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Michigan Tax Lawyer

STATE BAR OF MICHIGAN 1935

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

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact David B. Deutsch, 39395 West 12 Mile Road, Suite 200, Farmington Hills, MI 48333.

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Disclaimer

TAXATION SECTION

STATE BAR OF MICHIGAN

Dear Taxation Section Members:

Following eight years of service to the Taxation Section as Chairperson of the Estates and Trusts Committee, Council Member, Secretary, Treasurer, and Vice Chairperson, it is an honor to be the 2002-2003 Chairperson of the Taxation Section.

Collectively, the Section's other new officers (Vice Chairperson - Sherill A. Siebert, Secretary – Charles M. Lax, and Treasurer – Eric M. Nemeth), continuing and new Council Members (Thomas J. Kenny, Henry P. Lee and Steven Z. Ettinger), continuing and new Committee Chairpersons (John M. Neberle and George H. Runstadler III), and I, together with our program facilitator, Jan M. Baggett, are committed to making the following publications, meetings, and events available to you:

Michigan Tax Lawyer. Publication is scheduled at approximately four month intervals, with this being the first of the three publications for this fiscal year. David B. Deutsch has taken over as editor of the *Michigan Tax Lawyer* from Shirley A. Kaigler. Please call David at (248) 489-8600 if you are interested in submitting an article for a future issue of the *Michigan Tax Lawyer*.

After-Hours Tax Law Series. Aaron H. Sherbin assembled a fine group of speakers for a series of five late afternoon programs presented in conjunction with ICLE, which commenced October 15, 2002, consisting of Post-Death Administration: A View from the Trenches; Practice Before the IRS; Hot Topics with Partnerships, S-Corporations, and LLCs; Valuation Discounts, Gift Reporting Requirements for Operating and Pass-Thru Entities, and Other Selected Topics; and Essential Qualified Retirement Plan Documents. Shirley A. Kaigler is working on next year's series. Please call Shirley at (313) 961-8380 if you are interested in being a future program speaker.

Summer Tax Conference. This year's Annual Summer Tax Conference will be held at the Double JJ Resort near Muskegon, Michigan on June 27-28, 2003. Anthony J. Caputo (call him "Tex") has been hard at work on putting together an outstanding program at this new conference venue. When you're not being enlightened by our speakers, you and your family members can enjoy the various dude ranch offerings, golf, or swimming if you wish. Visit www.doublejj.com for more information about the resort. Conference information and registration forms should be in your mailbox any time now. Contact "Tex" at (586) 573-8900 for additional conference information.

Tax Court Luncheons. When the Tax Court holds a docket in Detroit and the presiding Tax Court Judge is available, our Section schedules a luncheon for the Judge which is open to IRS Area Counsel Members, IRS Appeals Officers and tax practitioners. Thomas J. Kenny, who can be contacted at (248) 357-3010, is responsible for the luncheons this year.

Committee Meetings. Each of the Taxation Section's five committees organizes and holds meetings to address timely issues relating to their respective areas of tax law. Tax Section Members can be placed on a Committee's mailing and /or e-mail list by contacting the Committee Chairperson. If you are interested in learning more about a particular committee, please contact the appropriate Committee Chairperson:

BUSINESS ENTITIES – Ronald T. Charlebois (248) 643-6500
EMPLOYEE BENEFITS – Mary Jo Larson (313) 465-7458
ESTATES AND TRUSTS – George H. Runstadler III (248) 645-9680
PRACTICE AND PROCEDURE – Jess A. Bahs (517) 706-5760
STATE AND LOCAL – John M. Neberle (248) 357-3010

Also please be sure to read the reports of the Committee Chairpersons in this issue of the *Michigan Tax Lawyer* for committee meeting and recent development information.

Directory. Our biennial publication of the Taxation Section Membership Directory is due out this year and is in the capable hands of Trevor T. Wetherington. In addition to containing the telephone numbers and e-mail addresses of Taxation Section Members, this publication also contains Internal Revenue Service, Department of Justice, Tax Division and Michigan Department of Treasury Telephone Directories.

Internet. The Taxation Section Website can be accessed either through the State Bar Website at www.michbar.org or directly at www.michigantax.org. Our website is an ongoing work in progress and Michael O. Love is responsible for advancing it to the next level. If you have any ideas or are willing to offer some assistance to Mike, please contact him at (248) 603-0522.

Annual Meeting. This year's State Bar Annual Meeting is scheduled for September 11 and 12, 2003 in Lansing, Michigan. The Taxation Section's program is scheduled for the morning of September 12. Jay A. Kennedy is working on lining up one or more speakers for that program.

I wish to thank my immediate predecessor, Eric T. Weiss, and the many other dedicated Chairpersons before him, for their outstanding contributions and leadership. I also want to encourage you to take advantage of what the Taxation Section has to offer. The Section's Officers, Council Members and Committee Chairperson look forward to your attendance at and participation in our activities.

Edward M. Deron, Chairperson

Report of the Business Entities Committee

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Recent Activities

On October 17, 2002, the Business Entities Committee met at the Bloomfield Hills offices of Rader, Fishman & Grauer, PLLC, a national intellectual property law firm. The speakers, all from that law firm, included Andrew S. Walker, Michael A. Lisi and Jill R. Neuvirth. The program featured a presentation of various tax issues impacting intellectual property. Some of the topics that were discussed included qualification for capital gains treatment for patent royalties, patent donations, use of holding companies to provide relief from the state tax burden on the royalty system, and methods to compute the research and experimentation credit. The update focused on the opportunities available for managing intellectual property with desirable tax planning results.

... a presentation by representatives of the Internal Revenue Service on current audit issues involving estate and gift taxes.

Report of the Employee Benefits Committee

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Summary of Activities

Recent Activities

The most recent meeting of the Employee Benefits Committee took place on Thursday, November 21, 2002, at the Red Run Golf Club. Paul Shultz, Director of Employee Plans Rulings and Examinations, TE/GE, Internal Revenue Service, spoke on "What's Happening and What's New at IRS' Employee Plans." This was a joint program held with the Michigan Employee Benefits Conference.

Upcoming Activities

The speaker, time and place for the next meeting have not yet been finalized. Announcements will be sent by e-mail when arrangements have been completed. Anyone who has not been receiving announcements by e-mail, or who would prefer to receive announcements by mail, should contact me to ensure timely receipt of meeting information.

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Report of the Estates and Trusts Committee

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Recent Committee Meetings

The Estates and Trusts Committee is planning two conferences. The first, to be held in late March, will speak to asset protection planning in Michigan following the decision in *U.S. v Craft*, 122 S.Ct. 1414 (4/17/02). The second, scheduled for late May, 2003, will be a presentation by representatives of the Internal Revenue Service on current audit issues involving estate and gift taxes.

Report of the Practice and Procedure Committee

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February 2003 Practice and Procedure Committee Report

The Practice and Procedure Committee has not met since the August summer meeting with attorneys Robert D. Heitmeyer and Alexandra E. Nicholaides of the Detroit IRS Chief Counsel office. We need your support. Attendance was down at the last meeting (although this may have been due to the meeting being in August).

The committee is in the process of planning another meeting to be held some time this spring. We were unable to make any commitments by the time of this committee report. The next meeting may be the day of the Tax Court luncheon scheduled for this spring. Alternatively, we may have a meeting regarding practice and procedure issues before the Michigan Tax Tribunal, which may be joint with the state and local tax committee. Another topic under consideration is litigation of family limited partnership (LLC) discounts. Stay tuned for further updates. We will send meeting notices by E-mail. If you would like to receive E-mail updates, please E-mail us at jess.bahs@fosterzacklowe.com. Please feel free to express interest in any of the above topics, or suggest additional topics, by sending E-mail to this E-mail address.

Report of the State and Local Tax Committee

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Recent Activities

The State and Local Tax Committee held a meeting on November 14, 2002, at the offices of Raymond & Prokop, P.C., Southfield, Michigan. The guest speaker was Professor Michael J. McIntyre, Wayne State University.

Professor McIntyre led a discussion on the topic of Michigan Business Taxation and the Looming State Deficit. His view is that the State should: (i) cut expenditures; (ii) replace the SBT with a business income tax that has a minimum tax component and is levied using a worldwide unitary basis measured by financial accounting income rather than federal taxable income; (iii) base personal income taxes on inflation indexed graduated rates; and (iv) uncap property assessments. California would be the model for unitary taxes.

For more information concerning Professor McIntyre's views, see his essay, dedicated to the memory of Paul Mines, at 2002 STT 184-3.

The Michigan Legislation discussed included potential legislation to enact the Internet Sales Tax Agreement.

Michigan Tax Legislative Update

The Michigan Legislation discussed included potential legislation to enact the Internet Sales Tax Agreement, SB 1369 to update the State's Uniform Unclaimed Property Act of 1995, SB 1194 that would permit the filing of non-property tax cases in the Court of Claims without paying the taxes in dispute, SB 1507 that would reinvigorate the Administrative Procedures Act of 1969, and HB 6501 & 02 that would amend the SBT and the Brownfield

Redevelopment Financing Act to extend the programs through 2007.

