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CONTENTS

Tax Section Matters

Feature Articles

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/October (Fall), January/February (Winter), and May/June (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 2016, please contact Katherine Kaile Wilbur, Varnum LLP, 333 Bridge Street NW, Grand Rapids, Michigan 49504, kkwilbur@varnumlaw.com; or (616) 336-6494

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LETTER FROM THE CHAIR

January 16, 2016

On behalf of the Taxation Section, I wish all of our members a happy, healthy, and prosperous new year. Like every new year, we start 2016 with a host of new developments in tax law, some new and others extensions or variations of tax laws that were set to expire. The Taxation Section is a great way to keep up-to-date with these developments.

With over 1,300 members, the Taxation Section is a dynamic, active organization. Our members include tax practitioners from solo practices to large law firms, accounting firms, corporations, government and law schools. With this diverse demographic, we encourage you to get involved and get know other members within the Taxation Section.

The Taxation Section offers a broad range of events and activities, such as the Annual Tax Conference and Tax Court luncheons. We also encourage you to get involved with one or more of our six Committees, which include: Federal Income Tax, State & Local Tax, Tax Practice & Procedure, Estates &Trusts, Employee Benefits, and Young Tax Lawyers. For information on upcoming events and activities or to join a Committee, please visit our website at www.connect.michbar.org/tax or contact Brian Figot, the Program Facilitator.

The Annual Tax Conference will be held on May 19, 2016 at The Inns at St. John's located in Plymouth, as well as available by webcast. The theme this year is "Elections, Entitlements, and Entrepreneurs: Prepare for and Handle the Most Recent Tax Developments." The Conference is intended to keep our members on top of constantly evolving developments in tax law on the national front, including a fascinating look at federal tax policy through the eyes of former U.S. Senator Carl Levin, *plus* an in-depth analysis of state and local tax developments. We encourage you to visit our website at www.connect.michbar.org/tax or www.icle.org to get more information, as well as, register for the Conference.

On behalf of the Taxation Section, I thank you for your membership. I also invite you to share your comments and suggestions on how we can improve your experience.

Sincerely,

Michael M. Antovski
Chairperson, Taxation Section

SECTION COMMITTEE REPORTS

Report of the Employee Benefits Committee

The Employee Benefits Committee met on December 16, 2015 at the Henry Center for Executive Development at Michigan State in East Lansing. Samantha Kopacz (Fraser Trebilcock) presented an update on wellness program guidance, outlining the three separate (and often conflicting) sets of regulations governing wellness programs and the challenges facing practitioners and employers given these discrepancies.

We will be hosting a joint event with the ASPPA Benefits Council ("ABC") of Detroit on January 21, 2016 (this Thursday) at the Management Education Center in Troy. Sherry Brackney (DOL-EBSA) will discuss various issues relating to EBSA investigations of employee benefit plans. This will be a breakfast meeting with the exact time TBD. The Committee has partnered with the ABC of Detroit for events in the past, and they have always been very successful.

Finally, Bob Miller (Calfee Halter & Griswold), will serve as a panelist with me at the 2016 Tax Conference, presenting on Announcement 2015-19 regarding modifications to the determination letter program. Bob is leading the ABA taskforce on this issue. Bob and Jeff Kirkey are still trying to secure a third panelist from the IRS. If they are unsuccessful, we will either try to find another local speaker to round out the panel, or Bob and I will serve on a panel of two.

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Report of the State & Local Tax Committee

The State and Local Taxation Committee, as well as other committees and members of the Taxation Section, joined forces with the MICPA and the MWTA for a "Meet the Players" reception in Grand Rapids, Michigan on October 22, 2015, where we were able to talk to various legislators across the State about upcoming state and local taxation initiatives.

The State and Local Taxation and Practice and Procedure Committees are hosting a joint mixer on January 27, 2016 at Fraser Trebilcock in Lansing. We look forward to hearing more about proposed Tax Tribunal reform legislation, and in particular Senate Bill 537, which seeks to make significant changes to the Michigan Tax Tribunal to improve the fairness and quality of adjudication in this forum. Featured speakers are Greg Nowak, JD, CPA, of Miller Canfield, Chair of the Detroit Regional Chamber of Commerce's Tax Committee and Jason Puscas, Director of Governmental Relations for the Detroit Chamber of Commerce.

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Report of the Practice & Procedure Committee

Last year, the former chair of the Taxation Section, Margie Gell, appointed an ad hoc Tax Litigation Reform Committee, and the current chair of the Taxation Section re-authorized it. Margie's last report speaks of the elimination of "pay-to-play" as a threshold to adjudication in the Court of Claims. This needed reform has a potential ripple effect on the Michigan Tax Tribunal. The Practice and Procedure Committee is in the process of reviewing a list of MTT reforms that the Taxation Section recommended several years ago to determine how current proposed MTT reform legislation matches up. The mixer event mentioned in the State & Local Tax Committee Report is a community service first and foremost: it will help educate any stakeholder who attends. But it will also help us sharpen our thinking about the legislative reform proposal, SB 537. In addition, various Tax Section members attended the Tribunal luncheon in Lansing this January. The Tribunal has had input into the legislation and Judge Lasher supports the legislation overall.

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Report of the Trust & Estates Committee

Trusts and Estates met at Clark Hill's Office on Tuesday, December 15, 2015. The event was well attended. Cambridge Consulting Group presented materials on strategies to be utilized by estate planners to further effectuate income and estate tax savings.

The Trusts and Estates Committee plans to meet again on March 15, 2016, June, 14, 2016, August 9, 2016, and then finally on December 13, 2016. The events are TBD.

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Report of the Federal Income Tax Committee

The Chair of the Federal Income Tax Committee was transitioned from Andrew MacLeod of Dickinson Wright to Mike Monaghan of Plante Moran. Andrew ensured that there was an orderly transition and continued to support Committee activities. The Committee thanks Andrew for his past and ongoing contributions.

The Federal Income Tax Committee was active during the past period and welcomed several new members to the Committee. The Committee also attempted video-conferencing in order to attempt to improve the participation of members on the west side of the state.

On December 9, 2015, James Combs and Allison Drutchas from Honigman Miller Schwartz and Cohn LLP presented "Transfers of Goodwill to Foreign Corporations under Recently Proposed Regulations." This presentation was well attended.

The Committee also completed an article for the Michigan Tax Lawyer that was titled, "Streamlined Partnership Audit Legislation – One of the Biggest Changes to Partnership Taxation in More Than Three Decades." This article was authored by Mike Monaghan, Kurt Piwko, and Becky Pugliesi from Plante Moran.

The Federal Income Tax Committee has two events scheduled for the near future. On January 21, 2016, Kurt Piwko from Plante Moran will be presenting, "Tax Efficient Acquisitions of S Corporations." The presentation will include issues such as planning for retained ownership, achieving a basis step-up in assets, minimizing the implications of the anti-churning limitations on amortizing goodwill, and minimizing holding period implications of structures involving newly formed partnerships as subsidiaries.

On April 12, 2016, Andrew MacLeod from Dickinson Wright will be presenting, "New Streamlined Partnership Audit Rules." The presentation will cover how the new rules operate, key elections, and potential issues to consider in operating agreements. A networking function will be held after the presentation.

The Committee also has events scheduled on June 22, 2016, September 8, 2016, and November 30, 2016. Topics will be determined as the dates approach.

The Committee is also looking for volunteers to speak at future events and write articles.

Report of the Young Tax Lawyers Committee

Ryan Peruski, as new Chair of the YTL Committee, is planning several events around the state to encourage young members of the Section to get involved. Ryan's first meeting will be held in Detroit on March 24th. The Section is in good hands for the coming year, and I know that Ryan will make significant contributions to the Section.

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REVISIONS TO MICHIGAN'S UNIFORM UNCLAIMED PROPERTY ACT SHOULD HELP CALM MICHIGAN HOLDERS' FRAZZLED NERVES

By Carolee Kvoriak Smith

A. INTRODUCTION

On December 22, 2015, Governor Snyder signed Senate Bill 538 into law, making sweeping changes to Michigan's Uniform Unclaimed Property Act.[1] This legislation is the product of a committee of various participants from the Michigan business community[2] and the Michigan Department of Treasury ("Treasury"), formed in response to an appropriation bill passed in summer of 2015.[3] The appropriation bill required Treasury to explore a "streamlined audit process" for unclaimed property. Pressure for some relief from this area came from repeated complaints from Michigan holders.[4]

Unclaimed property has been a hot topic over the past five years or so; holders complain that unclaimed property audits look more like efforts to raise revenue rather than actual attempts to return unclaimed property to its true owners.[5] This is particularly true in Delaware, where unclaimed property revenue has become the State's third largest source of revenue, increasing from 5.7% of the state's overall sources of revenue in 1999 to 13.9% in 2015.[6] Indeed, one commentator went so far as to call the State of Delaware a "bully" due to its unclaimed property audit practices.[7]

Issues with unclaimed property are not limited to Delaware. In a fairly recent case, the Ninth Circuit shut down the State of California's unclaimed property program until the state improved its system of notifying owners that the state was holding their unclaimed property.[8] And now the State of Michigan, in response to last year's appropriations bill, and together with other legislation enacted in 2012 – 2014, has taken some of the most progressive steps in the country to make unclaimed property audits more palatable for holders.

