v. N.C. Dept. of Revenue*, 777 S.E.2d 61 (N.C. 2015), in Illinois under the decision of *Linn v. Department of Revenue*, 2 NE3d 1203 (Ill. App. Ct. 2013), and in Pennsylvania under the decision *McNeil v. Commonwealth*, 67 A3d 185 (Pa. Commw. Ct. 2013).

11 *Id*.

12 Nenno, Richard W., "Bases of State Income Taxation of Nongrantor Trusts", Lecture, American College of Trust and Estate Counsel (2016); Nenno, Richard W., "State Income Taxation of Trusts", 869 Tax Mgmt. Port (2013). See also Berek, David, *Federal Income Taxation of Decedent's, Estates and Trusts*, Chapter 15 (2016), Wolters Kluwer.

13 See Berek, David A., *Federal Income Taxation of Decedent's, Estates and Trusts*, Chapter 15 (2016), Wolters Kluwer, citing to Jacob, *An Extended Presence, Interstate Style: First Notes on a Theme From Saenz*, 30 Hofstra L. Rev. 1133 (Summer 2002).

14 Currently, 27 states cite this criterion as a statutory contact. See Berek, David A., *Federal Income Taxation of Decedent's, Estates and Trusts*, Chapter 15 (2016), Wolters Kluwer, for a listing of the states and referring to the Nenno Chart.

15 Currently, 25 states cite this criterion as a statutory contact. *Id*.

16 See FN 15, 16, *supra*.

17 See Michigan Income Tax Act of 1967.

18 MCL §206.18(1)(c).

19 MCL §206.110(1).

20 MCL §206.36.

21 MCL §206.51(1)(b).

22 This was the decision in the *Blue v Michigan Department of Treasury*, 185 Mich App 406; 462 NW2d 762 (1990); See also Michigan Dept. of Treas. Instructions for Filing Michigan Fiduciary Income Tax Return MI-1041 (2016), at pg. 2.

23 *Blue v Michigan Department of Treasury*, 185 Mich App 406; 462 NW2d 762 (1990).

24 *Id.*

25 See Berek, David A., *Federal Income Taxation of Decedent's, Estates and Trusts*, Chapter 15 (2016), Wolters Kluwer, citing to U.S. Const. art. V ("nor be deprived of life, liberty, or property, without due process of law"); U.S. Const. art. XIV ("nor shall any state deprive any person of life, liberty, or property, without due process of law").

26 See Berek, David A., *Federal Income Taxation of Decedent's, Estates and Trusts*, Chapter 15 (2016), Wolters Kluwer, citing to *Oklahoma Tax Comm'r v. Chickasaw Nation*, 515 US 450,462-463 (1995).

27 See Berek, David A., *Federal Income Taxation of Decedent's, Estates and Trusts*, Chapter 15 (2016), Wolters Kluwer, citing to *Quill Corp. v. North Dakota*, 504 US 298, 305 (1992).

28 *Kaestner v. N.C. Dept. of Revenue*, 777 S.E.2d 61 (N.C. 2015) citing *Quill Corp. v. North Dakota*, 504 US 298, 313 (1992) and *International Shoe v. Washington*, 326 U.S. 310, 316 (1945).

29 *In re Swift*, 727 SW2d 880, 892 (Mo. 1987).

30 *Id.*

31 *Id.*

32 *Id.*

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TAKING THE FIRST BITE: WHO SHOULD TAX APPLE'S $187 BILLION IN IRELAND?

By Reuven S. Avi-Yonah and Gianluca Mazzoni

On December 19, 2016, the European Commission (hereinafter "Commission") published its final decision in the Apple State aid case.[1] The Commission concluded that two tax rulings granted in 1991 and 2007 on the allocation of profits to the Irish branches of Apple Sales International ("ASI") and Apple Operations Europe ("AOE") amounted to illegal state aid, and ordered Ireland to immediately recover this aid from Apple. The key issue in the *Apple* decision is where Apple's foreign income ($187 billion, as of 2016) should be regarded as being generated. In the authors' opinion, there is almost no basis for any argument that two-thirds of the profits of Apple were generated by functions performed, assets used and risks assumed in Ireland, where only 4 percent of its global workforce and approximately 1 percent of its customers are located. Indeed, under traditional principles, profits originate and taxes are due where value is created – that is, where the research and development is conducted. Accordingly, since almost all of Apple's research activity takes place in the United States, Apple should remit most of its taxes there. Such view was recently supported by Jacob Lew, Neelie Kroes and Pascal Saint-Amans, but does not take into account the fact that 60 percent of Apple's total net sales occur overseas and the significance of the customer market in value creation. In addition, it is also inconsistent with the position taken by the Internal Revenue Service in the *Glaxo* case[2], i.e., that intangibles derive their value primarily in the country where marketing activities are carried out and not where research and development activity is performed. This paper discusses how the arguments presented by the IRS in *Glaxo* can be used by high-tax EU countries to justify locating extra profits to sales and marketing support operations performed by Apple Europe's retail subsidiaries. While ordering Ireland to recover €13 billion in illegal tax benefits, the Commission left the door open for other tax authorities to claim for Apple's commercial risks, sales and other activities that might have taken place in their countries.

There are two questions that have been left unanswered by the Commission in its final decision in the Apple State aid case. The first question is: Where should Apple's foreign income be regarded as being generated? The second question is: Which country has the right to tax? Contrary to what Apple declared in its accounting statements, the authors argue that a substantial portion of Apple's foreign income was not generated by subsidiaries organized in Ireland. Seamus Coffey, a member of the Irish Fiscal Advisory Council, argued that:

> There is almost no basis for any argument that 60 percent of the profits of Apple Inc. over the period in question were generated by risks, functions or assets in Cork. Even thinking that someone might suggest it seems foolish. And if Ireland does take a big chunk of tax out of Apple's profits then we can be sure there will be another hearing of the US Senate on this matter. And this time they won't be calling us a tax haven; they'll be calling us a tax thief![3]

In this regard, J. Richard Harvey, in his testimony before Congress about the offshore tax practices of Apple Inc., noted in June 2011 that:

> Only 4 percent of the global workforce and 3 percent of global compensation expense [was] located in Ireland, and approximately 1 percent of customers [were] located in Ireland.

In addition, only de minimis research and development activity was conducted in Ireland, constituting less than 1 percent.[4] Moreover, in its appeal against EU's Apple ruling, Ireland claimed that the decision mischaracterized the activities and responsibilities of the Irish branches of ASI and AOE. These branches carried out *routine functions*[5], but all important decisions within ASI and AOE, including in relation to Apple's intellectual property (or "IP"), or the cost sharing agreement, which was signed by Apple Inc. U.S.-based employees[6], were made in the United States.[7] Nevertheless, a disproportionate amount (64 percent) of Apple's global pre-tax income was recorded in Ireland and Apple's Irish operations were more profitable than its US operations.[8] Indeed, as noted by Stephen E. Shay, the Apple Irish companies' EBT to sales margin was higher than that for Apple US (46 percent compared to 23 percent).