Michigan Tax Administration Update

The Michigan Department of Treasury has issued a proposed Revenue Administrative Bulletin, *i.e.,* RAB 2002-B, Individual Income Tax Nexus Standards for Non-Residents With Business Income. Committee Members were urged to contact the Department of Treasury on or before November 25 (deadline) with any comments they may have on the RAB. This Bulletin was reviewed by the Commissioner=s Advisory Group – Individuals.

Committee Members were urged to contact the Department of Treasury on or before November 25 ...

The Michigan Tax Commission has published numerous notices including the following:

- STC Bulletin 10 – Computerized Tax Rolls;
- STC Bulletin 11 – Inflation Rate Multipliers;
- STC Bulletin 12 – Electronic Records;
- STC Bulletin 13 – Equalization;
- STC Bulletin 14 – Property Tax Calendar;
- STC Bulletin 16 – Tax Tribunal Interest Rate;
- 2003 Personal Property Statement; and
- Letters to Assessors and Equalization Directors concerning the Danse and WPW decisions.

Michigan Judicial Tax Decisions Update

Michigan tax cases discussed included the following:

- *Danse Corp. v. City of Madison Heights,* MTT, (Michigan Manufacturers Association will be filing an Amicus in support of Danse);

Michigan Court of Appeals' decisions in:

- *Primestar, Inc. v. Township of Flint;*
- *Grunwo v. Township of Frankenmuth;*
- *WPW Acquisition Co. v. City of Troy.*

Tax cases not discussed included the following:

- U.S. Supreme Court decision invalidating Michigan's Motor Carriers' Registration Fees; and

Michigan Court of Appeals' decisions in:

- *South Davison Community Center v. Township of Davison;*
- *Thompson's Bear Lake Limited Partnership v. Township of Pleasanton;*
- *Sttege v. Department of Treasury.*

The Limited Liability Company: Who is responsible for the Federal Tax Liabilities of an LLC?

By: Michael M. Antovski, Esq.

Since the enactment of the Michigan Limited Liability Company Act ("LLCA") in 1993, the Limited Liability Company ("LLC") has fast become the entity of choice for doing business in Michigan.[1] The popularity of the LLC largely began due to its hybrid characteristics. The LLC offers the limited liability protection of a corporation, and the flexibility and tax treatment of a partnership. Moreover, legislative changes brought about in 1997, at both the state and the federal level, have contributed to an even greater attraction to the LLC. At the state level, Michigan revised the LLCA to allow the formation of single member LLCs. Whereas, at the federal level, the Treasury Department enacted Treasury Regulations section 301.7701-1 et seq. (commonly referred to as "the check-the-box regulations") providing greater choice and certainty as to the federal tax classification of the LLC.

Along with these benefits, however, emerge issues as to how the LLC and its members will be treated for purposes of collecting federal tax liability. For example, suppose a multi-member LLC is treated as a partnership for federal tax purposes—will the members of the LLC be regarded as shareholders given the LLC's corporate-like protection, which under state law generally limits the member's personal liability for debts of the LLC, or will the members of the LLC be treated as partners given the LLC's federal tax classification as a partnership?

On August 30, 2002, the Internal Revenue Service ("IRS") released a Chief Counsel Advisory (the "Advisory") addressing the issue of collecting federal employment tax and income tax liabilities[2] from an LLC.[3] The Advisory offers guidance on five issues as they relate to the collection of such taxes by the IRS, namely:

1. Who is liable for federal taxes in the context of a multi-member LLC?
2. Who is liable for federal taxes in the context of a single member LLC?
3. Whether an assessment made by the IRS against a disregarded LLC is valid against the single member owner?
4. Whether a Notice of Federal Tax Lien ("NFTL") filed against a disregarded LLC is valid against the single member owner?
5. What state law theories could be used to collect single member owner's liability from the disregarded LLC?

The IRS admits that there is much confusion regarding collection issues involving LLCs. The purpose of this article is to highlight each of the five (5) issues addressed in the Advisory and offer the reader some insight as to who is responsible for federal tax liability when operating an LLC in the state of Michigan.

Who is liable for federal taxes in the context of a multi-member LLC?

Who is liable for federal taxes in the context of a multi-member LLC?

For federal tax purposes, a multi-member LLC can be classified as either a corporation or a partnership.[4] Unless the LLC files an election to be classified as a corporation, it will be deemed as a partnership for federal tax purposes.[5]

Assuming the LLC has elected to be a corporation, the IRS will apply the general rules of corporate taxation.[6] The LLC will be taxed as a corporation, and the members will be treated equivalent to shareholders.[7] As a corporation, the LLC will be recognized as the taxpayer. The IRS will look to the LLC to satisfy any federal tax liabilities by filing either an NFTL against the LLC and foreclose, or levy the assets of the LLC.[8] Given the "shareholder" treatment of the members, the Advisory instructs the IRS not to file an NFTL against the members since they are not considered the taxpayers.[9] Note, the members may be liable for the trust fund recovery penalty under I.R.C. section 6672.[10]

General partners are ... liable for the employment tax liability under state law.

If the LLC does not file an election to be classified as a corporation, it will be treated as a partnership for federal tax purposes.[11] Depending on the type of federal tax liability due, either the LLC or its members will be deemed to be the taxpayer for collection purposes.

In regard to federal income tax liability, the members of a multi-member LLC are considered the taxpayers and are responsible for the payment of such liability because the income and losses arising from the operation of the LLC pass through to the members. Thus, the IRS could file an NFTL against the members to collect the liability.[12]

Unlike the typical partnership situation, the IRS will not assert an employment tax liability against the members of the LLC. The Advisory emphasizes that state law creates a major distinction between a general partner's liability for employment taxes and a member's liability when an LLC is classified as a partnership for federal tax purposes and incurs employment tax liability. General partners are derivatively liable for the employment tax liability under state law. "When a partnership incurs an employment tax liability, under state law the general partners are liable for the tax, just as they are liable under state law for other debts of the partnership."[13]

In contrast, no state law imposes a derivative liability on the members of an LLC. In fact, "[s]tate law explicitly provides that a member is not liable for an LLC's debts."[14] As a result, the IRS cannot collect the liability from the members, even though the LLC is treated as a partnership for federal tax purposes. Instead, the IRS must look to the LLC for the employment tax liability as the employer and file an NFTL solely against the partnership as the taxpayer.[15] The IRS may, however, assert the trust fund recovery penalty against members, depending on the facts and circumstances of the case.[16]

Who is liable for federal taxes in the context of a single member LLC?

For federal tax purposes, a single member LLC can be classified as either a corporation or a disregarded entity.[17] Unless the LLC files an election to be classified as a corporation, it will be disregarded as an entity separate from its owner and its activities will be treated in the same manner as a sole proprietorship, branch, or division of the owner.[18]

Assuming the LLC has elected to be classified as a corporation for federal tax purposes, the LLC will be treated as a separate legal entity for federal tax purposes. The LLC will accrue its own tax liability, and the IRS must look only to the LLC's assets for collection of the liability.[19] The Advisory states that "...just as a sole shareholder is not liable for the corporation's tax liability, the single member owner of the LLC would be similarly insulated from the LLC's federal tax liability."[20] The IRS may, however, assert the trust fund recovery penalty against any responsible person, which may in some situations include the single member owner. The single member owner, however, is not automatically a responsible person.[21] The IRS must examine the facts and circumstances of each case to determine the responsible person.[22]

Assuming the single member owner has not elected to be treated as a corporation for federal tax purposes, the LLC will be disregarded as an entity separate from its single member owner.[23] Consequently, the single member owner will be treated as the taxpayer for any federal tax liabilities that arise from the operation of the LLC.[24]

As the taxpayer, the single member owner must file federal income tax returns in order for the IRS to make assessments. The single member owner must also file employment tax returns. Pursuant to Notice 99-6, the single member owner has two choices in filing employment tax returns.[25] The single member can calculate, report and pay the employment tax liability under its own name and taxpayer identification number.[26] Alternatively, the employment tax can be calculated, reported and remitted under the LLC's name and taxpayer identification number.[27] Regardless of the method chosen, the single member owner of the disregarded LLC is the statutory employer and retains ultimate responsibility for the employment tax liability.[28]

Whether an assessment made by the IRS against a disregarded LLC is valid against the single member owner?

The current practice of the IRS is to assess employment taxes in the name and/or taxpayer identification number of the disregarded LLC. The IRS's position is that an assessment against the disregarded LLC is a valid assessment against the single member owner's liability.[29] The Advisory asserts that given the close relationship between a disregarded LLC and its single member owner, any reference in an assessment to a disregarded LLC is tantamount to an assessment against the single member owner as the taxpayer.

To avoid litigating the issue, the Advisory recommends that the name of the single member owner be added to the assessment. This recommendation appears to be a response to the pro-taxpayer decision in *United States v. Galletti*[30], which held that an assessment for unpaid employment taxes against a general partnership was not valid against the individual general partners. In *Galletti*, the IRS filed proofs of claim in bankruptcy court against the general partners for unpaid employment taxes assessed against the partnership. The claim was disallowed on the grounds that the IRS failed to make an individualized assessment against the general partners or obtain judgments against the partners holding them jointly and severally liable for the tax debts of the partnership before the IRS could collect the partnership's tax deficiency directly from the general partners.[31] Unfortunately for the IRS, the statute of limitations had run on the claim and thus, it was unable to make such an assessment or obtain such a judgment against the general partners.[32]

... any reference in an assessment to a disregarded LLC is tantamount to an assessment ...