B. RECURRING HEADACHES

There are several reoccurring issues that seem to consistently cause heartburn in the unclaimed property arena. As one commentator stated:

> No specific part of the unclaimed property statutes and audits is itself a problem. A 30-year lookback period will always be problematic, but if business-to-business transactions were excluded or the use of sampling weren't so extensive, a long lookback would not be so onerous.[9]

These issues include: 1) business-to-business transactions; 2) long statute of limitations; 3) the use of extrapolation to estimate an unclaimed property liability (rather than an actual audit of books and records); and 4) the availability of an independent administrative appeal process.[10] A report issued by a Delaware task force studying the fairness of Delaware's unclaimed property program named the following as issues: "the length of the 'look-back' period in the auditing process, the dominance of one audit firm in Delaware's audit portfolio, and the lack of a manual that contains procedural guidelines for use by Delaware contract auditors and guidance to the holder community."

These four issues may or may not be part of a particular state's unclaimed property law. One more additional issue frequently heard is not found in any state's version of the Uniform Unclaimed Property Act – aggressive auditing practices on the part of third-party contingent fee auditors.[11]

1. Business-to-Business Transactions

Some question whether unclaimed property laws should apply to business-to-business transactions because businesses do not require the type of consumer protection envisioned by such laws.[12] Business-to-business transactions are also the most susceptible to instances where there is merely a bookkeeping error rather than an actual occurrence of unclaimed property.[13] One example is when a vendor sends extra product to a customer, either in error or perhaps as a gesture of goodwill. If sent in error, the parties typically work out a solution between themselves – perhaps fewer products are sent in a subsequent shipment. Auditors auditing this type of property refused to recognize the standard business practice and instead characterized this as "unclaimed property" to be escheated to the state. As pointed out by COST, these types of transactions "are frequently not property actually due a creditor, and are so common in commercial transactions that requiring such items to be turned over to the government unnecessarily increases the cost of doing business.[14]

2. Statute of Limitations

Long statutes of limitations present problems because they typically exceed those for state tax laws and the normal business practice for record retention. The State of Delaware, for instance, limitation period goes all the way back to 1981 – not many businesses keep records that ancient.[15] In fact, the State of Delaware itself can't produce records from 1981.[16] Moreover, even if kept, the technology used to store the information may be so outdated it may not even be possible to access the information.[17] This "lack of records" opens the door for the next troublesome issue – extrapolation.

3. Extrapolation

Auditors use extrapolation as means to estimate an unclaimed property liability, usually in cases where the holder does not have records for the years under audit. Any unclaimed property estimated by means of an extrapolation cannot be linked to an actual owner and therefore goes straight into state coffers.[18] This seems to be inconsistent with the consumer protection purpose underlying state unclaimed property acts. It also partially accounts for the wide gap between the amount collected by the state and the amount actually returned to owners. [19] The State of Delaware, for instance, collected $428 million in 2011 but returned only $18.9 million to owners in 2012.[20] At least on the face of things, this practice seems to be at odds with a warning from the Ninth Circuit to the State of California in *Taylor v Chiang*: "if the purpose of the law is . . . to reunite owners with their lost or forgotten property, its ultimate goal should be to generate little or no revenue at all for the state."[21]

The use of extrapolation in and of itself is not necessarily the issue. Some taxpayers actually request estimations in the course of an audit to save time and resources. Holders are more concerned about the methodology used by third-party contingent fee auditors to extrapolate an unclaimed property liability. In *Temple-Inland, Inc. v Cook*,[22] the holder alleges that the auditor's extrapolation techniques took a very small amount of property due to the state of Delaware and extrapolated it into a liability of over $2 million by including items with addresses other than the state of Delaware and items already properly escheated to a state.[23] The federal district court for the district of Delaware denied a motion made by the state of Delaware to dismiss this lawsuit, allowing Temple-Inland's challenge to proceed.

Similar cases were filed by Plains All American Pipeline, LP[24] in 2015 and by Select Medical Corporation in 2013.[25] Both of these cases challenge the extrapolation method employed by the third-party contingent-fee auditor. In its complaint, Plains All American Pipeline alleges:

> These estimations are not tied to actual property – they are pure guesses and speculations. Defendants do not seek to have Plains or other holders turn over specific property for which no owner is known or address is known; rather, Defendants seek to have them simply pay an arbitrary amount they speculate might be owed if the unknown information was known.

4. Lack of an Independent Administrative Appeal Process

Another issue has been the lack of administrative relief. In Michigan, for instance, until recently, any disputes arising from an unclaimed property audit could only be appealed to the circuit court.[26] Out of the fifty states surveyed by COST in its unclaimed property scorecard published in October 2013, only four states had an independent tribunal to resolve unclaimed property disputes.[27]

5. Aggressive Audits

Many of the issues discussed above are exacerbated by overly aggressive audits conducted by third-party contingent-fee auditors.[28] As noted by COST in a letter in support of recent North Carolina legislation restricting contingent fee audits, "such arrangements jeopardize the neutral and objective weighing of the public's interest and instead create a direct economic interest in the outcome of the services rendered."[29] The National Conference of State Legislatures has adopted a resolution encouraging state governments to end contingent fee arrangements, on the grounds that they "may provide an incentive to the third party auditor to arbitrarily inflate a taxpayer's liability."[30]

These audits tend to be long –the average Delaware audit lasts between three and eight years.[31] The auditors request voluminous amounts of information and holders are often requested to "prove a negative."

For instance, suppose a company issues a check for John Smith to attend a conference. Something subsequently arises and Mr. Smith is not able to attend the conference. The company cancels both his reservation and the check. Later, under audit, the third-party contingent fee auditor uncovers this cancelled check and asks the holder to prove it is not "unclaimed property" (which it is not because the original payor is not entitled to the fee). Hopefully the company made a note somewhere or Mr. Smith is still employed at the company and remembers that he did not attend the conference. If not, the holder now has to spend quite a bit of time proving a negative. The more troublesome issue is the level of evidence required before the auditor is convinced - is Mr. Smith's word enough? How about a note on a form requesting the cancellation of the check? Is an email requesting the cancellation of the check enough? This could be difficult to prove even it happened only last year – what if it occurred ten years ago?

C. REFORM EFFORTS

1. Ban Contingent Fee Auditors

All fifty states have unclaimed property laws and just about every state uses contingent fee auditors to enforce those laws.[32] A handful, however, have shown these auditors the door. Illinois prohibits the state from using contingent fee arrangements to conduct unclaimed property audits, but only for holders located in Illinois.[33] Virginia has a similar rule.[34] North Carolina, however, enacted a more expansive ban on the use of contingent-fee auditors by the Secretary of Revenue and Treasurer, although it still uses these arrangements for audits of life insurance companies for unclaimed death benefits or holders of unredeemed bond funds.[35]

2. Delaware

In response to the heavy criticism leveled against its unclaimed property program, the Delaware General Assembly formed a task force to "inquire into, examine, study, and make findings and recommendations related to improving fairness and compliance in Delaware's unclaimed property program."[36] This task force issued its final report in December 23, 2014.[37] Some of the recommendations made in the report include:

- Develop a "detailed manual containing procedural guidelines for Delaware unclaimed property audits," . . . "to ensure greater transparency and predictability as to what should be expected by holders during a Delaware unclaimed property audit." The task force also recommends making sure that contract auditors comply with the manual.
- Modify the administrative appeals process "so as to provide a central role for third-party review, including replacing the Secretary of Finance as the final decision-maker in the administrative appeals process."
- Shorten the statute of limitations.
- Renegotiate the length of current contracts with unclaimed property auditors and "achieve more balance among the contract auditors who provide services to its unclaimed property program."
- Make more effort to bring unclaimed property audits in-house.[38]

With respect to the last recommendations, the task force recommended further reporting on the outcomes of these efforts.[39]

3. Michigan – Legislation Prior to Senate Bill 538

Senate Bill 538 is not the first attempt by the State of Michigan to address concerns raised by holders of unclaimed property – a number of bills in recent years were enacted to address the issues discussed above.