In the authors' opinion, the way Apple set up its sales operations was the main factor that made ASI extremely profitable. ASI purchased the finished goods from a third-party manufacturer in China and immediately resold them to Apple Distribution International (for sales in Europe, the Middle East, Africa and India) or Apple Singapore (for sales in Asia and the Pacific region, i.e. Hong Kong, Japan and Australia) which, in turn, sold the goods to Apple's retail entities, third

party resellers, or directly to end customers. ASI never took physical possession of the products. Title was transferred between the third-party manufacturer and ASI only while the products were being directly shipped to the eventual country of sale. An excerpt from the US Senate Report describes how Apple's distribution channel facilitated the concentration of offshore profits in Ireland:

> Apple products sold in Asia were not shipped to Ireland from the third-party manufacturer and then shipped back to Asia for sale. Rather, ASI took title to the manufactured products while they were being shipped to Apple's Asian distribution centers. *When they arrived, ASI sold the products to Apple Singapore at a substantial profit … Transferring title in this manner allowed Apple to retain most of its profits in Ireland … and limit the income it reported in the non-tax havens countries where the company did most of its business*. For example, in 2011, Apple reported $34 billion in income before taxes; however just $150 million of those profits, a fraction of one percent, were recorded for Apple's Japanese subsidiaries, even though Japan is one of Apple's strongest foreign markets. (According to its September 2016 Form 10-K, 8 percent of Apple's total net sales occurs in Japan).

ASI was thus hugely profitable but not because of activities done in Hollyhill in Cork. Indeed, as revealed by the US Senate Report, ASI did not conduct any of the manufacturing – and added nothing – in Ireland to the finished Apple products it bought. Two factors within the above-mentioned distribution channel drove the profitability of ASI: (i) the fee that ASI paid to the third-party manufacturer in China to assemble Apple products; and (ii) the price ASI charged to the Apple affiliates when selling the products. The difference between the two reflects the amount of accumulated foreign earnings in Ireland. Therefore, for the above reasons, Apple's foreign income does not belong to Ireland, because the two Irish subsidiaries were not economically able to generate it, thus, the question becomes to whom does such income belong?

The authors have already argued that, on the one hand, most of Apple's $187 billion of foreign income relates to intellectual property developed at its headquarters in Cupertino, California. On the other hand, another portion of its profits derive from foreign market countries, where Apple products are largely sold.[9] Thus, the taxing right over Apple's foreign income should be shared between the United States, where its intangible assets are developed, and foreign countries, where selling and marketing expenses are implemented. How Apple's foreign profits should then be split between Apple U.S. and its foreign distributing affiliates is another issue, which involves an objective assessment about the importance of the activities and functions performed by the parties to the transaction.

The authors believe that the affected European market countries have a strong case for collecting the taxes from Apple, since a lot of value was created for Apple in their respective market jurisdictions. Two U.S. Tax Court cases, *Medtronic, Inc. v. Commissioner*[10] and *The Coca-Cola Company and Subsidiaries v. Commissioner*[11] focused on how significant the customer market is in value creation. In both cases, the taxpayer argued that market related intangibles are more important than IP developed in the U.S. Thus, it can arguably be said that Apple's Irish profits belong to France, Germany, Italy, etc., more than to the U.S. and should be subject to tax there. That theory was initially developed in the *Glaxo* case, the largest tax dispute in the history of the IRS.[12] The main question was whether the profits made by GlaxoSmithKline plc (a multinational group involved in the pharmaceutical business headquartered in the U.K.) in the U.S. were primarily attributable to: (i) the U.K. research and development activities from which resulted Zantac that became the best selling prescription pharmaceutical product in the world beginning in 1986; or (ii) the marketing and launch expenses incurred by the U.S. subsidiary of Glaxo group. The transfer pricing policy used by Glaxo group resulted in the majority of the profits being allocated to the U.K. parent company, on the grounds that the unique characteristics and high quality of Zantac, one of the products discovered at Glaxo U.K.'s research facilities, were the main reason why Zantac had the greatest U.S. market share in 1987. Indeed, in its 2004 Tax Court petition, Glaxo claimed that:

> Zantac was marketed at a premium price over Tagamet (chemical name cimetidine), the first anti-ulcer drug that directly blocked acid production, because, although the second to market, *Zantac was more potent, had a twice-a-day dosage compared to Tagamet's four-times-a-day dosage, had fewer side effects, and had fewer drug interactions*.

In its response, the IRS denied and alleged that:

> [T]o the extent that Glaxo U.S. was able to sell Zantac at a premium price, if at all, *it was the result of its extraordinary efforts and expenditures, including expenditures for marketing, sales, and promotion …*

In this regard, it added that:

> [Glaxo U.S.] devised and implemented marketing strategies for the products it sold that were *unique, intensive, aggressive, not entirely in compliance with legal or regulatory requirements* (*i.e. warning letter, anti-trust*) *and costly and beyond 'standard industry practices'*.

The IRS also looked at the contractual terms of the 1987 license agreement and stated that the entrepreneurial risk was shifted to Glaxo U.S., by guaranteeing Glaxo U.K. a fixed sum regardless of the products supplied. Finally, the IRS argued that Glaxo U.S. was not entitled to deduct royalties it paid regarding trademarks and other marketing intangibles because Glaxo U.S. was the owner for tax purposes of the trademarks and marketing intangibles licensed from Glaxo U.K:

> [*Glaxo U.S. was*] *the owner of the trademarks and marketing intangibles since* [*Glaxo U.S. was*] *the developer of said intangibles and because the economic substance of* [*Glaxo U.S.'s*] *dealings with Glaxo Group* at the time the licensed products were first sold in the United States *established the existence of an imputed royalty-free*[13] license or other transfer of the U.S. trademarks and other marketing intangibles at that time.

For all the above reasons, the IRS allocated to Glaxo U.S. over 80 percent of Glaxo's total worldwide profits on Glaxo U.K.'s sales and distributions in the United States. The case was settled by the parties before trial. Glaxo U.S. paid the IRS approximately $3.4 billion. Under the settlement agreement, about 60 percent of the profits were allocated to Glaxo U.S. and the remaining 40 percent to Glaxo U.K.