Assuming there is a valid assessment and demand against the single member owner, the IRS would have a tax lien against the single member owner's property and rights to property for the federal tax liability.[33] The Advisory raises the question as to whether the taxpayer's "property and rights to property" include the assets of the LLC and concludes that they do not.

In defining the single member owner's property and rights to property, the Advisory applies the two-prong test articulated in *Drye v. United States.*[34] First, the taxpayer's interests or rights must be determined under state law.[35] Second, it must be determined whether such interests or rights are property or rights to property under the Internal Revenue Code.[36] The Advisory notes that if the taxpayer has no interest

If the LLC veil is pierced, the LLC and the single member owner are considered alter egos ...

or rights under state law, then the taxpayer has no property or rights to property under the Internal Revenue Code.

In applying the *Drye* test to a single member of owner of a disregarded LLC, the Advisory reasons that the single member owner has no property or right to property in the LLC's assets because under state law the single member owner has no interest in the LLC's property. Therefore, even though the LLC is disregarded as a separate entity from its single member owner for federal tax liability purposes, the IRS cannot satisfy the single member owner's tax liability form the assets of the LLC.[37] Note, however, that the IRS may either place a levy upon the single member's ownership interest in the disregarded LLC and sell that interest,[38] or file suit to foreclose the federal tax lien against the member's interest.[39]

Whether a Notice of Federal Tax Lien ("NFTL") filed against a disregarded LLC is valid against the single member owner?

The IRS admits that there is an issue as to who an NFTL could be filed against in situations involving disregarded LLCs. Although the Advisory emphasizes that the single member owner is the taxpayer with respect to any tax liabilities that may arise from the activities of the disregarded LLC, an NFTL identifying the disregarded LLC as the taxpayer may be valid notice against the single member owner, depending on the facts and circumstances in each case. An NFTL is valid against the single member owner if it substantially complies with the filing requirement so to put a third party on notice to the possibility of the federal tax lien against the taxpayer.[40] To avoid litigating this issue, however, the Advisory recommends that the NFTL be filed in the name of the single member owner.

What state law theories could be used to collect single member owner's liability from the disregarded LLC?

The IRS may rely on state law theories to collect a single member owner's tax liability. The IRS may assert alternate state law theories provided the precise distinctions between the theories are recognized and there are facts to support each theory. The Advisory suggests the following three state law principles that the IRS can apply to collect a single member owner's tax liability from the disregarded LLC, namely:

Alter Ego

The Advisory takes the position that the concept of piercing the corporate veil can be applied against an LLC.[41] Sufficient grounds for "piercing the LLC veil" include instances where the single member owner is using the LLC to evade the payment of taxes.[42] Such grounds would include situations where the LLC is used to shield assets from the IRS, such as by paying income earned by the taxpayer directly to the LLC.[43] If the LLC veil is pierced, the LLC and the single member owner are considered alter egos, and the federal tax liabilities of the owner attach to the assets the LLC.[44]

Nominee Liability

The IRS may assert nominee liability to collect the single member owner's tax liability where property is held nominally by someone other than the actual owner of the property. Under this theory, only the property being held by the nominee for the benefit of the single member owner may be attached.

There are no specific elements required for this theory to apply. The courts, however, have identified the following factors which, based upon the totality of the circumstances, may indicate that actual ownership of the property rests in the taxpayer: (1) no consideration or inadequate consideration paid by the nominee;

(2) property placed in the name of the nominee in anticipation of a suit or occurrence of liabilities while the transferor continues to exercise control over the property; (3) close relationship between transferor and the nominee; (4) failure to record conveyance; (5) retention of possession by the transferor; (6) exercise control or dominion by the taxpayer; and (7) expenses of the property paid by the taxpayer.[45]

Transferee Liability
The IRS may assert transferee liability to satisfy the single member owner's tax liability in situations where the member transferred property to the disregarded LLC. In order to satisfy this theory, two elements must be met. First, there must be a transfer of the single member owner's property to a third party. Second, the single member owner must be liable for the tax at the time of transfer and at the time transferee liability is asserted.

The transferee liability theory is based upon a fraudulent conveyance under state law.[46] A fraudulent conveyance generally arises where property is conveyed, or alienated or placed beyond the reach of ordinary process by a debtor in fraud of creditors.[47]

The Advisory notes that based on the facts and circumstances, courts often look to the following elements in determining whether a fraudulent conveyance exists: (1) the insolvency of the grantor; (2) inadequate consideration; (3) transfer of all of the debtor's property; (4) transfer made in anticipation of a suit or occurrence of liabilities; (5) close relationship between the parties to the transfer; (6) conveyance not in usual course of business; (7) failure to record conveyance by transferee; (8) retention of possession by grantor; (9) reservation of interest, trust, or benefit by grantor; (10) security in excess of debt; (11) secrecy or haste in transaction; and (12) assessment of real property taxes in name of grantor.[48]

Conclusion
The LLC has fast become the entity of choice for doing business. Its popularity is mainly due to the advantages it offers as a hybrid entity, such as corporate-like limited liability protection and partnership-like flow-through taxation. These very same advantages, however, have caused much confusion in terms of who is responsible for federal tax liabilities arising from the operation of the LLC. The Advisory provides practitioners with a relatively straight-forward analysis on who is liable for the federal tax liabilities arising from the LLC.

In short, the responsibility for federal tax liabilities of an LLC depends on whether the LLC is a single member or multi-member LLC, and whether the LLC is classified as a corporation, partnership, or disregarded entity for federal tax purposes.

The LLC has fast become the entity of choice for doing business.

MICHAEL M. ANTOVSKI is Of Counsel with the law firm of Sommers, Schwartz, Silver & Schwartz, P.C. Mr. Antovski's areas of practice include business tax planning, estate planning, and corporate law. Mr. Antovski graduated from Michigan State University, with a B.A. in accounting; University of Detroit-Mercy School of Law, J.D.; and Georgetown University Law Center, where he received his LL.M. in taxation. Mr. Antovski is a member of the American Bar Association (Tax Section), the State Bar of Michigan, and the State Bar of New York.

ENDNOTES

1. According to the Michigan Consumer and Industry Services website, division statistics indicate that 29,990 LLCs were formed in fiscal year 2002, compared to 20,964 profit corporations and 311 limited partnerships. http://www.michigan.gov/cis/0,1607,7-154-10557_12901_12923-37342—,00.html
2. Hereinafter in this article, federal employment tax and income tax liabilities will sometimes be referred to collectively as "federal tax liabilities" or "federal taxes."
3. Chief Counsel Advice 200235023 (August 30, 2002). In accordance with I.R.C. § 6110(k)(3), this guidance may not be used or cited as precedent.
4. Treas. Reg. § 301.7701-2(a).
5. Treas. Reg. § 301.7701-3(b).
6. Chief Counsel Advice 200235023 (August 30, 2002).
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*; Any reference to "section" or "sections" is to the Internal Revenue Code of 1986, as amended.
11. Treas. Reg. § 301.7701-3(b).
12. Chief Counsel Advice 200235023 (August 30, 2002).
13. *Id.* (citing *Ballard v. United States*, 17 F.3d 116 (5th Cir. 1994); *United States v. Hays*, 877 F.2d 843, 844 n. 3 (10th Cir. 1989)).
14. *Id.* The LLCA states that: "Unless otherwise provided by law or in an operating agreement, a person who is a member or manage, or both, of a limited liability company is not liable for the acts, debts, or obligations of the limited liability company." MCLA § 450.4501(2). Moreover, one commentator notes that state legislatures are beginning to strip away the limited liability offered to members with respect to federal, state, and local tax matters. See *Will LLC Members Face Personal Liability for LLC Taxes*? (Sheldon Banoff, J.D. ed., WG&L Journals: Shop Talk 2002).
15. *Id.*
16. *Id.*
17. Treas. Reg. § 301.7701-2(a).
18. *Id.*
19. Chief Counsel Advice 200235023 (August 30, 2002).
20. *Id.*
21. *Id.*
22. *Id.*
23. Treas. Reg. § 301.7701-3(b)(1)(ii).
24. *Id.*
25. Notice 99-6, 1999-3 I.R.B. 12.
26. *Id.*
27. *Id.*
28. See *Id.*; see also Memorandum to District Counsel 199922053 (June 15, 1999).
29. Chief Counsel Advice 200235023 (August 30, 2002).
30. 2002 WL 31558096 (9th Cir. 2002) Before the Ninth Circuit affirmed the district's decision in Galletti, the IRS issued a Chief Counsel Advisory disagreeing with the court's decision claiming that a separate tax assessment against general partners for employment tax liabilities of a general partnership is not required if a valid tax assessment has been made against the partnership. Chief Counsel Advisory 2001520044 (December 28, 2001).
31. *Id.*
32. *Id.*
33. I.R.C. § 6321.