a. Business-to-Business Transactions

Public Act 292 of 2012 amended the Michigan Uniform Unclaimed Property Act to exempt most business-to-business transactions. This exemption does not apply to "outstanding checks, drafts or other similar instruments."[40] It also shortened the period of limitations from ten years to five years for all transactions "between two or more associations."[41]

b. Administrative Appeal

Public Act 423 of 2014 implemented a process of administrative review for unclaimed property audits determinations (but not for disputes arising during the course of an audit). A holder that wishes to appeal an audit determination may do so either by bringing an action in circuit court or by filing a request for reconsideration with the Unclaimed Property Administrator within 90 days of receiving the audit determination.[42] The holder must turn over any property that is uncontested.[43] Within 60 days of receiving the request for reconsideration, the Unclaimed Property Administrator must issue a written decision on the matter, stating the reasons and authority supporting the decision.[44]

If the holder disagrees with this decision, it may either file an appeal in circuit court or file an appeal with the Unclaimed Property Administrator.[45] If the holder files an appeal, the Unclaimed Property Administrator must select an independent delegate to conduct the appeal.[46] This delegate will hold a hearing and then issue a written recommendation on the matter, again stating the reasons and authority supporting the recommendation.[47] Within 60 days of the date of the written recommendation, the Unclaimed Property Administrator shall, in writing stating reasons and authority in support, affirm, modify or reject all or part of the written recommendation.[48]

The holder may appeal this ultimate decision of Unclaimed Property Administrator in circuit court within 90 days, but may also withdraw the request for reconsideration or appeal and proceed to circuit court at various times during the process.[49]

c. "Indirect Audit Procedures"

Public Act 148 of 2013 moderates the use of extrapolation, or "indirect audit procedures," in unclaimed property audits.[50] It requires unclaimed property audits to "be performed in accordance with generally accepted auditing standards."[51] Any extrapolation must be reasonable and may only be used in the event a holder does not have "substantially complete records."[52] Treasury must provide the holder with the evidence used to determine any unclaimed property liability.[53]

D. Senate Bill 538

1. The Legislature Takes Further Action . . .

In early 2015 the Michigan Legislature directed Treasury to "complete a review of its unclaimed property audit procedures in an effort to streamline the process."[54] Treasury was further directed to "meet with businesses to discuss and propose an expedited audit procedure that allows Michigan residents and businesses the opportunity to regain their property but expedites the audit timeline and minimizes the impact on businesses that are subject to an unclaimed property audit."[55] Senate Bill 538 was the result of these efforts.

2. Summary of Senate Bill 538

Senate Bill 538 allows "eligible holders" to elect a streamlined audit process.[56] A holder is an "eligible holder" if it one or more of the following applies:

a. the holder's principal place of business is in Michigan, as evidenced by: (i) 20% or more of payroll in Michigan; (ii) 20% or more of real and tangible property (except inventory) owned or rented in Michigan; or (iii) the majority of officers that direct, control and coordinate the activities of the business are in Michigan.[57]

b. the holder is a corporation that wholly owns a corporation that is incorporated in Michigan and the wholly-owned corporation meets the above "principal business" test.[58]

c. the holder is a corporation that is wholly owned by a corporation that is incorporated in Michigan and the owner meets the above "principal business" test.[59]

An "eligible holder" elects the streamlined audit process by executing a nondisclosure agreement acceptable to the State Treasurer within 30 days of receiving notice of an unclaimed property audit.[60]

Because the length of these audits has been a concern to both holders and the Michigan Department of Treasury, Senate Bill 538 requires an audit conducted under the streamlined audit process to be completed within a time frame developed by the holder and the Michigan Department of Treasury. Because the audits can be fairly complex, however, neither the business representatives nor the Department felt that an inflexible deadline would benefit holders or the Department. Therefore, while the goal for completing an audit is 18 months, the actual time frame for a particular audit will be jointly developed at the beginning of the audit.[61] The Michigan Department of Treasury and the audit firm will be available for an entrance conference, as well as upon request by the holder, as opposed to these audits being conducted almost exclusively off-site.

Holders that elect the streamlined process will be subject to a four-year statute of limitations, as opposed to ten years for all other audits.[62] A four-year statute of limitations, combined with a three-year dormancy period for most property types, is consistent with standard business record retention requirements, which is typically seven years.

Senate Bill 538 also provides a de minimus filing requirement – holders are no longer required to escheat property with a value of $25 or less.[63] Excluding these small items from both reporting and audit should reduce instances, in which a small amount of unreported property escalates, by means of extrapolation, into a large liability, since holders typically don't keep extensive records for small liabilities. Also excluded from audits are checks voided within 180 days from the date of issuance of the check.[64] Eliminating this category of items from an audit reduces the instances in which holders are required to "prove a negative."

3. Coming Attractions

The Michigan Department of Treasury is not quite yet done with unclaimed property reforms – Senate Bill 538 requires the Department to promulgate regulations to address further audit improvements.[65] One area still to be tackled is extrapolation methods. The shorter statute of limitations, de minimus exclusion and elimination of certain voided checks, however, should reduce the need for extrapolation in many cases.

E. CONCLUSION

With the enactment of Senate Bill 538, and other legislation, Michigan has made significant strides in improving its unclaimed property laws. Hopefully these improvements lead to a less frazzled Michigan business community, less lawsuits and a more friendly business community for businesses looking to locate in Michigan.

About the Author

Carolee Kvoriak Smith, Esq. is a tax attorney with CMS Energy Corporation in Jackson, Michigan, responsible primarily for research, planning and managing controversies with respect to a wide variety of both federal and state tax issues. She started her legal career as a law clerk to the Honorable Justice Marilyn Kelly of the Michigan Supreme Court. Ms. Cameron holds an undergradutate degree in Economics, a JD and a LLM in Taxation, all from Wayne State University in Detroit, Michigan. She has been a Council Member of the State Bar of Michigan Taxation Section since 2010.

Endnotes

1 MCL 567.221 *et seq.*

2 The following Michigan businesses participated in the committee: Consumers Energy, SpartanNash, Stryker and Steelcase. See Consumers Energy Testimony to the Senate Finance Committee on Senate Bill 538 (October 13, 2015), available at http://www.senate.michigan.gov/committees/files/2015-SCT-FIN_-10-13-1-01.PDF. The author participated in this committee on behalf of her employer, Consumers Energy.

3 Section 919, Public Act 84 of 2015 (June 17, 2015).

4 A "holder" refers to a person in possession of property of another, and therefore, potentially subject to the Michigan Unclaimed Property Act. MCL 567.222(h).

5 *See, e.g.*, Jennifer Carr, *News Analysis: Delaware Unclaimed Property Audit Practices Raise Questions*, State Tax Today (July 22, 2013).

6 State of Delaware Department of Finance, Delaware Fiscal Notebook (2015 edition), available at http://finance.delaware.gov/publications/fiscal_notebook_15/fiscal_notebook_15.pdf.

7 See Douglas Lindholm, *Once a Friendly Locale to Business, The Modern State of Delaware is a Bully*, Forbes, Op-ed, March 16, 2013, available at http://www.forbes.com/sites/realspin/2013/05/16/once-a-friendly-locale-to-business-the-modern-state-of-delaware-is-a-bully.

8 Taylor v Chiang, No. Civ. S-01-2407 WBS GGH (E.D. Cal. June 1, 2007).

9 Jennifer Carr, *News Analysis: Delaware Unclaimed Property Audit Practices Raise Questions*, State Tax Today (July 22, 2013).

10 Each of these items is one that makes up the Council of State Taxation's ("COST") scorecard in its periodic review of state unclaimed property law. *See, e.g.,* Douglas L. Lindholm and Ferdinand S. Hogroian, *The Best and Worst of State Unclaimed Property Laws, COST Scorecard on State Unclaimed Property Statutes* (October 2013). COST is a nonprofit trade association with the objective of promoting "equitable and nondiscriminatory state and local taxation of multijurisdictional business entities." More information regarding COST can be found at www.cost.org.

11 This task force was formed by the Delaware General Assembly in response to holder complaints. Senate Concurrent Resolution No. 59, Delaware State Assembly, 147th General Assembly (June 2014). The task force's final report can be found at http://legis.delaware.gov/LIS/TaskForces.nsf/59da77da7c06f47485256ff6006f8346/43e4710bb1de80c285257cfa00767029/$FILE/SCR%2059%20Task%20Force%20Final%20Report-12-23-2014.pdf. It will be referred to herein as the "Delaware Task Force Report."

12 See, e.g., Douglas L. Lindholm and Ferdinand S. Hogroian, *The Best and Worst of State Unclaimed Property Laws, COST Scorecard on State Unclaimed Property Statutes*, p 3 (October 2013).

13 *Id.*

14 *Id.*

15 The author is referring, of course, only to business records and not anyone born in 1981 or earlier (as was the author).