In the authors' opinion, this case has broader implications for the State aid issue for several reasons. Firstly, the IRS took a new approach claiming that the value of marketing efforts prevail over the value of patents and technical know-how. That approach helps the argument that Apple's Irish profits stem in part from high-tax EU countries, such as France, Germany, Italy etc. and should be subject to tax in such jurisdictions. Secondly, the IRS presented very interesting arguments that can be used by other tax authorities against Apple in determining arm's length compensation for intangibles developed by Apple's foreign distributors. For example, the IRS argued that Glaxo U.K. under-compensated Glaxo U.S. for selling Zantac in the United States. The same policy was followed by Apple. Indeed, as argued by J. Richard Harvey, Apple's retail subsidiaries located in various countries around Europe appear to have only received relatively small commissions for the distribution and sale of Apple's products into their respective countries. Thus, EU tax authorities might seek to either: (i) increase the small commission that Apple Europe's retail subsidiaries receive for the sale of goods to customers, or (ii) reduce the price of the manufactured products, that Apple Europe's retail subsidiaries were required to purchase from ASI. As stated in the US Senate Report, when it re-sold the finished products, ASI charged the Apple affiliates a higher price than it paid for the goods and, as a result, became the recipient of substantial income. In addition, EU tax authorities might also look at the economic substance of the dealings between ASI and Apple Europe's retail subsidiaries and assert that a royalty should not be imputed from these foreign affiliates because they bore the costs and risks for development of the Apple trademark. Intercompany payments of (deductible) royalties are, indeed, one example of earnings stripping strategies used by multinationals to move profits from subsidiaries in high-tax countries to other jurisdictions with lower or no taxes.

All the above solutions suggested by the IRS in *Glaxo* are very similar to principles laid down in paragraphs 6.36-6.39 of the OECD Guidelines and paragraph 51 of the Discussion Draft, which consider how a distributor should be adequately compensated in those situations where it actually bears the costs of its marketing activities[14]. In the authors' opinion, this is the right way that EU Member States should pursue if their desire is to tax Apple and other U.S.-based multinationals on their trillions of profits that: (i) are untaxed by anyone, and (ii) can arguably be said to stem in part from EU countries.

Finally, *Glaxo* is precisely the proof that if the situation were reversed, the U.S. would be clamoring to collect taxes from a foreign company.[15]

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ENDNOTES

1 State Aid SA. 38373 (2014/C) (ex 2014/NN) (ex 2014/CP) – Ireland, Brussels, June 11, 2014, C(2014) 3606 final (hereinafter the Apple case). For purposes hereof, any general references to "Apple" shall mean Apple Inc. and its affiliates.

2 *GlaxoSmithKline Holdings v. Comm'r*, U.S. Tax Court Docket No. 5750-04.

3 See, http://economic-incentives.blogspot.it/2016/03/apple-sales-internationalby-numbers.html

4 Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigation, "Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.)" (May 21, 2013), at 28.

5 State Aid SA. 38373 (2014/C) (ex 2014/NN) (ex 2014/CP) – Ireland, Brussels, June 11, 2014, C(2014) 3606 final (hereinafter the Apple case), section 43: "As

regards the agreements in the rulings in favor of ASI, the Irish authorities express the view in their letter of 25 March 2014 that *ASI's branch was considered to carry out routine, albeit important, functions in the procurement and onward sale and supply of goods for Apple. It would therefore have had no special valuable assets*. Although the Irish branch arranged the procurement and onward sale and supply of goods (which did not pass though the Irish branch), *the goods concerned derived their value largely from intangibles created in the US. There were also no indications that the Irish branch bore significant risks in relation to the activities of ASI*"; and section 44: "Furthermore, according to Irish authorities' letter of 25 March 2014, Irish Revenue was satisfied that the agreed margin on operating costs delivered a net profit commensurate with the value added by the Irish branch. *On the basis of a branch-focused analysis of the operations undertaken in Ireland, it would have been clear that the main profit-generating functions and assets were not located in Ireland. All significant risks and all intellectual property would have been borne and economically owned elsewhere in the ASI enterprise or the Apple group and the profit attribution to the Irish branch would have represented full remuneration of its role in that process*".

6 Permanent Subcommittee on Investigations, *supra* note iv, at 30-31.

7 Apple case, *supra* note v, at section 28: "*All strategic decisions taken by ASI, including in relation to IP, are taken outside of Ireland*. As with AOE, ASI is a party to the R&D cost sharing agreement with other Apple Inc. subsidiaries under which the total costs of the group's worldwide R&D are pooled. *ASI's Irish branch has no authority to make decisions relating to Apple IP or the cost sharing agreement. No rights in relation to the Apple IP concerned are attributed to the Irish branch*".

8 Testimony of J. Richard (Dick) Harvey, Jr. Before the U.S. Senate Permanent Subcommittee on Investigations (May 21, 2013), at 5: "Very little income recorded in countries other than the US and Ireland – Although 60% of its 2011 sales were to customers in countries other than the US and Ireland, only 6% of the consolidated pre-tax income was recorded in such countries. This result was accomplished by recording substantially all of the pre-tax income from customers outside of the Americas in ASI".

9 Testimony of Stephen E. Shay Before the U.S. Senate Permanent Subcommittee on Investigations Of the Committee on Homeland Security and Governmental Affairs Hearing on Offshore Profit Shifting and the Internal Revenue Code (May 21, 2013), at 9: "There is no doubt that some income is shifted from the market countries, but it is reasonably clear that the largest part of the value in Apple's products arises from its proprietary technology. Some is attributable to Apple's marketing, for which Apple U.S. makes a small charge to affiliates. It is doubtful that the preponderance of the Irish income is properly allocable to the in-country selling activity".

10 Medtronic, Inc. v. Commissioner of Internal Revenue, T.C. Memo. 2016-112 (U.S. Tax Ct., 2016). This case involved the allocation of income between Medtronic US and its Puerto Rican affiliate, MPROC. All of the R&D activities related to the medical devices sold by MPROC to Medtronic for distribution in the US took place at the parent company (Medtronic US). On the other hand, MPROC was mainly responsible for assembling devices and assuring quality in the final products assembled. However, Medtronic's CEO, in his testimony before the Tax Court, was able to persuade judges that *quality control was a critical aspect in determining market share*. For a comment on this case see, Reuven Avi-Yonah, Back To The Future? Medtronic And The Future Of Transfer Pricing, 42 *International Tax Journal* 4, 2016, at 23-33.