ENDNOTES (continued)

34. 528 U.S. 49 (1999).
35. Chief Counsel Advice 200235023 (August 30, 2002).
36. *Id.*
37. *Id.*
38. *Id.*; see also I.R.C. § 6331.
39. *Id.*; see also I.R.C. § 7403.
40. *Id.*
41. *Id.* (citing Hollowell v Orleans Regional Hospital, 1998 U.S. Dist. LEXIS 8184 (E.D. La. 1998), aff'd 217 F.3d 379 (5th Cir. 2000)).
42. Chief Counsel Advice 200235023 (August 30, 2002).
43. *Id.*
44. *Id.*
45. *Id.* (citing *United States v. Miller Brothers Construction Co.*, 505 F.2d 1031 (10th Cir. 1974); *Towe Antique Ford Foundation v. Internal Revenue Service*, 791 F. Supp. 1450, 1454 (D. Mont.1992), aff'd without opinion, 786 F. 2d 686 (5th Cir. 1985)).
46. Chief Counsel Advice 200235023 (August 30, 2002).
47. *Id.*
48. *Id.*

The Constructive Receipt Doctrine – Is Ignorance Bliss?

By: Mary Jo Larson and Brock A. Swartzle

I was gratified to be able to answer promptly, and I did. I said I didn't know.
— Mark Twain, Life on the Mississippi

... a vast body of statutory, regulatory and case law is devoted to the issue.

I. Introduction

Individuals are taxed on the income they receive for services performed, whatever the form of the compensation — cash, cash equivalents, property, services, or some combination of these.[1] Disputes between the Internal Revenue Service ("IRS") and taxpayers involving the measure or value of income are common, and a vast body of statutory, regulatory and case law is devoted to the issue. With the ever-increasing complexity of commercial society, and especially the rise of qualified and non-qualified deferred compensation arrangements, another issue has become increasingly important — the timing of the receipt of income.

It is a fundamental principle of tax law that income must be realized before it can be included in gross income and subject to taxation.[2] For cash-basis taxpayers, income is generally realized in the year it is received. An exception to this rule, however, is income that is "constructively received." Under the constructive receipt doctrine, if a taxpayer has complete control in determining when to receive income, that income will generally be subject to current taxation regardless of when the taxpayer actually receives the income. As explained by Justice Oliver Wendall Holmes in *Corliss v. Bowers*, "income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."[3]

Implicit in the phrase "free to enjoy at his own option" is the notion that the taxpayer has notice or knowledge of the right to and availability of income. Unfortunately, the IRS has not generally adopted this common-sense viewpoint, arguing instead that the taxpayer should be taxed on income when it is "made available" to him, whether he knows of the right to and availability of income or not. The courts, however, have adopted a more tolerant approach. This Article sets out the respective positions of the IRS and the courts on this issue, and argues that the position taken by the courts makes more sense, both from a legal and equitable standpoint.

II. Legal Authority

A. The IRS' Position

Constructive receipt is a fundamental principle of tax law, dating back at least to the inception of the federal income tax.[4] In 1957, the Department of Treasury promulgated Income Tax Reg. § 1.451-2 – Constructive receipt of income.[5] The current version of Treas. Reg. § 1.451-2 is substantially unchanged, and provides in part:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. How-ever, income is not constructively received if the

> taxpayer's control of its receipt is subject to substantial limitations or restrictions.[6]

Beginning in the 1960s, the IRS began issuing revenue rulings and private letter rulings on questions involving constructive receipt. In Revenue Ruling 60-31,[7] the IRS discussed a series of examples involving deferred compensation arrangements, and concluded that "[a] mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method."[8] The Service also quoted approvingly from a 1935 Board Tax Appeals case, *Gullet v. Commissioner*:[9]

> It is clear that the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice.[10]

Yet, even with its seeming en-dorsement of the standard set out in *Gullet*, the IRS's subsequent position (as set out in revenue rulings, private letter rulings and court decisions) has effectively read the "exercise of his own choice" element out of its constructive receipt analysis. Rather than look to the subjective intent or understanding of the taxpayer — necessarily implicit in the requirement that the taxpayer "exercise ... his own choice" on when to receive income — the IRS simply asks whether the income was "made available" to the taxpayer, so that the taxpayer could have drawn upon it during the taxable year if notice of intent to withdraw had been given.[11]

In the IRS's own words, it has "consistently taken the position that knowledge is not determinative in deciding a question of constructive receipt, but that unqualified availability is decisive."[12] For example, the IRS has gone so far as to find constructive receipt in the case of POWs and MIAs who had the legal right to withdraw interest on certain deposits.[14] The IRS determined that the soldiers constructively received the interest because (a) the funds were made available to them, and (b) the payor was willing to pay the amounts upon demand, notwithstanding the fact that the soldiers had no notice or knowledge of the interest due to them, nor any way personally to collect or even make a demand for the interest. It seems clear that where a taxpayer has the legal right to income and the payor is willing to pay if notice of intent to withdraw is given, the IRS will find constructive receipt.

> ***It is clear that the doctrine of constructive receipt is to be sparingly used ...***

B. The Courts' Position

In contrast to the IRS' position, courts have not adopted such a narrow reading of *Gullet* and Treasury regulations. For example, in *Davis v. Commissioner*,[14] the taxpayer's employer sent her severance check via certified mail, which arrived on December 31, 1974. It was returned and held at the post office because the taxpayer was not at home. The taxpayer did not receive the notice until after the post office closed that day, and therefore did not pick up her check until January 2, 1975. The IRS argued that the taxpayer constructively received the severance payment in 1974 because (a) the payment was unqualifiedly committed to the taxpayer on December 31, 1974, (b) delivery was attempted but failed due to the taxpayer's own absence from her home, and

(c) the check was made available to the taxpayer at the post office after 3:00 pm that same day. The Tax Court disagreed with the IRS, finding that implicit in the requirement of Treas. Reg. § 1.451-2(a) that "funds be made available to the taxpayer" is notice to the taxpayer that the funds are subject to her will and control.[15] As to the IRS's argument that the taxpayer "chose" not to be home at the time of postal delivery, the court noted:

> [i]t is true that case law has consistently held that any delay in receipt, any substantial limitation or restriction cannot be of the taxpayer's unilateral making. *See, e.g., Romine v. Commissioner*, 25 T.C. 859, 873-75 (1956); *Frank v. Commissioner*, 22 T.C. 945, 952-53 (1954), *aff'd* 226 F.2d 600 (6th Cir. 1955); *Kunze v. Commissioner*, 19 T.C. 29, 31-32 (1952), aff'd, 203 F.2d 957 (2d Cir. 1953). Those cases, however, dealt with situations where the taxpayer knew he could have receipt in the earlier year and took steps specifically designed to prevent actual receipt. The error in [the IRS's] logic lies in equating [the taxpayer's] choice to be absent from home with a conscious choice not to receive the severance pay until the following year. In fact, [the taxpayer's] absence here was not procured to prevent actual receipt. Under these circumstances application of the doctrine of constructive receipt is inappropriate.[16]

"... the [taxpayer] cannot be said to have 'constructively received' income attributable to the transfer of the property in that tax year."

The district court similarly rejected a strict reading of the constructive receipt doctrine in *Decker v. United States*.[17] In that case, the taxpayer's ex-husband recorded a deed on December 31, 1985, purporting to transfer property to the taxpayer in satisfaction of past-due alimony. The taxpayer argued that she was not aware of the property transfer in 1985, and, therefore, should not have been taxed on that amount until 1986. Rejecting the IRS's position that the taxpayer received income in 1985, the court concluded that "[i]t is clear that without any knowledge that the deed had been recorded, the [taxpayer] could not in any sense exercise control over the property or derive any benefit from it. Accordingly, absent any showing of her knowledge of the recordation of the deed, the [taxpayer] cannot be said to have 'constructively received' income attributable to the transfer of the property in that tax year."[18]

A more liberal reading of the constructive receipt doctrine does not always act in the taxpayer's interest, however. In *Alexander v. United States*,[19] the executor of an estate failed to promptly notify the heirs of their interests in royalty payments for certain oil drilling and extraction activities which took place in 1970. The heirs were finally notified in 1980 of their interests, and the royalty payments were disbursed to them that same year. The taxpayer-heirs claimed that their royalty payments resulted from drilling and extracting activity in 1970, that the payments were set aside and constructively received that year, and, therefore, the payments should not be subject to tax in 1980. Based on their argument, they claimed a refund for tax year 1980.

The district court disagreed with the taxpayers. Among other things, the court noted that "[t]he intent and belief of the parties as to their legal rights at the time in question is . . . relevant to the issue of constructive receipt."[20] There was no evidence that the taxpayer-heirs were ever aware prior to 1980 of their right to the royalty payments. The actual knowledge of the executor could not be imputed to the taxpayer-heirs. The court concluded that "[w]ithout possessing knowledge of the existence of the account it is difficult to understand how it could have been 'unqualifiedly subject to the demand' of the tax-payer."[21]

From these and other cases,[22] it is clear that courts look to the intent and belief of the parties regarding their legal rights at the time in question. While a taxpayer may not deliberately turn his or her back on income and select the year for reporting the income, some abuse appears necessary before courts will apply the doctrine.[23] This position is at odds with the one staked out by the IRS. As shown below, this split in authority causes unnecessary confusion for taxpayers and practitioners alike.