16 See The Delaware Task Force Report, supra at 11.

17 In the Consumers Energy audit, for instance, some of the information requested was available only on microfiche. While obtaining the information would not be physically impossible, logistically it becomes nearly so. The author therefore invited the out-of-state auditors to come to Jackson, Michigan and have at it themselves – they declined this invitation.

18 This results from the "priority rules" set forth by the US Supreme Court in a series of three cases, *Texas v New Jersey*, 379 US 674 (1965), *Pennsylvania v New York*, 407 US 206 (1972) and *Delaware v New York*, 507 US 490 (1993). These rules determine which state gets the property to be escheated. Unclaimed property for which the holder has a "last known address" is reported and remitted to the state of the last known address. The state then typically notifies the owner (usually by means of a state website) that the state is holding the owner's unclaimed property. If the holder does not have a "last known address" for the owner, then the unclaimed property escheats to the holder's domicile. Unclaimed property "uncovered" by means of an extrapolation falls under this second rule.

19 *See, e.g.,* Jennifer Carr, *News Analysis: Delaware Unclaimed Property Audit Practices Raise Questions*, State Tax Today (July 22, 2013); The Delaware Task Force Report, supra at 11.

20 Jennifer Carr, *News Analysis: Delaware Unclaimed Property Audit Practices Raise Questions*, State Tax Today (July 22, 2013).

21 *See, e.g.,* Douglas L. Lindholm and Ferdinand S. Hogroian, *The Best and Worst of State Unclaimed Property Laws, COST Scorecard on State Unclaimed Property Statutes* (October 2013), citing Order re: Preliminary Injunction, Case 2:01-cv-02407-WBS-GGH, June 1, 2007.

22 US Dist Ct (Del Dist), Civ No 14-654-SLR (03/11/2015).

23 The author faced this same problem in an audit conducted by a contingent-fee auditor of her employer, Consumers Energy. The author never saw the outcome of this extrapolation, however, because the audit ended after the auditors declined the author's invitation in note 17.

24 *Plains All American Pipeline, LP v Cook*, Case 1:15-cv-00468-UNA (06/05/2015).

25 *Select Medical Corp v Cook,* No. 1:13-cv-00694-UNA (D.Del. 2013).

26 MCL 567.247, prior to amendment by Public Act 423 of 2014.

27 Douglas L. Lindholm and Ferdinand S. Hogroian, *The Best and Worst of State Unclaimed Property Laws, COST Scorecard on State Unclaimed Property Statutes* (October 2013), pp 4, 7.

28 States often hire these auditors due to "fiscal and political constraints in hiring and appropriately compensating experienced personnel." Hollis L. Hyans and Amy F. Nogid, *A Mutiny Against the Bounty Hunters is Long Overdue,* Tax Notes Today (November 4, 2013).

29 Letter from Ferdinand S. Hogroian to Members of the North Carolina House of Representatives, "Re: COST's Support of H.B. 462 (An Act to Limit Use of Contingent-Based Contracts for Audit or Assessment Purposes)."

30 The National Conference of State Legislatures, *Resolution Concerning the Use of Contingent Fee Arrangements in Tax Audits and Appeals,* Sept. 30, 2011, available at http://www.ncsl.org/documents/standcomm/sccomfc/ContingencyFeeAuditResolution.pdf. The National Conference of State Legislatures is a national organization formed in 1975 to "support, defend and strengthen state legislatures." More information about the National Conference of State Legislatures is available at www.ncsl.org/aboutus.aspx.

31 See, e.g., the Delaware Task Force Report, supra at note 11. The author's audit lasted almost four years.

32 Douglas L. Lindholm and Ferdinand S. Hogroian, *The Best and Worst of State Unclaimed Property Laws, COST Scorecard on State Unclaimed Property Statutes* (October 2013), p 7.

33 765 ILCS 1025/24.5.

34 Va. Code Ann. 55-210.24(D).

35 N.C.G.S.A §116B-8.

36 Senate Concurrent Resolution No. 59, Delaware State Assembly, 147th General Assembly (June 2014).

37 The Delaware Task Force Report, supra at note 11.

38 The Delaware Task Force Report, supra at note 11.

39 The Delaware Task Force Report, supra at note 11.

40 MCL 567.257a.

41 MCL 567.252(1).

42 MCL 567.251a(1).

43 MCL 567.251a(5).

44 MCL 567.251a(7).

45 MCL 567.251a(8).

46 MCL 567.251a(8).

47 MCL 567.251a(10), (11).

48 MCL 567.251a(12).

49 MCL 567.251a(2),(4),(8),(13).

50 MCL 567.251.

51 MCL 567.251(4).

52 MCL 567.251(5). "Substantially complete records" means at least 90% of the records necessary for unclaimed property examination purposes. MCL 567.251(8).

53 MCL 567.251(4).

54 Section 919(3), Public Act 84 of 2015.

55 *Id.*

56 MCL 567.251b.

57 MCL 567.222(g)(i).

58 MCL 567.222(g)(ii).

59 MCL 567.222(g)(iii).

60 MCL 567.251b(1). The execution of a "standard" nondisclosure agreement was chosen as the trigger for the streamlined audit process because Treasury felt negotiating these agreements bogged down the audit. The committee developed a "standard" nondisclosure agreement for use in these audits.

61 MCL 567.251b(2)(a).

62 MCL 567.250(3).

63 MCL 567.224a(1). This exclusion does not apply to dividends, shares and other ownership interests in associations. MCL 567.224a(2).

64 MCL 567.251(8).

65 MCL 567.251b(2)(b).

ATTORNEY-CLIENT PRIVILEGE: CONSULTING WITH ACCOUNTANTS AND OTHER EXPERTS; AND THE USE OF *KOVEL* LETTERS

By Wayne D. Roberts and Katherine K. Wilbur

Throughout the course of either litigation or a business transaction, a legal issue may arise in which a taxpayer may need to provide personal and business information to his or her attorney. Taxpayers are able to obtain legal assistance and can feel confident in disclosing such information to their attorney, because such disclosures are confidential and subject to the attorney-client privilege.

When attorneys require the assistance of third-party experts to sort through a problem, the attorney or the taxpayer may be required to disclose confidential information to the expert. In the area of tax practice, privilege issues are prevalent – and relatively obvious – due to the often fine line between a civil tax case and a criminal tax defense matter, and the frequent need to consult third parties, like accountants, for assistance with respect to accounting or tax analysis. Virtually any tax analysis conducted affects the legal advice given, whether the advice relates to a contract, litigation, commercial, or other matter. Therefore, when a complex tax or accounting issue requires analysis and an expert is retained, the attorney should maximize the derivative protection available from the attorney-client privilege. In a non-tax practice, maximizing privilege with respect to both tax and non-tax analysis is also critical.

The seminal case in this area – *United States v Kovel* [1] – stands for the proposition that the attorney-client privilege will apply in cases in which the attorney discloses confidential information to a third-party expert. In the *Kovel* case, an accountant was employed by a law firm that specialized in tax law. The accountant was hired to listen to the facts of the case as communicated by the client, and then assist the attorneys in analyzing complex accounting and tax issues. Eventually, the accountant was ordered to testify in a grand jury investigation of one of the law firm's clients for alleged tax violations. When the accountant refused to respond to questions in the grand jury investigation on grounds of attorney-client privilege, the judge noted that he was not a lawyer and charged him with contempt. The accountant defended his refusal to answer questions by asserting the attorney-client privilege because the questions related to conversations that took place with the law firm client and the attorney.

In a holding that forms part of the foundation for attorney-client communications with respect to experts – for both tax and non-tax practitioners – the United States Circuit Court of Appeals held:

> The attorney-client privilege[2] extends to an accountant such that an accountant can be present when the client relates a complicated tax story to an attorney because the accountant is facilitating the privileged communication as the attorney's agent.

The court in *Kovel* specifically noted that accounting concepts are like a foreign language; the accountant is similar to an interpreter used to translate another language into English, which is done to allow the attorney to provide legal advice to a non-English speaker. To the extent the communications with the third party helped the attorney understand and convey information to the client, and were used to assist the lawyer in providing legal advice, the communications remained privileged. In addition, the court explained that the attorney-client privilege could be used to protect communications between a client, third party, and attorney where those communications were "necessary or at least highly useful" to discussions between the client and the attorney. The key practice point is that *Kovel* protections rely on the "facilitation of communications."

By applying to the specific decision in *Kovel*, an attorney may avoid inadvertent privilege waivers in cases in which an expert is used to either interpret client communications or otherwise assist in the rendition of legal services. The following sections outline considerations for structuring an expert engagement to maximize attorney-client privilege protections.