11 The Coca-Cola Company and Subsidiaries (Petitioner) v. Commissioner of Internal Revenue (Respondent), (U.S. Tax Ct., Dec. 14, 2015). In this case, taxpayer is trying to demonstrate how important is customer market in value creation: "the non-alcoholic ready-to-drink (NARTD) beverage industry is highly competitive. *To remain competitive, the Company must continuously recruit new consumers and build consumer awareness, both of which require significant ongoing investments in advertising and marketing, product and package offerings, and other innovation*. Consumer tastes, consumption habits, cultural norms and trends, and population demographics are dynamic and vary widely among countries and regions. *To capture and retain market share, the Company must tailor its beverages, beverage portfolios, and marketing and advertising messages to the unique market conditions in different geographies around the world*". For a comment see, J. Clark Armitage, Patricia G. Lewis and Natalie Punchak, Coca-Cola Company Challenges $9 Billion Transfer Pricing Adjustment, International Law Office, February 5, 2016, available at: http://www.capdale.com/files/17528_Coca-Cola_Company_challenges_9_billion_transfer_pricing_adjustments.pdf

12 However, it should be noted that the concept of 'marketing intangibles' initially gained prominence in the late 1980s through a docketed U.S. Tax Court case (*Club Mediterreanne and Subsidiaries*) involving the sale of vacation destinations by a U.S. distributor on behalf of a prominent foreign travel and vacation entity. Particularly, the level of advertising, marketing and promotion expenditures (AMP) that the U.S. distribution

affiliate incurred for these sales was scrutinized. The IRS sought either to: (i) disallow a portion of the AMP under the notion that it was incurred on behalf of the foreign trademark owner, or (ii) establish a service fee for the marketing efforts that the U.S. distributor performed on behalf of the foreign trademark owner. For a comment see Marc M. Levey, Monique van Herksen, Stephan Schnorberger, Stephen Breckenridge, Kazuo Taguchi, James Dougherty and Antonio Russo, The Quest for Marketing Intangibles, 34 *Intertax* 1, (2006), at 1; see also Marc. M. Levey, Philip W. Carmichael, Imke Gerdes, and Daniel A. Rosen, Marketing Intangibles – The Expanding Global Analysis, 27 *JITAX* 20, 22, 2016 WL 7116201, 1.

13 It should be noted that this technical argument was applied by taxpayer in the DHL Tax case decided in 2002. See DHL Corp. v. Comm'r, TC Memo. 1998-461, aff'd and rev'd on other grounds, 285 F3d 1210 (9th Cir. 2002). In the DHL case, the U.S. Tax Court addressed the IRS's attempt to impute a trademark royalty for the use of the DHL trade name by DHL's foreign affiliates. DHL asserted that a royalty should not be imputed from these foreign affiliates because they bore the economic investment for development of the DHL trademark … the DHL Tax Court case stood for the proposition that for items of intangible property, the party who bore the economic burdens of the investment should bear the economic the economic rewards. For purposes of this economic investment, the Tax Court considered the aggregate levels of advertising, marketing, and promotion expenses (i.e. the "AMP" expenses), as well as certain other expenses that DHL foreign affiliates incurred, although there was no analysis of either the expenditures that made up the AMP expenses or the AMP costs that were directed to trademark development versus the surrounding intangibles. While the Tax Court found in favor of the IRS and assessed penalties against the taxpayer, in 2002 the Appellate Court reversed the finding and held that under the then applicable regulations under Section 482 of the Internal Revenue Code, the DHL foreign affiliates made the economic investment for the development of the DHL trademark and were considered the owners of those intangibles for tax purposes and entitled to its economic return. For a comment see *supra* note 12.

14 See OECD, Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions, para. 51 and example 5 in paras. 197-201.

15 Alan Rappeport, Yesterday, Outraged by Apple's Tax Dodge. Today, by Its Tax Bill, THE NEW YORK TIMES, Aug. 31, 2016.

THE CONTROVERSY REGARDING THE APPLICABLE STATUTE OF LIMITATIONS FOR STATE TAX ASSESSMENTS AND THE COURT OF CLAIMS RECENT DECISION IN *OLD ORCHARD BRANDS LLC V. DEP'T OF TREASURY*

By Daniel L. Stanley

Introduction

Taxpayers and the Michigan Department of Treasury (the "Department") are at odds over the application of the 2014 amendments to the statute of limitations contained in the Revenue Collection Act.[1] The Department claims that the 2014 amendments apply only to assessments that arise out of audits that were initiated after the effective date of the 2014 amendments while taxpayers claim that the 2014 amendments apply to all assessments issued after that effective date. The Court of Claims recently ruled in favor of the Department in *Old Orchard Brands LLC v. Dep't of Treasury*, No. 16-000114 (Mich. Ct. of Cl. Feb. 3, 2017) and the taxpayer has appealed to the Michigan Court of Appeals. State tax practitioners should be aware of this controversy because many taxpayers either receiving assessments or claiming refunds will be affected by this issue.

Statutory Background

The procedures of the Revenue Collection Act generally apply to all taxes administered by the Department of Treasury.[2] The Revenue Collection Act contains a 4-year statute of limitations for refund claims and assessments that can be suspended or extended under certain circumstances.[3] For decades, Michigan was a "notice" state for statute of limitations purposes. That is, upon notice of a state tax audit, the 4-year statute of limitations of MCL 205.27a was "suspended." Specifically, prior to amendment in 2014, MCL 205.27a(3) provided:

> (3) The running of the statute of limitations is suspended for the following:
>
> (a) *the period pending a final determination of tax, including audit, conference, hearing, and litigation of liability for federal income tax or a tax administered by the department and for 1 year after that period.*
>
> (b) The period for which the taxpayer and the state treasurer have consented to in writing that the period be extended.[4]

Due to this statutory provision, the Department took the position that the statute of limitations was suspended after the Department issued an Audit Confirmation Letter to the taxpayer and remained suspended until the Department issued a Final Audit Determination Letter.[5]

All this changed when the Legislature passed 2014 Mich. Pub. Act No. 3 ("Public Act 3"), which took immediate effect on February 6, 2014. As amended by Public Act 3, MCL 205.27a(3) provides:

> (3) The statute of limitations shall be extended for the following if the period exceeds that described in subsection (2):
>
> (a) *The period pending a final determination of tax through audit, conference, hearing, and litigation of liability for federal income tax and for 1 year after that period.*
>
> (b) The period for which the taxpayer and the state treasurer have consented to in writing that the period be extended.
>
> (c) The period described in section 21(6) and (7) or pending the completion of an appeal of a final assessment.
>
> (d) A period of 90 days after a decision and order from an informal conference, or a court order that finally resolves an appeal of a decision of the department in a case in which a final assessment was not issued prior to appeal.[6]

As can be seen, the language that existed under the former version of MCL 205.27a(3)(a) that suspended the running of the statute of limitations during the pendency of a state tax audit no longer exists. This omission gave rise to the issue before the Court in *Old Orchard* – what statute of limitations applies to assessments issued after the February 6, 2014 effective date of Public Act 3 that arose from audits begun before that date?