III. Illustrative Examples

Examples from the context of deferred compensation plans will help to illustrate the different approaches adopted by the IRS and courts to determine whether a taxpayer has constructively received income. We chose the examples because of our experience in employee benefits; however, constructive receipt has general applications to most areas of tax law.

A. Example 1

An employer sponsors a nonqualified deferred compensation plan (the "Plan") for the benefit of its employees. The Plan was established in 2000. Under the current Plan, participants can defer income until 2006, as long as the election is made prior to the service that gives rise to the compensation. The employer amends the Plan in 2003 to extend the period for deferring compensation to 2010. The employer notifies the Plan participants of the extension. Neither the Plan nor the notice makes a distinction between extending deferrals for services already performed and otherwise due in 2006 and deferred compensation for services to be performed in the future. In response to the notice, participants elect to receive all of their deferred income in 2010. No Plan benefits are paid from 2006 through 2009. A participant must make a claim for a benefit before any amounts will be paid out of the Plan. If a participant prior to 2010 had made a claim for a benefit, the employer would have refused, citing the participant's election to defer until 2010.

It is likely that neither the IRS nor the courts would find constructive receipt under these circumstances.[24] Both would first look to whether the taxpayer has an unambiguous legal right to that income. Where the legal basis for the right is unclear, both the IRS and the courts would then look to the actions of the parties for guidance.[25] Because the amended Plan is silent on the issue of whether an election applies to all deferred income, or just future deferments, the actions of the parties becomes relevant. Here, it is undisputed that the employer would have refused to pay out any amounts until 2010. Furthermore, none of the participants filed a claim for a benefit before 2010. Given the ambiguous Plan document and consistent actions of the parties, neither the IRS nor the courts would likely find constructive receipt.

... constructive receipt has general applications to most areas of tax law

B. Example 2

Now assume that the Plan amendment states that the extension to 2010 applies only to future elections. Previous elections to defer income until 2006 remain effective. A copy of the amended Plan document is not provided to participants (although it is on file for viewing in the employer's benefits office); rather, each participant is given a notice that purports to summarize and explain the amendment to them. The notice, however, does not explain this distinction between past and future elections, stating only that the election period has been extended from 2006 to 2010. Based on this, participants believe that the extension applies to all elections, past and future. Accordingly, because none of the participants file a claim for a benefit before 2010, no benefits are paid from the Plan until that date. If a proper claim had been submitted, however, the employer would have paid a benefit.

... any new elections apply only to income deferred for service performed after the amendment ...

Under this scenario, the IRS would likely assert that beginning in 2006 participants had constructive receipt of deferred compensation earned prior to the Plan amendment. Participants have a clear right under the Plan to a portion of their deferred compensation beginning in 2006. The notice does not contradict the Plan, but is simply silent as to whether the amendment applies to all elections, or only future elections. The employer is willing to pay a Plan benefit if a proper claim is filed. Under the IRS' reading of Treas. Reg. § 1.451-2(a), the funds were therefore "unqualifiedly available" to participants as of 2006, regardless of their subjective understanding as to their right to a benefit.

In contrast, a court applying the relevant case law would likely not find participants in constructive receipt of deferred compensation earned prior to the Plan amendment. Participants do not know or have reasonable notice that the election change applies only to future elections. While the Plan document clearly sets out the requirement that any new elections apply only to income deferred for service performed after the amendment, the notice summarizing and explaining the amendment does not include this important distinction. Thus, it is hard to see how much notice — let alone knowledge — could realistically be attributed to participants here.

C. Example 3

We will modify our example one last time. The Plan is amended in 2003 to permit elections until 2010 only for deferred income earned after the amendment. This change is explained in the notice provided to participants; however, the distinction is not set out in the "change of election" form used by participants. None of the participants actually read the notice, but instead rely on the instructions found on the change of election form. All participants choose the 2010 date. No participant makes a claim for a benefit before 2010, although, as before, the employer would have paid in 2006 amounts attributable to service performed before the Plan amendment if a claim had been filed. Have participants constructively received income beginning in 2006 for amounts attributable to their earlier service?

Clearly, under the IRS' reading of Treas. Reg. § 1.451-2(a), its answer would be yes. Whether a court would come to the same conclusion is more uncertain. In this last modification of our example, both the Plan document and the notice provided to participants distinguish between elections for amounts attributable to past and future service. If notice of the right to income in 2006 is, in and of itself, sufficient, a court may conclude that participants constructively received income in that year.

Recall, however, that the question of constructive receipt turns on the specific "facts and circumstances" of each case,[26] and is to be applied sparingly by courts. The change of election form — arguably the most effective means of communicating to participants changes in a Plan's election schedule — does not distinguish between elections for deferred income attributable to pre- and post-amendment service. None of the participants actually read the notice or file a claim for a benefit before 2010. Based on this, a good-faith argument can be made that participants do not have the requisite notice or knowledge to make a "conscious choice" to turn their back on income rightfully theirs in 2006. Of course, whether a court would believe they had no knowledge depends not only on the facts briefly set out in this example, but other factors as well, including the sophistication of the participants, the number of participants in the Plan (the larger the population of participants, presumably the greater the evidentiary force of the absence of any claim for benefits filed before 2010), and the methods and effectiveness of the delivery of notice to participants.

IV. Conclusion

In response to the *Davis* decision, the IRS suggested that it may adopt a "constructive notice or knowledge" approach to application of Treas. Reg. § 1.451-2(a),[27] thereby permitting it to establish the "notice or knowledge" element required by courts without having to show actual notice or knowledge. It is unclear whether the IRS ever acted on this suggestion, made in a 1978 General Counsel Memorandum. Such an approach, however, would completely gut the "notice or knowledge" element of any conceptual or practical meaning, and would likely be no different than the IRS' approach described above. Should it really be the case that a taxpayer can be taxed on income he does not have, based on information he never received or understood? The absurdity of this position should be clear — one legal fiction at a time is enough.

It is unclear whether the IRS will clarify its position on this issue ...

The position taken by the courts is the proper one. It prohibits a taxpayer from turning his back on income in order to avoid taxation, but requires the IRS (or the taxpayer, as the case may be) to establish that the taxpayer intentionally (or at least with reasonable notice) refused to take the income. It strikes a reasonable balance between dissuading individuals from trying to "game the system" by delaying taxation, and taxing individuals only on income they know they were entitled to receive. The IRS' position, on the other hand, fails on both legal grounds — by failing to follow the clear reasoning of the courts' decisions — and equitable grounds — by suggesting that individuals pay taxes on income they did not receive, based on information they did not receive or understand.

The split in authority on this issue can be frustrating to practitioners trying to give useful, yet accurate guidance to their clients. It is unclear whether the IRS will clarify its position on this issue in the near future, although the American Bar Association in 1996 suggested the IRS take a fresh look at its approach to constructive receipt. Any fresh look should include a review of the issues set out in this article.

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ENDNOTES

1. Internal Revenue Code of 1986, as amended ("I.R.C.") §§ 61, 83; Treas. Reg. § 1.61-2.
2. I.R.C. § 61; Treas. Reg. § 1.61-1(a).
3. 281 U.S. 376, 378 (1930).
4. A. Thomas Brisendine et al., *Deferred Compensation Arrangements*, 385-4th T.M., 2002, at A-13 (citing Article 67 of Regulation 33 promulgated under the Tariff Act of 1913, Ch. 16, § 2B, 38 Stat. 114, 167 (1913)). The constructive receipt doctrine is analytically distinct from, although often confused with, the economic benefit doctrine. "The former identifies when income that has not actually been received is nevertheless reportable for income tax purposes. The latter identifies when income is deemed to have been received, but other than by direct cash payment due to the taxpayer's unfettered discretion over the property or because the taxpayer's exercise of certain rights over the property." American Bar Association Section of Taxation Committee on Employee Benefits, *Report on the Proposed Restatement of the Service's Procedural Guidance for the Issuance of Advance Rulings on the Application of the Doctrine of Constructive Receipt to Nonqualified Deferred Compensation Arrangements*, 50 Tax Law. 217, 219 at n.9 (1996) ("ABA Report").
5. An earlier version of the regulation can be found at Income Tax Reg. § 39.42-2 – Income not reduced to possession (1954).
6. Determining whether a taxpayer has constructively received income will depend on the specific facts and circumstances of each case. *See, e.g., Warren v. United States*, 613 F.2d 591, 593 (5th Cir. 1980); *Kasper v. Banek*, 214 F.2d 125, 127 (8th Cir. 1954). The taxpayer has the initial burden to show that credited amounts were not unqualifiedly subject to his or her demand. The burden of proof shifts to the IRS once the taxpayer has produced credible evidence on an issue of fact. I.R.C. § 7491(a).
7. 1960-1 C.B. 174, *modified*, Rev. Rul. 64-279, 1964-2 C.B. 121.
8. 1960-1 C.B. at 177 (citations omitted).
9. 31 B.T.A. 1067, 1069 (1935).
10. 1960-1 C.B. at 178.
11. Rev. Rul. 72-317, 1972-1 C.B. 128, 129.
12. P.L.R. 8333035 (May 16, 1983).
13. Rev. Rul. 74-37, 1974-1 C.B. 112; *see also* Rev. Rul. 73-99, 1973-1 C.B. 412; Rev. Rul. 68-126, 1968-1 C.B. 194.
14. *Davis v. Commissioner*, 37 T.C.M. (CCH) 42 (1978).
15. *Id.* at 46.
16. *Davis*, 37 T.C.M. (CCH) at 46; see also *Furstenberg v. Commissioner*, 83 T.C. 755, 791 (1984).
17. No. 5:91-172, 1993 WL 402814 (D. Conn. June 9, 1993).
18. *Id.* at *7.
19. No. 1:87-CV-730, 1988 WL 92109 (N.D. Ga. May 13, 1988).
20. *Id.* at *3.