The Hiring Process

First, an attorney should directly coordinate the retention of the expert in order to ensure that communications are covered by the attorney's privilege with the client. If the attorney is the party who actually retains the expert, this indicates to courts that the attorney believed the third party was necessary and helpful for representing the client. Indeed, the retention by the attorney sheds light into the purpose for retaining the third party. This is important because the privilege will not apply to communications with a third party to the extent the third party is hired for a purpose other than assisting the lawyer to provide legal advice. For example, if an accountant is hired directly by the client to provide accounting or tax preparation services for the client, or if the client hires the accountant in order to obtain the accountant's advice, rather than the lawyer's advice, then the attorney-client privilege will not apply. Consequently, the attorney should coordinate the hiring and confirm that the retention of the expert is to assist the attorney in providing legal advice to his or her client. To the extent possible, communications and contact with the third party should flow through counsel.

The *Kovel* Letter

Any engagement letter – *i.e.,* the *Kovel* letter – with the expert should also specifically state that the third party is being retained to assist the attorney in providing legal advice, and should prohibit any work that would involve the preparation of a tax form or other document that is intended to be filed with or disclosed to the government.[3] When courts are required to analyze the necessity of retaining and disclosing confidential information to the third party, judges have looked to the nature of the advice given, the structure of the relationship, and the manner in which the advice was conveyed. Because such questions can arise years after the disclosures were made, often the best evidence of the relationship among the attorney, the client, and the third party is the engagement letter. Consequently, such letters are often closely scrutinized, and a well-advised attorney would take care to describe the legal purposes of the relationship with the third party both accurately and specifically in an engagement letter.

Timing Issues

The formality and order in which attorneys and experts are retained can be important to maintaining the attorney-client privilege. In general, if the attorney is retained before the accountant, then it is possible to maximize the available privilege. Alternatively, if the accountant is retained first, there may be no – or a limited – privilege. This issue generally arises in cases in which the client has a previous relationship with the third party before the attorney is hired. Because *Kovel* protects the attorney-client privilege only where the accountant has been hired to explain or interpret certain concepts to the attorney and to help the attorney better represent the client, it will be very important to distinguish that, notwithstanding the third party's prior engagement, the current engagement relates only to assistance of the attorney in providing legal advice. If the client and attorney seek to use a third party, such as a client's long-time accountant to assist with providing legal advice, the attorney should take great care to document that the third party's advice is vital to the attorney's representation of the client and the third party's engagement for this purpose is separate from any prior engagements. Otherwise, in most cases, the attorney will need to be retained before the third party is hired to assist the attorney.

Beyond Accounting

Attorneys are often required to use the assistance of non-attorney third parties throughout their representation of clients. As outlined above, the holding in *Kovel* specifically addresses accountants, but the logic of *Kovel* also indicates that the attorney-client privilege may extend to a broad group of an attorney's agents outside of the accounting and tax areas. For example, courts have noted that, at times, communications between an attorney and a doctor,[4] secretary, investigator,[5] accountant, foreign translator, foreign legal consultant, technical expert, investment banker, auditor, or patent agent[6] who is hired to assist the attorney in providing legal advice may be privileged.[7] It is easy to see how communications with a patent agent or physician may be necessary in a complicated patent or medical malpractice case, but the *Kovel* doctrine has also even been extended to less obvious experts such as public relations firms.[8] Indeed, some courts have found that high profile cases require a public relations strategy as part of a party's claim or defense, and are then willing to extend privilege protection to the attorney's communications with a public relations consultant directed at supporting the client's legal position or case.[9] Other courts extend the privilege on the basis that the public relations consultant is the functional equivalent of the lawyer's employee.[10]

Conclusion

In both tax and non-tax practice, *Kovel* (i.e., expert) engagements are important. But many engagements that are entered into to facilitate attorney-client communications do not provide for maximum protection because they are not structured based on solid *Kovel* principles. In some instances, the lack of a properly drafted *Kovel* letter may not become a primary issue in a case – e.g., because the case involves a transaction that closes without dispute, because the case does not raise criminal issues, or because the accountant or expert's testimony can be disclosed without harm or embarrassment. In some cases, the attorney-client privilege can be critical. Therefore, attorneys and other third party experts are well-served to learn how to draft a proper *Kovel* letter, and to add a discussion of *Kovel* to their checklist of topics to cover in pre-engagement conferences with potential clients. And that discussion should note that any expert engagement must be structured so the agent is being used to facilitate a communication that is made both (1) in confidence and (2) for purposes of obtaining legal advice.[11]

About the Authors

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Endnotes

1 296 F.2d 918 (2nd Cir 1961). The *Kovel* case serves as a guide for expert engagement letters that are routinely used by attorneys when an accounting or tax expert is retained to assist with complex accounting or tax issues; these engagement letters are often referred to as "*Kovel* letters."

2 The attorney-client privilege is a "communication" privilege; therefore, the focus in a *Kovel* arrangement should be based on facilitating communications between the attorney and the client.

3 If legal advice relates to the preparation of a tax return or an item otherwise disclosed to the government, the communication generally will not be privileged.

4 *United States v. Alvarez,* 519 F.2d 1036, 1045–46 (3d Cir. 1975).

5 *Welland v. Trainer,* No. 00 Civ. 0738(JSM), 2001 WL 1154666, at *3 (S.D.N.Y. Oct.1, 2001).

6 *In re Rivastigmine Patent Litigation,* 237 F.R.D. 69 (S.D.N.Y. 2006).

7 *Louisiana Mun. Police Emp's. Ret. Sys. v. Sealed Air Corp.,* 253 F.R.D. 300, 311 (D.N.J.2008)

8 *See* for granting privilege*: In re Grand Jury Subpoenas Dated March 24, 2003,* 265 F. Supp. 2d 321 (S.D.N.Y. 2003) *F.T.C. v. Glaxosmithkline,* 294 F.3d 141 (D.C.Cir.2002); and *In re Copper Market Antitrust Litigation,* 200 F.R.D. 213 (S.D.N.Y.2001), *but see* for contrary position: *Scott v. Chipotle Mexican Grill Inc.,* 2015 WL 1424009, *3 (S.D.N.Y.2015); *Egiazaryan v. Zalmayev,* 290 F.R.D. 421, 431 (S.D.N.Y.2013); *Calvin Klein Trademark Trust v. Wachner,* 198 F.R.D. 53, 54–55 (S .D.N.Y.2000); *Fine v. ESPN, Inc.,* 2015 WL 3447690, *11 (N.D.N.Y.2015); and *McNamee v. Clemens,* 2013 WL 6572899, *1, 6 (E.D.N.Y.2013).

9 *Grand Canyon Skywalk Dev. LLC v. Cieslak*, No. 2:13-CV-00596-JAD, 2015 WL 4773585, at *11 (D. Nev. Aug. 13, 2015) citing *In re Grand Jury Subpoenas,* 265 F.Supp.2d at 326 as a case in which the privilege was extended from the lawyer to the public relations consultant because the lawyer hired the consultant to assist in dealing with the media and confidential communications were made for the purpose of assisting the lawyer in giving legal advice and at the direction of the lawyer.

10 *Grand Canyon Skywalk Dev. LLC v. Cieslak*, No. 2:13-CV-00596-JAD, 2015 WL 4773585, at *11 (D. Nev. Aug. 13, 2015) citing *In re Copper Market Antitrust Litigation,* 200 F.R.D. 213, (S.D.N.Y.2000) for the proposition that "[o]ther courts have upheld the assertion of the attorney-client privilege to communications with a public relations consultant on the grounds that the consultant is the functional equivalent of the client's employee."

11 Even in favorable cases in which the attorney-client privilege is extended to third parties, however, courts caution that the privilege will not apply if the client directly hires such a third party or the third party plays only a minimal role in assisting the lawyer in providing legal advice.

STREAMLINED PARTNERSHIP AUDIT LEGISLATION — ONE OF THE BIGGEST CHANGES TO PARTNERSHIP TAXATION IN MORE THAN THREE DECADES

By Michael Monaghan, Kurt Piwko, and Rebecca Pugliesi

On November 2, 2015 the Bipartisan Budget Act of 2015[1] was signed into law. While most of the bill was dedicated to budgetary issues, several tax items were included as revenue raisers. The most significant was a complete overhaul of the audit regime applicable to partnerships beginning for the 2018 tax year.[2] These streamlined partnership audit procedures will result in partnerships either paying tax assessments at the partnership level or putting the onus on the partnership to facilitate the determination of tax to be assessed to the partners. These provisions may result in a partnership paying more tax than its partners would have under previous rules and can result in one partner absorbing the tax liability associated with former partners, making them one of the biggest changes to partnership taxation since the enactment of TEFRA in 1982.[3] Given the hasty enactment of these rules and the significant delegation of authority to Treasury and the IRS to issue additional guidance and create processes around these rules, there are many unanswered questions as to how these rules will operate in practice.