THE FACTS IN OLD ORCHARD

In June 2011, the Department began auditing Old Orchard Brands LLC for use tax for the period from March 1, 2006 through July 31, 2011. As was its practice at the time, the Department sent an Audit Confirmation Letter to the taxpayer stating that the statute of limitations was suspended during the pendency of the audit.[7] In August, 2012, the Department sent a revised Audit Confirmation Letter stating that the period under audit was May 1, 2007 through December 31, 2011 and, again, stating that the statute of limitations was suspended.

On February 6, 2014, Public Act 3 took effect. On April 20, 2015, the Department issued a final audit determination letter to the taxpayer alleging the taxpayer owed additional use tax, interest and penalties. This letter stated that it "reinstate[d] the running of the statute of limitations that was suspended on 6/14/2011. . . . The statute of limitations will expire at the conclusion of one year after 4/20/2015, plus any remaining balance from the four-year limitation period that was suspended by the audit." The Department subsequently issued an Intent to Assess and Final Assessment.

The taxpayer challenged the Department's Final Assessment at the Court of Claims, arguing that the assessment was untimely under the current version of MCL 205.27a. The Department argued that Public Act 3 must be given prospective effect and that, to do this, the former version of MCL 205.27a controlled because the audit was started prior to the effective date of Public Act 3. The taxpayer argued that it too was seeking prospective effect for Public Act 3 but interpreted prospective effect to mean that Public Act 3 applied prospectively to all assessments issued after its effective date.

THE COURT OF CLAIMS DECISION IN OLD ORCHARD

The Court of Claims framed the issue before it as follows:

> Thus, the outcome of this matter depends solely on what it means to give 2014 PA 3 prospective effect. To give an amendment prospective effect, an event must exist that determines which version of the statute applies. Plaintiff contends that this event is the date of the assessment. According to Plaintiff, if the assessment is issued after 2014 PA 3 took effect, the amended version of the statute applies. The Department believes that the relevant event is when the audit commenced. Thus, according to the Department, giving 2014 PA 3 prospective effect means applying the earlier version of MCL 205.27a(3)(a) to matters that were in audit when 2014 PA 3 took effect.[8]

The Court of Claims then stated that the Michigan Court of Appeals decision in *Davis v. State Employees' Retirement Bd*, 725 N.W.2d 56 (Mich Ct. App. 2006) was "instructive." In *Davis*, a state employee was terminated in 2000. At that time, there was no time limit on submitting an application for disability retirement benefits. In March 2002, however, the statute was amended to put a one-year time limit on the application for disability retirement benefits. The employee applied for benefits in August 2002. The Court of Appeals in *Davis*, relying upon case law holding that amendments to statutes of limitations do not apply to claims that have already accrued, held the employee was not bound by the new one-year time limit.

The Court of Claims held that the situation before it was analogous to the facts presented in *Davis* and the statute of limitations should be determined based on the law as it existed when the "claim accrued." The Court of Claims then turned its attention to the issue of what would constitute a comparable accrual date under tax law for purposes of either bringing a refund claim or issuing an assessment. The Court of Claims held that "the event most comparable to an 'accrual' date is the date the Department began its audit" because "[o]n that key 'trigger' date, the running of the statute of limitations was suspended."[9] Therefore, the Court of Claims held that the suspension of the statute of limitations under former MCL 205.27a continued to be effective for audits that were begun prior to the effective date of Public Act 3.

ISSUES TO BE RESOLVE BY THE COURT OF APPEALS

The taxpayer in *Old Orchard* has appealed to the Michigan Court of Appeals. There are several arguments that the taxpayer could and likely will make at the Court of Appeals. For example, in *Old Orchard*, the Court of Claims analogized the beginning of an audit with the accrual of a cause of action and the issuance of an assessment to the filing of a suit. The taxpayer could argue that this analogy is inappropriate. The accrual of a cause of action gives a plaintiff the immediate right to file suit.[10] The beginning of an audit, however, does not give the Department the right to either immediately file suit or issue a tax assessment. It is only after an audit is finished, and the Department finds that tax is owed, that the Department has the right to issue a tax assessment.[11] Indeed, many audits are conducted that do not result in assessments. Thus, it could be argued that the beginning of an audit is not really analogous to the accrual of a cause of action.

Furthermore, it is unclear whether *Davis* is applicable to tax cases. The cases relied upon in *Davis* held that changes to a statute of limitations do not affect claims that had already accrued because otherwise they would adversely affect vested rights. The Michigan Court of Appeals has held, however, that taxpayers have no vested rights regarding tax claims even

after a refund request has been made.[12] If taxpayers have no vested rights after having made a refund claim, it is difficult to conceive how the Department could have a vested right to make a tax assessment merely because it had begun an audit. Indeed, the law is generally that state agencies and legislative subdivisions of the state have no vested rights or due process protections at all.[13] It is therefore unclear whether the Court of Claims reliance upon *Davis* was appropriate.

The Court of Claims held that, if it adopted the position advocated by the taxpayer, it would be giving Public Act 3 "retroactive effect."[14] That does not appear to be correct. A statute is not regarded as operating retrospectively solely because it relates to an antecedent event.[15] Rather, a "retrospective" or "retroactive" law is one "that takes away or impairs vested rights acquired under existing laws or creates new obligations and imposes a new duty, or attaches a new disability with respect to transactions or considerations already past."[16] For example, 2014 Mich. Pub. Act No. 282 was clearly a retroactive law. That act was passed in September 2014 and repealed the Multistate Tax Compact effective January 1, 2008 and therefore "reached back" in time to change the law at a prior date.[17] It is unclear whether applying Public Act 3 to apply to all assessments issued after its effective date is a "retroactive" application of the law in any sense of the word.

Taxation is not based upon common law but only upon express statutory authority.[18] The Michigan Supreme Court has held that "tax collectors must be able to point to such express authority so that it may be read when it is questioned in court."[19] As of February 18, 2016, however, there was no statutory language that supported the issuance of the tax assessment at issue in *Old Orchard*. Indeed, the current law forbade the assessment and all the Department could point to was a law that used to be in force but was no longer effective.