ENDNOTES (continued)

21. *Id.* (quoting *Ross v. Commissioner*, 169 F.2d 483, 490 (1st Cir. 1948)).
22. *See, e.g., Gambling v. Commissioner*, 42 T.C.M. (CCH) 1372 (1981), *aff'd*, 682 F.2d 296 (2d Cir. 1982); *Alexander*, 1988 WL 92109, at *3.
23. Brisendine et al., *supra* note 5, at A-20.
24. This assumes that the IRS would permit an election to change the time of payment subsequent to the service performance period, but prior to payment. It is unclear what position the IRS would take on this issue, although it is clear that case law permits such subsequent elections in many, if not most, cases. *See, e.g., Viet v. Commissioner*, 8 T.C.M. (CCH) 919 (1949); *Viet v. Commissioner*, 8 T.C. 809 (1947), *acq.*, 1947-2 C.B. 4; *see also ABA Report, supra* note 5, at 233-36 (recommending that subsequent elections to alter the time and form of payment be permitted if made substantially before payment would otherwise occur). Because this article focuses on notice and knowledge issues, it is assumed the IRS would permit such subsequent elections, at least in instances in which bad faith is not apparent.
25. *See*, e.g., P.L.R. 7907017 (Oct. 31, 1978); Gambling, 682 F.2d at 300.
26. *See supra* note 7.
27. G.C.M. 37662 (Aug. 31, 1978).

Preserving a stepped-up basis of assets in nursing home planning with Medicaid "Safe Harbors"

By: Joel C. Tuoriniemi

Often in the context of Medicaid or nursing home planning, a practitioner is faced with advising a client on the viability of making transfers of assets to family members. A typical scenario involves an elderly client who is concerned with potential loss of assets in the event that a nursing home admission is required. All too often, the client is simply advised to remove his/her name from the asset, effectively transferring full ownership of the asset to a family member, often a child. The purpose of this article is to compare the tax consequences of an outright and complete transfer of an asset with the creation of a joint tenancy form of ownership. This joint tenancy arrangement is often referred to as a "safe harbor," as the asset is not considered available to a client seeking Medicaid assistance. As set forth below, the creation of a joint tenancy results in a more desirable tax outcome for the family, while at the same time protecting the asset from nursing home spenddown.

... a joint tenancy results in a more desirable tax outcome for the family ...

As an example, assume a widowed client with two children. The client owns a family cottage in his/her sole name that is worth $100,000 and was acquired at a cost of $10,000. In such form, the cottage is considered a "countable asset" for Medicaid purposes and would be subject to loss to a nursing home.[1] One option would be for the client to transfer full ownership of the cottage to the children. However, a second, preferred alternative would be for the client to retain his/her name on the cottage while adding the children as joint tenants with full rights of survivorship. The Medicaid implications and tax consequences of these alternatives are as follows:

I. Medicaid Implications

Alternative 1: Removal of Client's Name / Complete Transfer to Children

Per the Michigan Family Independence Agency's Program Eligibility Manual (hereafter, "FIA's PEM"), if the client's name were removed from the cottage and transferred to the children, a divestment has taken place.[2] A Medicaid penalty of 21 months would be incurred.[3] As a result of the transfer, the cottage would no longer count toward the client's asset allowance of $2,000, as the client has no ownership interest in the cottage.[4] After the 21 month penalty has expired, the client would be eligible to receive Medicaid assistance.

Alternative 2: Retention of Client's Name / Creation of a Joint Tenancy with Full Rights of Survivorship

If a client were to create a joint tenancy with full rights of survivorship, a divestment has again occurred with the same resulting penalty period.[5] The children must now join in any further transfer of the cottage. Because the client needs consent of the children, the cottage will not be considered as part of the client's $2,000 asset allowance.[6] Rather, the cottage is now deemed to be an "unavailable" asset per the Michigan FIA's PEM and is, therefore, non-countable and not subject to nursing home spenddown.[7] As with Alternative 1, after the 21 month penalty has expired, the client would be able to receive Medicaid assistance.

It should be noted that there are techniques available to decrease the resulting Medicaid penalty under each alternative, such as a systematic, monthly divestment of smaller interests in the cottage property as opposed to a single transfer of the entire interest. Due care must be exercised when advising a client to divest assets. In any event, the point of the preceding comparison is to demonstrate that Medicaid eligibility can be achieved through either an outright transfer (Alternative 1) or creation of a joint tenancy with full rights of survivorship (Alternative 2). Given that each approach protects the cottage from loss to a nursing home, an appropriate inquiry should then be made comparing the tax consequences of each alternative.

II. Tax Consequences

Alternative 1: Removal of Client's Name / Complete Transfer to Children

Under this alternative, the children would receive a carry-over basis on the cottage of $10,000 when the transfer is made.[8] Upon the client's death, the children would retain that same historical basis, precluding a stepped-up basis to the fair market value at the time of the client's death. There obviously is no inclusion of the cottage in the client's gross estate for estate tax purposes, but this should not be considered as any type of "advantage," as estate tax considerations are almost certainly rendered moot with a client seeking Medicaid assistance. If the cottage were sold following the client's death, the children would be faced with a large capital gains tax as a result of receiving the lifetime transfer from the client.

A second disadvantage of Alternative 1 is with property taxes. The transfer would cause the historic assessment level of the cottage to be uncapped from the date of the transfer[9], resulting in what can quite often be a dramatic increase in the property taxes that would now be paid on the cottage.

Alternative 2: Retention of Client's Name / Creation of a Joint Tenancy with Full Rights of Survivorship

Should the client opt instead to create a joint tenancy with full rights of survivorship, the children would be able to receive a full stepped-up basis on the cottage. Authority for a stepped-up basis is available is found in Internal Revenue Code Sections 2040 and 1014. Per IRC § 2040, "the value of the gross estate shall include the value of all property to the extent of the interest therein held as joint tenants with right of survivorship by the decedent and any other person ...;" more specifically, IRC § 2040 further provides "... there shall be excepted only such part of the value of such property [from the decedent's gross estate] as is proportionate to the consideration furnished by such other person."[10] Although the children's names were added to the cottage during the client's lifetime, no portion of the cottage is excluded from the client's gross estate upon death because the children provided no consideration. Because IRC §2040 mandates inclusion of the entire value of the cottage in the client's gross estate, a full stepped-up basis in available pursuant to IRC §1014, which states that property included in a decedent's gross estate for federal estate tax purposes (i.e., through IRC §2040) shall receive a stepped-up basis.[11] Under Alternative 2, the capital gains tax would be greatly reduced, if not completely eliminated, if the cottage were sold following the client's death. Again, inclusion of the cottage in the client's gross estate for estate tax purposes should not be deemed a "disadvantage" because of the high likelihood that the client does not have a taxable estate.

... no portion of the cottage is excluded from the client's gross estate upon death because the children provided no consideration.

Should the present version of the estate tax remain, the question becomes what happens under

Each of these issues affect the final amount of such property considered to be owned by the decedent ...

Alternative 2 should the client live past the year 2009. If the estate tax is indeed eliminated, using IRC §2040 as a means of achieving a stepped-up basis through IRC §1014 would no longer be available. However, the Economic Growth and Tax Relief Reconciliation Act of 2001(hereafter, "2001 Act") established a "general basis increase" of a decedent's assets of up to, in this case, $1,300,000.[12] IRC §1022, as added by the 2001 Act, allows a full stepped-up basis of the cottage to the fair market value at the time of the client's death.[13] IRC §1022 is similar to IRC §2040/IRC § 1014 in that it uses a "consideration furnished" approach in determining the extent to which property such as the cottage is eligible for a stepped-up basis.[14] Again, because the children did not furnish any consideration under Alternative 2, IRC §1022 allows a full stepped-up basis of the cottage.

Concerning property taxes, Alternative 2 would not eliminate the issue of the increased assessment, but it at least postpones the increase until the time of the client's death,[15] rather than having it occur, as in Alternative 1, immediately upon the date of the transfer to the children.

III. Application to other types of assets

Use of a joint tenancy arrangement to protect an asset from loss to a nursing home is available for other assets as well, including stock and bank accounts. The same type of analysis as set forth above is relevant to stock, but must be expanded to address such items as dividends received post-transfer,[16] as well as the use of brokerage accounts to create the joint tenancy arrangement.[17] Each of these issues affect the final amount of such property considered to be owned by the decedent and, therefore, eligible for a stepped-up basis. It is recommended that a practitioner review the cited authority in this article to further explore these issues. As to bank accounts, care must be exercised as to the form of ownership on the account. Two signatures (in this case, from the client and from a child) should always be required for withdrawal in order to qualify the account as "non-countable" under the Michigan FIA's PEM.[18] Basis considerations are obviously eliminated when dealing with assets such as bank accounts. However, an overall, non-tax consideration that is favored by clients is the comfort of knowing that the children do not yet have outright ownership of the asset under Alternative 2. In other words, the client's consent is still required under Alternative 2, while Alternative 1 gives the children full control of the transferred asset.