BACKGROUND

Tax partnerships have many advantages over S corporations and C corporations because they allow for flow-through taxation, have no limitation on the types of ownership, and allow for significant flexibility in structuring different economic allocations among different ownership units. This has caused the number of entities classified as partnerships for tax purposes to increase significantly over the last several decades. This has also resulted in partnerships with highly complex, tiered-ownership structures.

The increasing complexity of partnerships also created more complexity for the IRS in both auditing partnerships and in assessing tax to the partners. As a result, Congress enacted the so-called TEFRA audit procedures in 1982[4] and the electing large partnership ("ELP") rules in 1997.[5] The TEFRA rules provided for a set of unified audit procedures for partnerships and their partners, rather than having separate audits of the partnership and each partner, while the ELP rules resulted in certain partnerships reporting audit adjustments in current-year tax returns. However, these provisions did not provide their intended administrative benefits. Very few partnerships elected into the ELP rules. The TEFRA rules, on the other hand, were burdensome to the IRS since they required the IRS to determine the amount of tax to be assessed to each partner, direct or indirect, once a partnership-level income adjustment was made. This could take significant manpower for partnerships with complex ownership, resulting in very few partnership returns being audited.

BASICS OF THE STREAMLINED PARTNERSHIP AUDIT PROCEDURES

The streamlined partnership audit rules are intended to address the problems with the TEFRA and ELP procedures in a manner that minimizes the IRS's administrative efforts when assessing tax resulting from a partnership audit. It is anticipated that this will allow the IRS to significantly increase its audit activity of partnerships without necessarily increasing the resources dedicated to this function. They are effective for tax years beginning after December 31, 2017[6] and will apply to all partnerships.

CERTAIN PARTNERSHIPS CAN OPT OUT

Partnerships can opt out of these new rules if:

1. The partnership has 100 or fewer partners;
2. All partners are individuals, C corporations, a foreign entity that would be treated as a C corporation, S corporations,[7] or estates of decreased partners (i.e., no partner can be a partnership or trust); and
3. The partnership properly elects to opt out for the year on a timely filed return.[8]

If a partnership elects out of the streamlined procedures, it is subject to the standard partnership audit procedures currently applicable to non-TEFRA partnerships.

DETERMINING PARTNERSHIP ADJUSTMENTS AND IMPUTED UNDERPAYMENTS

When an examination is complete under the new rules, all items of income, gain, loss, and deduction are netted and multiplied by the highest applicable tax rate, discussed immediately below, and any adjustments to credits are added or subtracted to this amount. If the result is a net increase in tax, defined as an imputed underpayment, the assessment will be made at the partnership level, including penalties and interest, unless the partnership elects to pass the adjustments through to its partners (see "Alternative to Partnership Paying Imputed Underpayment" section below).[9] If the result is a net decrease to tax, the adjustments are taken into account by the partnership on its tax return for the adjustment year.[10] The adjustment year is defined as the partnership tax year that includes the date the notice of the final partnership adjustment is mailed to the partnership.[11]

Where an adjustment reallocates the distributive share of any item between partners, those adjustments are not netted.[12] Therefore, it would appear that the unfavorable adjustment is included in the computation of the imputed underpayment while the favorable adjustment is included on the tax return for the adjustment year. However, the partners involved in the reallocation may be able to amend their respective tax returns to avoid these disparate results.[13]

Any payment made by a partnership under these provisions is considered a nondeductible expense.[14]

Highest Applicable Tax Rate

The tax rate used to determine an underpayment of tax is generally the highest individual or corporate tax rate in effect for the year under exam, regardless of the makeup of the partnership's partners.[15] Under current law, this rate is 39.6 percent, although it is subject to certain modifications discussed immediately below.[16]

Modifying the Imputed Underpayment

The imputed underpayment may be reduced in several ways:

- If the partnership can show that a portion of the adjustments would be allocable to a tax-exempt organization, that portion of the adjustment can be removed from the imputed underpayment calculation.[17]
- If the partnership can show that a portion of the adjustments would be allocable to a partner that would pay a rate less than the highest applicable tax rate on that adjustment, if the adjustment were passed through to the partner, then the imputed underpayment can be reduced to reflect that lower rate. However, this reduction is limited to adjustments allocable to a C corporation or adjustments of qualified dividend or capital gain income allocable to an individual.[18]
- If a partner files an amended return, properly accounts for its share of the adjustment, and pays any tax due with the amended return, the imputed underpayment can be recomputed to exclude that partner's share of the adjustments.[19]

The final modification discussed above is critical for a number of reasons. First, unlike the other imputed underpayment modification provisions, it actually results in a shifting of the liability from the partnership to the partner. More importantly, if all partners were to take advantage of this provision, the result of the audit would be similar to the result of an audit that is not subject to these rules or an audit of a non-TEFRA partnership under current law. However, until further guidance is issued, it is not clear whether a partner will be able to amend its return in all circumstances.[20]

Any information required to be provided to the IRS under any imputed underpayment modification provision is required to be provided within 270 days of the mailing of the notice of proposed adjustment to the partnership but may be extended by the IRS.[21]

Alternative to Partnership Paying Imputed Underpayment ("Pass-Through Election")

Rather than paying the imputed underpayment, the partnership can instead make an election to pass the adjustments to income, gain, loss, deduction, and credits through to its partners ("pass-through election"). This election must be made within 45 days of the notice of the final adjustment.[22] If the election is made, the partnership must provide each partner with a schedule showing the share of the adjustment that the partner is responsible for. Each partner must then recalculate its tax liability for the reviewed year (i.e., the year under audit) and also recalculate its tax liability in each subsequent year to the extent that the changes in the year under examination resulted in a change to tax attributes carrying to a later tax year.[23] The partner must then include the increased tax liability from all prior years on its tax return for the tax year in which the partnership provided the adjustment statement to the partner.[24]

When a pass-through election is made, penalties are calculated at the partnership level but are also passed through to the partners for payment.[25] Interest is calculated and paid only at the partner level but is computed at a rate that is 2% higher than the ordinary rate applicable to underpayments.[26] It is not yet clear how or when the partner pays this tax assessment.

If the pass-through election is made, the partners do not actually file amended returns for the prior years. However, it is likely that procedures will ultimately require detailed calculations to be provided to the IRS which may end up practically necessitating the preparation, but not the filing, of an amended returns.

The pass-through election is similar to the amended return option discussed immediately above but differs in two key ways. First, when the pass-through election is made, the tax liability is included on the partner's tax return in the year the partnership notifies the partner of the adjustment. On the other hand, the tax liability on the amended return is included on the amended return for the prior tax year. Second, the pass-through election is made by the partnership, and all partners are bound by that election. The option for a partner to amend its return is available to each partner separately, so some partners may choose to amend their returns while others can allow the partnership to pay the imputed underpayment on their share of the examination adjustments.

Amended Returns and Administrative Adjustment Requests ("AAR")

Partnerships subject to the streamlined audit rules are not permitted to file amended tax returns, and any voluntary adjustment is required to be made through an AAR.[27] If the AAR results in a net underpayment of tax, the additional tax due may be paid at the partnership level or passed through to the appropriate partners in a similar manner to a pass-through election.[28] If the AAR results in a net benefit, the partnership's only option is to pass-through the adjustments to the partners in a manner similar to a pass-through election.[29] Note that this is a different process from when a similar adjustment is made under examination, discussed further above, where those benefits are required to be reported on the partnership's tax return for the adjustment year.

In general, under current law, the amendment of any tax return does not impact the statute of limitations for assessment with respect to that return unless it is filed within 60 days of the expiration of the statute of limitations.[30] However, the statute of limitations is now extended for three years after filing the AAR.[31]

Statute of Limitations

The statute of limitations on when a partnership-level adjustment may be assessed is defined separately from the general statute of limitations rules applicable to other tax returns. Generally, the assessment must be made within three years of the later of the date the return was filed, the due date of the return, or the date an AAR was requested. In effect, these rules now make the statute of limitations of the partner irrelevant. For example, if the partnership agrees to extend the statute of limitations for a partnership-level assessment and the statute of limitations of the partners have expired at the time a partnership-level assessment is made, the assessment can still be made because the statute of limitations of the partnership is still open. This is true even if the partnership makes a pass-through election. However, it appears that the option of a partner to amend its tax return to modify the partnership-level assessment would not be permitted if the statute of limitations had expired with respect to that partner, even if the partnership's statute of limitations was still open.