In *Old Orchard*, the Court of Claims determined that there was no indication that the Legislature intended to effectively override the suspension of the statute of limitations previously provided in MCL 205.27a(3).[20] It could be argued, however, that the clearest way for the Legislature to indicate such an intent would be to amend the statute to eliminate the language that suspended the limitations period for assessments and to not provide any grandfathering provision, which is exactly what the Legislature did. Furthermore, the Court of Claims concern that there was no indication that the Legislature intended to override the prior suspension of the statute of limitations could easily be turned on its head because there is likewise no statutory language in Public Act 3 that indicates an attempt to "grandfather" audits that were pending at the time the statute was enacted. In Public Act 3, however, the Legislature did phase in certain other new statutory changes, such as new time limits imposed for issuing audit workpapers and assessments. Those new time limits specifically only apply to audits "commenced after September 30, 2014."[21] Thus, the Legislature clearly considered and enacted language delaying the effect of certain new provisions of Public Act 3 but did not enact language to do so with respect to the new statute of limitations provisions. It could therefore be argued that the Court of Claims decision in *Old Orchard* improperly reads into the statute language that "grandfathers" the prior suspension language that the Legislature did not see fit to include.[22]

Conclusion

The issues raised in *Old Orchard* are quite complex and, ultimately, will have to be resolved in the appellate courts. The Michigan Court of Appeals will probably issue its decision in late 2017. State tax practitioners should keep an eye on this case because there may be hundreds of other taxpayers who have assessments or refund claims that are affected by it.

About The Author

Daniel L. Stanley *is a partner in the Litigation Department with the law firm of Honigman Miller Schwartz and Cohn LLP and a member of the firm's SALT Practice Group. He has practiced in state and local taxation for 19 years. He received a Bachelor of Science degree in Aerospace Engineering from San Diego State University and a Master of Science degree in Aeronautics and Astronautics from Stanford University. Mr. Stanley received his law degree magna cum laude from the University of Michigan Law School, where he was a member of the Law Review. He is the co-author of the BNA State Tax Portfolio on the Michigan Corporate Income Tax and has spoken on state tax topics at conferences sponsored by the Council on State Taxation, Tax Executives Institute, Michigan Association of Certified Public Accountants, and the State Bar of Michigan.*

Endnotes

1 MCL 205.1, *et seq.*

2 MCL 205.20.

3 MCL 205.27a(2) and (3).

4 MCL 205.27a(3) prior to amendment by 2014 Mich. Pub. Act No. 3 (emphasis added).

5 See Revenue Administrative Bulletin 2008-8.

6 MCL 205.27a(3) (emphasis added).

7 See Revenue Administrative Bulletin 2008-8.

8 *Old Orchard,* slip op.at 6.

9 *Old Orchard,* slip op.at 9.

10 MCL 600.5827.

11 MCL 205.21 (requiring the Department to obtain information and determine the tax due before issuing an assessment).

12 See, *e.g.*, *Gillette Commercial Operations NA & Subsidiaries v. Dep't of Treasury*, 878 N.W.2d 891 (Mich Ct. App. 2015).

13 See, e.g., *Kent County Aeronautics Bd v. Dep't of State Police*, 609 N.W.2d 593 (Mich Ct. App. 2000), *Flint City Council v. State*, 655 N.W.2d 604 (Mich Ct. App. 2002).

14 *Old Orchard*, slip op. at 9.

15 *Selk v. Detroit Plastic Products*, 345 N.W.2d 184 (Mich. 1984); *Hughes v. Judges' Retirement Board*, 282 N.W.2d 160 (Mich 1979).

16 *In re Certified Questions from the US Court of Appeals for the Sixth Circuit,* 331 N.W.2d 456 (Mich 1982).

17 See *Gillette, supra*.

18 *Molter v. Dep't of Treasury*, 505 N.W.2d 244 (Mich. 1993).

19 *In re Dodge Bros*, 217 N.W. 777 (Mich. 1928).

20 *Old Orchard*, slip op.at 9.

21 MCL 205.21(6) and (7).

22 *Lake Forest Partners 2, Inc v. Dep't of Treasury*, 720 N.W.2d 770 (Mich Ct. App. 2006).

Fundamentals of Taxation

Thursday, October 12, 2017, 7:30 a.m. - 1:00 p.m.

The Fundamentals of Taxation program is a new initiative by the Taxation Section to provide instruction on the basics of taxation and on spotting tax issues that arise in transactional matters and tax controversies. The courses are intended both for new tax attorneys seeking an introduction to the practice of tax law and for more experienced tax and transactional attorneys who are seeking a refresher course. There are two tracks: (1) a core track, with a broad but comprehensive focus, for those with less experience in tax matters; and (2) an advanced track with in-depth analysis of specialized tax issues for more experienced professionals. The program will be held semi-annually (as a stand-alone offering in the fall and as a component of the Taxation Section's Annual Tax Conference held each May). Other tax practitioners, including CPAs and lawyers practicing at accounting firms, should also find the program useful.

The registration form for the program is included in this edition of the *Michigan Tax Lawyer.* For more details and to electronically register for the program visit http://connect.michbar.org/tax/events.

TAXATION SECTION **REGISTRATION**

Fundamentals of Taxation

October 12, 2017 • 7:30 a.m.-1:00 p.m.
Honigman • 660 Woodward Ave • Detroit • 48226

Video links in Honigman's Ann Arbor, Kalamazoo, Lansing and Grand Rapids Offices*

The "Fundamentals of Taxation" program is a new initiative by the SBM Taxation Section to provide instruction on the basics of taxation and on spotting tax issues that arise in transactional matters and tax controversies. The courses are intended both for new tax attorneys seeking an introduction to the practice of tax law and for more experienced tax and transactional attorneys who are seeking a refresher course. There are two tracks: (1) a core track, with a broad but comprehensive focus, for those with less experience in tax matters; and (2) an advanced track with in-depth analysis of specialized tax issues for more experienced professionals. The program will be held semi-annually (as a stand-alone offering in the fall and as a component of the Taxation Section's Annual Tax Conference held each May). Other tax practitioners, including CPAs and lawyers practicing at accounting firms, should also find the program useful.

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Questions

For additional information regarding the seminar, contact James H. Combs at (313) 465-7588 or jcombs@honigman.com

Register One of Two Ways

Online: Pay by credit/debit card at http://e.michbar.org

Mail your check and completed registration form to:

State Bar of Michigan, Attn: MLS Seminar Registration
306 Townsend Street, Lansing, MI 48933

Agenda

7:30 a.m.	Registration and continental breakfast
8:15 a.m.	Introductory Panel: The Role of the Tax Attorney
9:00 a.m.	**Core Track:** Types of Taxes and Basics of Income Taxation
	Advanced Track: Tax Aspects of Mergers and Acquisitions
10:05 a.m.	**Core Track:** Introduction to Entity Classification
	Advanced Track: Advanced State and Local Taxes
11:10 a.m.	Closing Panel: Providing Tax Advice – Levels of Comfort and Tax Penalties
12:05 p.m.	Taxation Section Luncheon

Cost

REGISTRATION DEADLINE: October 9, 2017
Limited on-site registration
(Only checks or money orders will be accepted on-site.)