IV. Conclusion

Tax considerations must be addressed by a practitioner providing Medicaid planning services. Clients have often been advised that the best solution is to make a transfer to family members, relinquishing all ownership over the asset. However, use of a properly established joint tenancy arrangement — a Medicaid "safe harbor" — achieves the same nursing home protection and allows the client to retain some control over the asset. From a tax standpoint, the safe-harbor arrangement preserves the stepped-up basis available to capital assets and delays increased assessments for property tax purposes. As such, Michigan attorneys should consider use of this technique to achieve a client's objectives both from a Medicaid and tax perspective.

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ENDNOTES

1. Michigan Family Independence Agency Program Eligibility Manual Item 400, pp. 16-17.
2. Michigan FIA PEM Item 405, p.1.
3. Michigan FIA PEM Item 405, p. 9.
4. Michigan FIA PEM Item 400, p. 1.
5. Michigan FIA PEM Item 405, p. 9.
6. Michigan FIA PEM Item 400, p. 6.
7. Michigan FIA PEM Item 400, pp.1 and 6.
8. Internal Revenue Code §1015(a).
9. MCLA §211.27a(2)(a); MCLA §211.27a(6).
10. IRC §2040.
11. IRC §1014; Reg. §1.1014-1 - §1.1014-8.
12. IRC §1022. The amount is increased under this section to $3,000,000 if the decedent's estate is passing to a surviving spouse.
13. IRC §1022(b)(2)(B).
14. IRC §1022(d)(1)(B)(i)(II).
15. MCLA §211.27a(7)(h).
16. See *MP Goldsborough Est. v. Comm'r.*, 70 TC 1077 (1978); Rev. Rul. 80-142 (Jan 1, 1980).
17. See *First Wisc. Trust Co. v. US*, 553 F. Supp. 26 (E.D. – Wis. 1982); Rev. Rul 69-148 (Jan 1, 1969).
18. Michigan FIA PEM Item 400, p. 6.

Taxability of disability income benefits: A tax trap for the disabled employee?

By: Matthew L. Tuck

Statistically, 1 in 3 workers will become disabled for at least 90 days at some point in their working lives.[1] Many employers offer some form of disability insurance, which is becoming an increasingly popular means of replacing lost income during periods of extended disability. However, such programs can have significant tax consequences. This article addresses the tax implications of disability insurance benefits.

... the taxability of any benefit paid will be governed by who pays the premiums ...

Disability insurance is generally of two types, long term and short term. Short term generally covers disability lasting 90 days or less. Long term insurance is generally 90 days or more, including permanent disability. Payments under such policies generally range from 45% to 60% of the employee's regular gross income and the income from benefits received may or may not be taxable. Whether benefits are taxable or not depends ultimately upon the type of benefits received and who pays the premium (employee or your employer). Disability benefits are excludable from gross income under Internal Revenue Code Section 104(a)(3) or Section 105(c) if certain requirements are met.[2]

If the employee is enrolled in a group disability insurance plan sponsored by the employer, the taxability of any benefit paid will be governed by who pays the premiums: employee or employer. Unlike medical insurance premiums, income disability insurance premiums when paid by an individual are generally paid in after tax dollars. Therefore, any benefits received by the employee in the event of a qualifying disability will not be taxable. However, unlike medical insurance premiums, you cannot deduct premiums paid for individual disability insurance as a medical expense. This is logical since disability insurance is generally intended to replace income, and is not intended to pay for medical treatment. Where the premiums are paid by the employer, these premiums are generally considered to be pre-tax and any benefits paid will be taxable.

The rules become slightly more complicated where the employer and employee both pay a portion of the premiums. In that situation, where the employee's contribution is made in after-tax dollars, a pro rata portion of any benefits paid will likewise be tax-free. Similarly, a pro rata share of benefit attributable to the employer's contribution will be included in the employee's gross income and taxed.

Benefits Under a Cafeteria Plan or Group Benefit Plan

A "cafeteria plan" is the term given to a benefits plan which allows the employee to select from a variety of insurance benefits, such as health, life, or disability insurance. Such plans are often paid for on a pretax basis. In many cases the employer may pay these premiums for the benefits selected by the employee, often up to a certain amount (a floor). If the employee has the option of selecting additional coverage, any additional premium cost will be paid by the employee. Depending on the plan, the employee portion of the contribution may be paid in either pretax or after-tax dollars. Here again, how the premium is paid (and who pays it) will govern taxation of benefits.

Under a cafeteria plan, the same general rules apply: employer payments are treated as pretax rendering that portion of the benefit taxable. If the employee also pays his contribution in pretax dollars, then the entire benefit is taxable. If the employee's contribution is after-tax, then only that proportionate share will be non-taxable.

Disability insurance policies purchased through an association are called group polices since the members of association are able to take advantage of special terms, conditions and rates owing to the characteristics of the group. Group policies function much like individual policies and taxation of benefits paid as a result of participation in a group policy are similar.

IRS Guidance

Obviously there are a number of possible combinations of short-term vs. long-term disability coupled with various payment arrangements. The courts have provided some guidance in a relatively recent case, *Stolte v. Commissioner*. In *Stolte*[3], the taxpayer was a physician who sought to exclude disability payments from his gross income under Section 105(c). As noted above, Section 105(c) allows a disabled person to exclude disability income where disability payments (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work. *Stolte* is significant for the reason that all the premiums in that case were paid not by the taxpayer but by his employer. Nevertheless, the court found in favor of the taxpayer on the basis of the Section 105(c) language.

In that case, Dr. Stolte had suffered polyneuropathy[4] caused by chemotherapy which impaired the use of his hands and feet and prevented him from working as a surgeon. In reaching its decision, the Court employed a two-pronged analysis. Under the first prong, the court found based on the testimony that Dr. Stolte had been robbed of his ability to function as a surgeon and to lead the kind of life he had enjoyed prior to the onset of the condition. The Court rejected the government's arguments which urged an interpretation of Section 105 which would have required Stolte to show that he was disabled from performing any job.

In the second prong, the court analyzed the nature of the policy held by Dr. Stolte. The Court observed that the policy contemplated that a though a beneficiary might be disabled from work as a surgeon, he might not be disabled from all work. Because Stolte's policy was not based upon his actual wages (it only provided about $2,500 per month), and was not based upon years of service, it was not a substitute for the taxpayer's salary and was not includable as gross income under Section 105.[5]

... the IRS based its decision on the payment of the policy premiums.

In another disability case addressed in a tax memo published by the United States Tax Court, the taxpayers did not fare as well as in *Stolte*. In *Robert B. and Daisy A. Miley*[6], the taxpayers sought to exclude $7,618 in disability payments from their gross income on their 1997 income tax return after a deficiency was determined. The source of the deficiency was attributable to disability income payments made to Robert Miley as the result of an automobile accident which prevented him from working for a period of several months. In ruling that the disability payments were not excludable, the IRS based its decision on the payment of the policy premiums. In that case the premiums were paid entirely by Miley's employer. As such, the IRS ruled that the disability payments were taxable.

The IRS has provided some additional guidance in three Private

Letter Rulings (PLR) which addressed the issue of taxability of long-term disability benefits. In each case, the premiums were paid entirely by the employers (not as part of a cafeteria plan), the cost of the premiums was not imputed as gross income or reported on the employee's W-2, and benefit payments were included as gross income to disabled employees for federal tax purposes.[7]

The employees were also required to either elect between total pretax or total after-tax treatment of the premiums.

In each case, the employers planned to amend their plans to allow employees to elect the way in which the premiums would be paid (and hence the way in which any benefits would be treated for tax purposes) and sought an IRS ruling as to the tax consequences for the employees under the amended plans.

The IRS ruled in each PLR that where an employee opted to be taxed currently on the premiums paid by the employer, any benefits paid would be non-taxable. Similarly, where the employee opted to exclude the premiums from gross income, any disability benefits paid would be included in the employee's gross income and would be taxable.[8]

One key aspect of these cases relied upon by the IRS was that the employee's decision would be irrevocable and a decision would be made about the premium payment and tax treatment each year in writing. The employees were also required to either elect between total pretax or total after-tax treatment of the premiums. There was no third option where the premiums would be paid by both.[9]

It should be noted that Private Letter Rulings are not binding precedent and are applicable only to the taxpayer who requests them. However, they do provide insight into the way the IRS views a particular tax issue.

Government Disability Insurance

Disabled individuals may also qualify for certain government sponsored disability policies. Social security, workers compensation benefits, Veteran's Administration benefits, military benefits and Federal Employees Retirement System benefits are all different types of disability benefits. Taxability of these benefits is generally governed by the enacting legislation and is beyond the scope of this article.