Partnership Representative

Each partnership is required to appoint a representative, defined as the partnership representative, who will have sole authority to act and make decisions regarding the audit and adjustment procedures. If the partnership does not appoint a partnership representative, the IRS will select one. The partnership and all its partners, including partners that held an interest in the year under examination but are no longer partners, are bound by the decisions of the partnership representative.[32]

Examples of the Basic Operation of the Streamlined Audit Procedures

Example 1: In 2021, the IRS imposes a $1 million increase to the income of Partnership A's 2019 taxable year. Partnership A does not make a pass-through election. Therefore, the $1 million adjustment is taxed at the highest applicable tax rate. Under current law, the $1 million is taxed at 39.6%, and Partnership A is required to pay $396,000. No amended returns would be filed by either Partnership A or the partners.

Example 2: This example reflects the same facts as in Example 1, except that a partner holding a 25% interest is a tax-exempt entity. If the Partnership A can show that the $250,000 of income allocable to this partner would not have been subject to tax (i.e., would not be considered unrelated business income), this portion of the adjustment would be removed from the imputed underpayment computation. Under current law, the remaining $750,000 of income is taxed at 39.6%, and Partnership A is required to pay $297,000. No amended returns would be filed by either Partnership A or the partners.

Example 3: This example reflects the same facts as in Example 1, except that Partnership A makes a pass-through election. The $1 million of income is then passed through to the partners that held an interest in the partnership in 2019. Each partner must then determine any additional tax that they would have owed had they included their share of the $1 million adjustment in their 2019 tax returns. To the extent that the changes to the 2019 tax returns would have impacted tax attributes carrying forward to 2020, the partners must also recalculate their 2020 tax liabilities as well. The total of any additional tax owed by the partners must be included on their 2021 tax returns. Any impact to tax attributes carrying into the 2021 tax year is reported on the original 2021 tax return. No amended returns would be filed by either Partnership A or its partners for any tax year.

Example 4: In 2018 and 2019, Partnership B was owned by three individuals. In both tax years, the partnership opted out of the streamlined partnership audit procedures on its timely filed tax returns. The income of Partnership B can be audited through the individual returns of the partners, and the individual partners will generally be directly responsible for the tax resulting from any adjustments to income. Amended returns may need to be filed by the individual partners for years subsequent to the year under examination.

Example 5: On November 1, 2021, Partnership C filed a request for an AAR for the 2019 tax year that increased income by $1 million. Partnership C may pay $396,000 like in Example 1, pay the tax but substantiate certain modifications to the tax as in Example 2, or it can pass the adjustment through to the partners as in Example 3. In any case, the statute of limitations for the 2019 tax year with respect to any future partnership level assessment for Partnership C is extended until November 1, 2024.

Unanswered Questions and Observations

Over the next several years, it is expected that a significant amount of guidance will be issued by the Treasury and the IRS to implement these rules. It is also possible that a number of amendments and technical corrections will also be enacted by Congress.[33] As of now there are many unresolved questions, some of which are discussed below:

- *Electing in to Streamlined Audit Rules Early* — Taxpayers are permitted to elect in to the streamlined partnership audit procedures for any tax year beginning after November 2, 2015 (e.g., 2016 and 2017 calendar years), but mechanics of that election are left to the Treasury to determine.[34] While it may not be common for a partnership to elect in to these rules early given the uncertainty surrounding their implementation, it is possible that the election could be required soon, especially with respect to short tax years.
- *Tiered Partnerships* — When tiered partnerships exist, it is not clear if an upper-tier partnership can elect to pay a tax liability at the partnership level if the lower-tier partnership makes a pass-through election. Absent further guidance, it is possible that once the lower-tier partnership makes a pass-through election, the calculation must proceed on a full pass-through basis through all tiers of ownership.
- *Treatment Where Partnerships Cease to Exist* — If a partnership ceases to exist before an assessment to the partnership is made, then the adjustment is to be taken into account by the former partners.[35] It is unclear whether this rule is referring to the former partners at the time the partnership ceases to exist or from the tax year of the adjustment. It is also unclear how this rule would apply when a partnership is deemed to cease to exist, such as when a partnership undergoes a technical termination or becomes a disregarded entity.
- *Partner Basis Limitations* — If a partner has losses from the partnership that were suspended under the basis or at-risk basis rules, those attributes do not appear to be able to be taken into account in order to reduce the imputed underpayment at the partnership level. However, if a pass-through election is made or amended returns are filed, it would appear that the suspended losses could be included to reduce the tax assessment. This disparity could provide for unique planning opportunities and could also apply to many similar tax attributes.
- *Impact on Outside Basis* — If partners do not amend their returns and the partnership does not make a pass-through election, it is not clear how any items or income, gain, loss, or deduction will impact the partner's outside basis in the partnership. While it would seem logical that outside basis should be impacted by any adjustment to partnership income, the rules do not appear to provide for any reporting of audit adjustments from the partnership to the partner when no pass-through election is made and the partnership pays the tax assessment. If outside tax basis is not adjusted for a partner's proper share of an adjustment, disparities would result between the partnership's inside basis of the assets and the partner's outside basis in its partnership interest. This could lead to unintended consequences, such as the adjustment essentially being double taxed in the future. On the other hand, similar unintended disparities could exist if a partner adjusts its outside tax basis for an item of income when the tax liability for that item was computed without taking that partner's specific tax situation into account. It is likely that additional guidance will address these issues.
- *Impact on Self-Employment Tax ("SE Tax") and Net Investment Income Tax ("NIIT")* — When a partnership makes the pass-through election, the partner's tax liability is recalculated based solely on the change to its liability under Chapter 1.[36] However, the SE Tax and the NIIT are assessed in Chapter 2 and Chapter 2A, rather than Chapter 1. If the streamlined audit procedures apply, it would appear that no additional SE Tax or NIIT could be assessed to either the partnership or the partner. However, if the partnership did not make the pass-through election and the partner chooses to amend its tax return, it would appear that SE Tax and NIIT would

be adjusted. It is possible that this difference is simply an oversight in the drafting of the legislation and that the reference to Chapter 1 is more restrictive than what was intended.

- *Separately Stated Items That Are Not Income, Gains, Deductions, Losses or Credits* — These rules focus on income, deductions, gains, losses, and credits. However, none of those categories is defined, and certain items do not fit into the common definitions of those categories. For example, the domestic production activities deduction ("DPAD") under §199 requires that the partnership provide DPAD information to its partners, but the deduction itself is computed solely at the partner level. If a change to DPAD were made as a part of an examination, it is not clear how that would factor in to a partnership level assessment.

- *Impact on Subsequent Carrybacks and Amendments* — If an assessment is paid by the partnership, it does not appear that a partner would have an opportunity to ever claim a refund of the tax paid. For example, if a partnership is assessed tax on an extra $1 million of income in the 2019 tax year, 50% of which is allocable to Partner A, and Partner A also has a $500,000 NOL in 2021 that it carries back to 2019, it does not appear that the partner would be able to use the NOL to offset the additional income resulting from the audit to obtain a refund of any tax paid by the partnership. However, it appears that Partner A would still be able to offset any income originally reported in its 2019 tax return, even if subsequently adjusted at the partnership level. It is also unclear how a pass-through election would impact this. If a pass-through election were made, Partner A would have recalculated its 2019 tax liability and included that tax liability on its tax return for the year in which the examination closed. However, if that income was not actually reported in Partner A's 2019 tax return, it is not clear if that income would be available to be offset by the 2021 NOL carryback to obtain a refund of additional 2019 tax paid in the later year. It seems likely that a refund should be available under these facts but additional guidance will likely be necessary to clarify the process.

- *Utilization of Attributes Typically Determined Only at the Partner Level* — A partnership-level assessment is determined solely at the partnership level and does not appear to take into account any potential limitations or differences that may typically exist at the partner level. For example, if an increase to a foreign tax credit would not have been utilizable by the partners due to a lack of foreign source income, those same limitations do not appear to be applied to the partnership when determining an imputed underpayment. Therefore, the partnership still appears to be able to utilize the increased amount of the credit to reduce the imputed underpayment. This possibility may allow for unique planning opportunities based on the nature of examination adjustments.

- *State and Local Tax Implications* — Many states use federal taxable income as a starting point to determine the state taxable income. However, when a tax liability is assessed at the partnership level, the federal taxable income of the partner is not necessarily changed. Even if it is argued that taxable income is adjusted regardless of whether or not a formal assessment is made to the partner in the previous year, a formal process does not necessarily exist to allocate adjustments to the partners when the tax assessment is paid by the partnership. Without further guidance at the federal or state level, it may not be clear how state taxes are to be adjusted in these circumstances.

WHAT CAN BE DONE NOW?