❑ Taxation Section Member $50

❑ Non-Taxation Section Members $85

Non-Taxation Section members who join the section before registering will enjoy an overall savings of $5 on their registration for the Fundamentals of Taxation program.

Join the section online at http://e.michbar.org (after login, select Section Membership)

Options

❑ I will be staying for the luncheon.
❑ I would like to request the vegetarian lunch option.

Location (*Detroit Core Track live, all other locations Core Track via video link.)

I will attend at the following location:
❑ Ann Arbor-Core ❑ Grand Rapids-Core ❑ Kalamazoo-Core
❑ Lansing-Core
❑ Detroit-Core **OR** ❑ Detroit-Advance

CANCELLATIONS must be received at least 48 business hours before the start of the event and registration refunds are subject to a $20 cancellation fee. Cancellations must be received in writing by e-mail, or by U.S. mail. No refunds will be made for requests received after that time. That notice can be made by e-mail (tbellinger@michbar.org), fax (517-372-5921 ATTN: Tina Bellinger), or by U.S. mail (306 Townsend St., Lansing, MI 48933 ATTN: Tina Bellinger.) Refunds will be issued in the same form payment was made. Please allow two weeks for processing.

STRATEGIC PLANNING INITIATIVE: 10/2016-9/2018 TAXATION SECTION OF THE STATE BAR OF MICHIGAN APPROVED BY COUNCIL AND EFFECTIVE AS OF JANUARY 18, 2017

Mission

The Strategic Plan provides a plan for implementing the Taxation Section's Mission: "The Section, as a representative of the legal profession, shall serve its members and the public through education and leadership in efforts to achieve an equitable, efficient, and workable tax system. The purpose of this Section is to improve public understanding of, confidence in, and respect for the federal, state and local tax systems; to provide leadership in simplifying and improving the federal, state and local tax systems; to provide unbiased, thoughtful and timely input into the legislative and administrative process at the national, state and local levels; To promote and maintain an active, vigorous, growing and interested Section membership; To provide programs and services of unique quality which promote professionalism, competence and ethical conduct; to provide a forum for communication among Section members and interchange between the public and private sectors."

Matters that are relevant to the Mission include the following: (i) educating Taxation Section members and other attorneys regarding our current federal, state and local tax systems; (ii) engaging in improving public policy, by filing amicus curiae briefs, and commenting on proposed and finalized legislation and regulatory guidance; (iii) establishing, implementing, and improving pro bono, grant, and other public service programs; (iv) offering networking opportunities for Taxation Section members, other attorneys, government officials, etc.; and (v) maintaining a strong foundation for the Section by increasing membership, planning ahead for seamless leadership changes, increasing leadership training, and sponsoring substantive programs.

Background

Recognizing the importance of establishing a mission statement and goals and of developing methods and strategies to accomplish said mission and goals, the governing board of the Section of Taxation of the State Bar of Michigan determined to develop said mission, goals, and methods and strategies.

Drafts of said mission, goals and strategic plan were circulated to the Council of the Section during the Section's 2016 and 2017 fiscal years. A final version of said mission, goals and strategic plan was circulated to, and approved by, the Council on January 18, 2017.

Recommendations for Strategic Plan Framework:

The following recommendations are steps to be implemented in the 2017 and 2018 fiscal years in order to meet the goals that form the mission of the Section.

Mission	Goal	Strategy	Responsible Council Member(s)/ Committee Chairs
Communications	Improve the quality and content of communications about Section activities, events, and initiatives with Section members; non-Section attorneys in government, accounting firms, universities, and practicing out-of-state; members of other tax associations (including the MICPA and the Michigan Women's Tax Association) law students; tax professionals at tax clinics (non-academic); and non-attorney tax professionals.	Maintain contact with Section members via more frequent email communications highlighting important developments and upcoming events.	Chair and committee chairs
		Drive traffic to the SBM website by including links in emails and publications to materials on the website.	Chair and committee chairs; MTL editor
		Keep the Section website updated with information relevant to members.	Committee chairs and administrator
		Post at least one communication per week on social media platforms, which currently consist of Facebook and LinkedIn.	Social media Council member
Communications	Continue working with the State Bar of Michigan to improve the efficiency of SBM Connect to enhance, expand, and improve communications between Council and Section members. Pursue reforms for simplifying communication resources by, for example, improving the effectiveness of email communications and refining the Section's listserv.	Continue learning more about the capabilities and limitations of SBM Connect and adapt, change, or find a substitute for it (where feasible) to meet the Tax Section's needs.	Officers and administrator
Communications	Serve as a catalyst for improving communications between taxpayer attorneys and government attorneys for the purpose of finding common ground and collectively improving the efficiency and fairness of tax administration and tax litigation in Michigan.	Each committee will reach out to government attorneys to participate in or present at committee events in order to promote greater interaction.	Committee chairs
Leadership	Performing public service in tax law.	Expand and improve the pro bono initiative.	Pro Bono Initiative Council member
		Improve the grant program.	Grant Program Council member
Leadership	Improve leadership transitions so that new committee chairs and new Council members are well informed and prepared when they join Council.	Appoint a vice chair to each committee to assist chairs with planning committee meetings and with reaching out to new tax attorneys and students about attending committee meetings. The vice chair would also learn how the committee operates in order to facilitate the future transition of the chair position.	Chair and committee chairs
Education to Achieve an Equitable, Efficient, and Workable Tax System	Promote the passage of legislation that represents sound tax policy by the United States Congress and Michigan Legislature.	Monitor activities of legislative tax/revenue house/senate committees and provide regular comments on pending legislation and regulatory projects.	Legislation Monitor/ Public Policy Liaison Council member; SALT chair; FIT chair

Mission	Goal	Strategy	Responsible Council Member(s)/ Committee Chairs
Education to Achieve an Equitable, Efficient, and Workable Tax System	Assist in enhancing and expanding the knowledge of Michigan legislators about tax law and tax policy.	Implement annual tax law seminar for Michigan legislators.	Officers; Legislation Monitor/Public Policy Liaison Council member; SALT chair
Education to Achieve an Equitable, Efficient, and Workable Tax System	Continue serving as a resource that Michigan legislators can call upon for insight and input when bills impacting tax laws are being drafted and amended.	Serve as needed, and proactively educate legislators about how the Section can be of assistance to the Legislature.	Legislation Monitor/ Public Policy Liaison Council member; SALT chair
Education to Achieve an Equitable, Efficient, and Workable Tax System	Continue serving as a resource in appellate cases by submitting amicus curiae briefs in cases impacting tax policy.	Serve as needed.	Legislation Monitor/ Public Policy Liaison Council member; committee chairs
Education to Achieve an Equitable, Efficient, and Workable Tax System	Implement and expand programming focused on educating new tax attorneys as well as seasoned practitioners with limited time for continuing legal education or who are looking for a resource on new developments.	Offer "Tax Boot Camp"/"Core Concepts" as one break-out track at the Annual Tax Conference.	Tax Conference chairs (for current and next year); Officers
		Each committee to sponsor presentations as provided in the Section manual and develop one presentation into an annual "signature" event.	Committee chairs
		Implement regular "Brown bag" programs for a "lunch-and learn" approach to education, hosted by the committees.	Committee chairs
		Partner with other SBM Sections (such as the Business Law Section) to offer joint educational opportunities.	Committee chairs
Education to Achieve an Equitable, Efficient, and Workable Tax System	Improve and expand the Michigan Tax Lawyer, including by growing readership, diversity of authors, and diversity of topics.	Engage all Council members, as well as the membership at large, in looking for ways to continuously improve the content of the Michigan Tax Lawyer so that the publication is elevated to the status of a "must read" for Michigan tax practitioners.	MTL Editor; Officers
Education to Achieve an Equitable, Efficient, and Workable Tax System	Develop better participation by academics, in-house tax attorneys and attorneys working as tax professionals in accounting and other non-legal firms.	Assign a Council member to act as a liaison to these different constituencies.	Chair
Maintaining a Strong Foundation	Increase membership by reaching out for new members through promoting the Tax Section on Facebook and LinkedIn.	Once a year, conduct an online Facebook/ LinkedIn membership drive that rewards members with a small incentive for referring a new member.	Social Media Council member
Maintaining a Strong Foundation	Increase membership through organizing drives to reach out to past members to encourage them to re-join the Section.	Recruit at least 20 former members to join the Section each year.	Council and committee chairs; Strategic Planning Council member

Mission	Goal	Strategy	Responsible Council Member(s)/ Committee Chairs
Maintaining a Strong Foundation	Increase sponsorship at meetings.	Focus on maintaining existing sponsors and obtaining new sponsors each year.	Tax Conference Chair and Vice Chair; Annual Meeting Council member; Strategic Planning Council member
Maintaining a Strong Foundation	Strengthen relationships with existing sponsors.	Add a dedicated sponsorship person who will maintain contacts, find new sponsors, learn about their sponsorship timelines (*e.g*., when they have budgets approved). Collect information, analyze and monitor what the Section can offer to sponsors in terms of potential customers and patronage.	Tax Conference Vice Chair
Maintaining a Strong Foundation	Retain institutional knowledge.	Annual review and updating, as needed, of the Section manual.	Vice Chair
		Mandatory training session at time of transition to new Council, Committee chairs and Liaisons.	Vice Chair
		Memorialize process for the Annual Tax Conference, with explanation of expected role of Council and Committee chairs.	Chair
Maintaining a Strong Foundation	Promote opportunities for diversity and inclusion in Taxation Section membership and events.	Provide evaluation of diversity and inclusion in the Section.	Officers, with participation of Council and Committee chairs

2017 STUDENT ACHIEVEMENT AWARD WINNERS

The Taxation Section of the State Bar of Michigan would like to congratulate the recipients of the 2017 Tax Student Achievement Award in recognition of their excellence and contributions to the field of tax law.

Eric F. Sloat

Eric attends University of Michigan's law school and is a third year law student there. He has worked at the University of Michigan Low Income Taxpayer Clinic since May of 2015. He initially planned to work at the Clinic for a summer, but developed a passion for working there and has continued with work at the Clinic, sometimes for neither academic credit nor salary, ever since. Eric excels at tax work and is extremely dedicated to his clients. He is now also working as a law clerk at Ferguson & Widmayer in Ann Arbor while finishing his final term of law school. He is already excellent as a lawyer, but is also skilled at working with clients and is a mentor for new clinicians. He has taken the lead on the Clinic's outreach projects, letting people in the community know about its services and also doing educational programming on tax literacy for ESL and other low income taxpayers. Before law school, Eric received a Master's degree in classics. That means that he actually understands and speaks ancient Greek and Latin. Upon request, Eric will provide the correct pronunciations of those phrases we lawyers like to fling about.

Anastassia O. Kolosova

Anastassia (Ana) attends University of Michigan's law school and is a second year law student. Ana has worked in the University of Michigan Low Income Tax Clinic since May of 2016, and like Eric, has continued working there, sometimes for neither academic credit nor salary, ever since. Ana shares with Eric both a phenomenal capacity for tax work, which is matched only by her compassion and dedication to her clients. At the law school she is also active with the Food Stamp Advocacy Project as well as Student Funded Fellowships (a program whereby students working for big firms over the summer help fund students doing public interest work over the summer). Like Eric, she has been proactive doing outreach projects, building on the connections she has made through her work. Ana has also been a great mentor to other law students. Ana is committed to continue working in the public sector to assist the underserved, and will be working at Legal Services of Southeastern Michigan this summer. Ana has also been a great mentor to other law students. Ana has also been a great mentor to other law students. Ana was a scientist before attending law school, is a patent agent, and also speaks fluent Russian, Chinese and French.

Delanie McCabe

Delanie M. McCabe attends Michigan State University College of Law. Delanie has worked at the MSU Alvin L. Storrs Low Income Taxpayer Clinic ("MSU Tax Clinic") since August 2016. Delanie quickly proved to be a valuable asset to the MSU Tax Clinic, and more importantly, to her clients. Delanie has readily accepted the more challenging case work, such as the complex task of amending dual status nonresident alien tax returns. Delanie has developed client counseling skills and works patiently and tirelessly to ensure her clients fully understand the tax resolution process. Delanie's clients have benefited greatly from her work and dedication. She will continue to assist taxpayers in need at the Michigan Department of Treasury's Office of Taxpayer Advocate Services this summer.

Michael Foster

Michael Foster attends Michigan State University College of Law. He has worked at the Michigan State University College of Law Alvin L. Storrs Low-Income Taxpayer Clinic for two fall semesters. Michael is a skilled litigator. During the fall of 2016, Michael argued a case involving the property tax exemption of a Montessori school before the Michigan Court of Appeals. He also drafted an Application for Leave to Appeal to the Michigan Supreme Court in the same case. Along with litigating, Michael's ability to communicate and advocate for a diverse client base proves that he has chosen the right career path. In addition to his work at the clinic, Michael served in various teaching assistant capacities for first-year and foreign-educated writing classes where he helped mentor students on objective and persuasive writing. Michael also served as the President of the Board of Advocates, which is the student-run organization overseeing all moot court and mock trial teams, and served as an Associate Editor for the *Michigan State Law Review*.

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Published by the
TAXATION SECTION
State Bar of Michigan
306 Townsend Street
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