The potential impact that the streamlined partnership audit procedures will have on partnerships will be dramatic. In order to properly reflect the intentions of the partners, it is likely that significant adjustments will have to be made to the partnership agreement. These revisions may be difficult since the rules do not become mandatory until the 2018 tax year, and there is still a significant lack of clarity as to how these rules may be implemented. Even with this uncertainty, there are steps that partners and partnerships should consider taking now:

- *Decision Processes* — There will be many decisions for a partnership to make in determining how it should implement these rules, such as who will act as the partnership representative, whether or not a pass-through election will be made under different circumstances, and how decisions will be made when competing interests are involved. While it may not be possible to make those decisions just yet, partners may want to define the process under which those decisions will be made. This is particularly true where a partnership is being formed currently or with respect to a partner that anticipates having less influence in the future when the rules are clearer. However, appointing a partnership representative may still be an appropriate current step.

- *Electing in to Streamlined Audit Rules Early* — Given the uncertainty as to how these rules will function in practice, many partnerships and partners will likely prefer to not utilize them until there is more clarity. On the other hand, some partnerships may prefer to elect into the rules knowing there is uncertainty in how the rules will operate. These entities may favor the administrative simplicity of the rules. Widely-held partnerships, in particular, may see the value in their partners not having to amend their returns for audit adjustments. Partnerships and their partners should consider amending their partnership agreements to clarify whether they will opt-in to the rules early or define how any decision to elect in would be made from a governance standpoint.

- *Partners Acquiring an Interest in an Existing Partnership* — Partners entering an existing partnership are now entering into a whole new world whereby they may become indirectly liable for the tax liabilities of former partners from prior years. The new partners may want to consider ensuring that the partnership agreement does not permit early adoption of the streamlined audit procedures before entering. Alternatively, the new partners may want to obtain protections in the partnership agreement that require the partnership to make a pass-through election. If the new partners do not obtain such protections in the operating agreement and the partnership could be responsible for a tax assessment, the new partners should give consider how the tax contingencies will influence the economics of the transaction including whether indemnifications from the partnership or from a selling partner may be appropriate. These issues should also be considered when determining the scope of due diligence performed to identify potential exposures.

- *Partners Exiting a Partnership* — Partners that are selling their interest have historically had little opportunity to foreclose the possibility of tax adjustments for previous tax years. However, the streamlined audit procedures provide an opportunity for the selling partner to eliminate its responsibility for prior year tax issues if a pass-through election is not made by the partnership. As a result, such partners should consider protections to avoid the making of the pass-through election by the partnership. This result can be obtained even for current transactions if the partnership were required to elect in to these rules early. The acquiring partner may still require the selling partner to indemnify against this potential result. However, even an indemnification of the acquiring partner would still ensure that the selling partner would never be required to amend a prior tax return. The administrative simplicity of indemnification may be preferable to amending a prior tax return, especially when the selling partner is a widely-held flow-through entity. Consideration should be given to these issues in transaction documents and partnership agreements.

About the Authors

Michael Monaghan*, JD, is a Tax Partner who leads Plante Moran's National Tax Office and serves on the leadership team of the firm's Tax and Private Equity practices. He specializes in handling the tax aspects of transactions and frequently plans the purchase, sale, formation, and restructuring of businesses, including liquidations, mergers, and acquisitions. He also focusses in the areas of tax due diligence and planning for troubled companies. Mike is the current chair of the Federal Income Tax Committee of the Tax Section of the State Bar of Michigan*

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Endnotes

1 Bipartisan Budget Act of 2015, Pub. L. No. 114-74, 129 Stat. 584.

2 *Id.* at §1001(g)(1).

3 Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324.

4 *Id.*

5 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

6 Bipartisan Budget Act of 2015, Pub. L. No. 114-74 § 1001(g)(1), 129 Stat. 584.

7 § 6221(b)(2)(A)(ii) (stating that all owners of the S corporation are included in the 100 partner limitation).

8 § 6221(b).

9 §§ 6221(a) and 6225(a)(1).

10 § 6225(a)(2).

11 § 6225(d)(2).

12 § 6225(b)(2).

13 § 6225(c)(2)(B).

14 § 6241(4).

15 § 6225(b)(1)(A).

16 As the 3.8% net investment income tax applicable to certain unearned income of individuals, estates and trusts is assessed by §1411 and not by §1, it is not included in the determination of the highest applicable tax rate.

17 § 6225(c)(3).

18 § 6225(c)(4) as amended by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, § 411 (reflecting technical corrections made to § 6225(c)(4)).

19 § 6225(c)(2).

20 § 6225(c)(1).

21 § 6225(c)(6).

22 § 6226(a).

23 § 6226(b)(2).

24 § 6226(b)(1).

25 § 6226(c)(1).

26 § 6226(c).

27 §§ 6227(a) and 6031(b).

28 § 6227(b).

29 § 6227(b)(2).

30 § 6501(c)(7).

31 § 6235(a)(1)(C).

32 § 6223.

33 The first set of technical corrections were made by Congress in Pub. L. No. 114-113, less than 2 months after the initial enactment.

34 Bipartisan Budget Act of 2015, Pub. L. No. 114-74 § 1001(g)(4), 129 Stat. 584.

35 § 6241(7).

36 § 6226(b)(2).

MAY 19, 2016 | PLYMOUTH

Taxation Section
29TH ANNUAL TAX CONFERENCE

Schedule

8:00am Continental Breakfast, Exhibitor Showcase, and Registration

9:00am Welcome and Introductions
Michael M. Antovski, Chair, State Bar of Michigan Taxation Section, Bodman PLC, *Detroit*

9:10am Washington Update: Current Tax Legislative Developments[1]
future budget outlook • trends in U.S. taxation • legislative outlook • prognosis for tax reform
Tom Crawford, C2 Group/FTI Consulting, *Washington, DC*

10:20am The Affordable Care Act: What Every Tax Lawyer Needs to Know Today[1]
ways employers are responding to the ACA employer mandate • the Supreme Court and *King v Burwell* • reporting rules, their (many) challenges, and what steps employers need to be taking now to be ready • the tax on high cost health plans—Code §4980I and its likely impact on plan design • the coming group health plan nondiscrimination rules (and why you should be worried) • recent developments in wellness programs • current legislative activity involving the ACA
Alden Bianchi, Mintz Levin Cohn Ferris Glovsky and Popeo PC, *Boston, MA*

11:30am Detroit, Entrepreneurism, and Tax Policy[1]—*Sponsored by the Young Lawyer Committee*
latest developments with economic and tax programs designed to activate commercial space and enable entrepreneurs with leveraged grant dollars • Detroit's foundation for small businesses • Detroit's collaborations with public, philanthropic, and private sector partners
Jill Ford, Special Advisor to Detroit Mayor Mike Duggan, *Detroit*

12:30pm Luncheon Keynote and Awards Presentation
Carl Levin, Former U.S. Senator, Honigman Miller Schwartz and Cohn LLP, *Detroit;* Tammie J. Tischler, Tax Conference Planning Chair, International Union, UAW, *Detroit*

1:30pm State and Local Tax Committee: An Update on the Michigan Economy[2]
current state of Michigan's economy and budget • what does the future hold?
Robert J. Schneider, Director of State Affairs, Citizens Research Council of Michigan, *Lansing*

Federal Income Tax Committee: International Update: FATCA, FBARS, and Streamlined[2]
overview of filing requirements for offshore financial assets and income for individuals • offshore voluntary/streamlined disclosure update • FATCA implementation update
Tracy Marrin, Rehmann, *Ann Arbor;* Thomas Quinn, Rehmann, *Ann Arbor*

2:40pm State and Local Tax Committee: Michigan Tax Update: Policy Developments[2]
Michigan Department of Treasury update • other tax developments, including offers in compromise
Wayne D. Roberts, Varnum LLP, *Grand Rapids;* Nichole Shultz, Michigan Department of Treasury, *Lansing;* Lance R. Wilkinson, Tax Policy Division, Michigan Department of Treasury, *Lansing*

Practice and Procedure Committee: A View from the Tax Court[2]
rule revisions and other new developments at the Tax Court • best practices for appearing in court • pet peeves • your questions answered
Hon. Ronald L. Buch, United States Tax Court, *Washington, DC*

3:50pm Employee Benefits Committee: Life After Determination Letters[2]
overview of announcement 2015–19 • potential exposure for plan sponsors and practitioners • further shift toward preapproved plans? • impact on accepting rollovers • impact on EPCRS eligibility • impact on M&A transactions • open issues where further guidance is necessary
Brian Thomas Gallagher, Fraser Trebilcock, *Lansing;* Robert A. Miller, Calfee Halter & Griswold, *Cleveland, OH*

Estates and Trusts Committee: Dissecting GRATs and SCINs[2]
statutory support for GRATs • economic leverage from GRATs • creative planning with GRATs • legal authority for self-canceling installment notes • tax treatment of SCINs • valuing a SCIN • use of SCINs after *Davidson* decision
J. Thomas MacFarlane, Clark Hill PLC, *Birmingham*

5:00pm Networking Reception

[1]On-Demand Webcast and MP3 download available
[2]MP3 download available

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