Conclusion

In the event that a taxpayer becomes disabled, disability benefits may be excludable from gross income for federal taxation purposes under certain circumstances. The general rule is that if the taxpayer pays the all premiums on the policy, the income derived from the policy will be excluded from gross income. If the employer pays the premium, then the disability payments will be included in gross income and taxed. If the employer and taxpayer share the cost of the premiums, then any disability payments will be apportioned between taxable and non-taxable according to the amount of premium that is employer paid and employee paid, respectively. Even so, the Tax Court decision in *Stolte v. IRS* did allow exclusion of disability payments where premiums were paid by the employer but the exclusion from gross income was sought under Section 105(c) rather than Section 104(a).

ENDNOTES

1. 1985 Disability Table Study developed by the Society of Actuaries.
2. To satisfy the requirements under Section 105, the payment(s) must:

   (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and

   (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work.
3. *Stolte v. Tax Commissioner*, Trial Court Memo 1999-271 (2002).
4. A severe inflammation of the nerves causing pain and loss of motor function.
5. For an excellent discussion of the *Stolte* Case and related issues, see Weiss, Eric, "Exclusion of Disability benefits from Tax", *Physician's News Digest* (online), June 2002. http://www.physiciansnews.com/finance/602.html.
6. T.C. Memo 2002-236.
7. See Priv. Ltr. Rul. 200146010, Priv Ltr. Rul. 200146011, and Priv. Ltr. Rul. 200146012, all June 25, 2001.
8. Code Section 104(a)(3).
9. These rulings can be viewed on the IRS website at http://www.irs.gov./pub/irs-we/0146010.pdf; http://www.irs.gov./pub/irs-we/0146011.pdf, http://www.irs.gov./pub/irs-we/0146012.pdf.

Recent Developments

Michigan Supreme Court Holds that Sick Leave Payments are Subject to Withholding Tax

In *Stone v. Michigan Department of Treasury*, 651 N.W.2d 64, 467 Mich. 288, 2002 Mich. LEXIS 1629 (Sept. 24, 2002), the Michigan Supreme Court, reversing the Court of Claims and the Court of Appeals, held that the monthly sick leave payments for state employees who retired under Michigan's 1996 early retirement program were subject to withholding taxes.

In 1996, the Legislature amended the State Employees Retirement Act ("SERA") to create an early retirement program for some state employees. As part of the SERA changes, accumulated sick leave time would be paid in 60 monthly payments, instead of the usual lump sum payment. Consistent with its treatment of other sick leave pay, the state believed the payments to be subject to withholding taxes. The Plaintiffs, members of a class consisting of employees who retired under the early retirement program, sued the State and the Department of Treasury and argued the SERA statute precluded taxation of the payments.

While the Court of Claims and Court of Appeals agreed with Plaintiffs, the Supreme Court disagreed. The Court reasoned the SERA altered the manner of payment, but did not create the right to receive the payment.[1] As such, the Court reasoned that the tax exemption provision provided by SERA was inapplicable. Additionally, the Supreme Court disagreed with the plaintiffs' argument that taxation of the payments diminished a contractual benefit in violation of the state constitution because the Plaintiffs contractually relinquished their constitutional right. In conclusion, the Court held the monthly sick leave payments were subject to withholding taxes.

Michigan Supreme Court Will Not Hear Smurfit Appeal

On December 11, 2002, the Michigan Supreme Court issued an order denying the application for leave to appeal in *Jefferson Smurfit Corp. v. Michigan Department of Treasury*, 2002 Mich. LEXIS 2263. This effectively leaves the appellate court's decision in tact which previously held that the SBT's capital acquisition deduction, which provides an apportioned deduction for the cost of certain assets located in Michigan, did not violate the Commerce Clause of the U.S. Constitution. *See, Jefferson Smurfit Corp. v. Michigan Department of Treasury*, 248 Mich. App. 271, 639 N.W.2d 269, 2001 Mich. App. LEXIS 221 (Nov. 13, 2001). A summary of the Court of Appeals decision appears in the state and local tax update portion of the *Michigan Tax Lawyer*, Vol. 27, Issue 4.

Michigan Court of Appeals Finds that Michigan Taxpayer had Sufficient Nexus with California to Avoid Throwback

In *Kaiser Optical Systems, Inc. v. Michigan Department of Treasury*, 2002 Mich. App. LEXIS 2265 (Dec. 27, 2002), the Michigan Court of Appeals affirmed the Tax Tribunal and found that Kaiser, a Michigan taxpayer, had sufficient nexus with the state of California to avoid throwback of its sales to Michigan.

For tax years 1989 through 1992, Kaiser had manufacturing operations in Michigan. However, the company had most of its accounting and financial functions performed in California by personnel of a division of Kaiser's parent, Kaiser Electronic Division ("Division").[2] Kaiser received monthly invoices from Division for the time spent on Kaiser's work to reimburse the division for the compensation and benefits it paid to the accounting staff. Division also assessed Kaiser a monthly use and occupancy charge for maintaining Kaiser's accounting books and records in California. During the years in question, Kaiser's California sales were to Division. These sales were treated as California sales by KAEC when Division resold the products purchased from Kaiser. Kaiser and KAEC did not file a combined SBT return in Michigan.

When Kaiser calculated its Michigan SBT sales factor, it did not include sales it made to California under the "throwback" provisions. On audit, the Michigan Department of Treasury ("Department") disagreed and threw Kaiser's California sales back to Michigan. The Tax Tribunal, applying the Department's Revenue Administrative Bulletin ("RAB") 1998-1 concluded that Kaiser had sufficient nexus with California to prevent the Department from throwing back the California sales to Michigan for SBT purposes.

Upon review, the Court of Appeals held that Kaiser's activities in California were sufficient to establish that Kaiser was engaged in a business activity in California sufficient to establish nexus under RAB 1998-1. In upholding the Tax Tribunals' decision, the Court of Appeals stressed that RAB 1998-1 I.(2) merely requires that a taxpayer maintain or have the right to use either tangible personal or real property in another state to establish nexus there. As such, the Court of Appeals held that because Kaiser's accounts and financial records in California were part of Kaiser's activity in that State, the use of the office space in California was sufficient to establish nexus with California under RAB 1998-1 I.(2).

Michigan Court of Appeals Affirms Tribunal's Dismissal of Petitions for Lack of Jurisdiction

In the consolidated appeals of *Electronic Data Systems Corp. v. Township of Flint, City of Troy, City of Buena Vista, and City of Auburn Hills*, 2002 Mich. App. LEXIS 1470 (Oct. 25, 2002), the Michigan Court of Appeals affirmed the Tax Tribunal's dismissal of the taxpayer's petitions for lack of jurisdiction because the petitions were untimely.

In 1999, the various respondent municipalities assessed certain personal property of EDS which EDS believed was in excess of half of the true cash value. On June 30, 1999, EDS appealed the municipalities' tax assessments to the Tax Tribunal by first-class mail. The Tax Tribunal received EDS' appeals on July 2, 1999. The applicable statute (i.e., M.C.L. § 205.735(2)) required that the appeals be mailed by certified mail on or before June 30.

The court also stressed that certified mail provides proof of mailing, whereas first-class mail does not.

In affirming the Tax Tribunal's decision, the Court of Appeals emphasized that certified mail does two things that first-class mail does not: (1) it provides the sender with a mailing receipt and (2) a record of delivery is maintained at the post office address. The court also stressed that certified mail provides proof of mailing, whereas first-class mail does not. The court also rejected EDS's arguments that the statute at issue violates the Due Process and Equal Protection clauses of the state and federal constitutions.

Petitions Were Timely Filed Even Though They Were Received by Tax Tribunal After Filing Deadline, Finds Michigan Court of Appeals

In the consolidated appeals of *Aztec Air Service, Inc. and Robert L. Shroyer v. Michigan Department of Treasury*, 2002 Mich. App. LEXIS 1356 (Sept. 27, 2002), the Michigan Court of Appeals found that the taxpayers' petitions to the Tax Tribunal were timely filed because the petitions were mailed via certified mail within the 35-day time period specified by statute (i.e., MCL §§ 205.22(1; 205.735(2)). The petitions were timely even though the Tax Tribunal received the petitions 36 days after the Department of Treasury had issued its final assessment.

Aztec Air Service was appealing a use tax assessment and Shroyer was appealing an individual income tax assessment. In reviewing the cases, the court stated that it was bound by the *Florida Leasco* decision,[3] which established that mailing an appeal of a tax assessment by certified mail within thirty-five days constitutes mailing for purposes of MCL § 205.735(2). This is so even though the petitions are received after the time period expires.

... the petitions were properly filed even though the Tax Tribunal actually received them after the statutory time period for appeal had expired.

The court also noted that notwithstanding the Florida Leasco decision, the amendment to M.C.L. § 205.735(2) would have applied retroactively to plaintiff's cases, reversing the Tax Tribunal's dismissal. Thus, the appellate court found that because the petitions sent the petitions for appeal by certified mail within the statutory time period, the petitions were properly filed even though the Tax Tribunal actually received them after the statutory time period for appeal had expired.

Michigan Tax Tribunal Upholds Penalties

In *Bantam Doubleday Dell Publishing v. Michigan Department of Treasury*, MTT Docket No. 249480 (Aug. 20, 2002), the Michigan Tax Tribunal upheld the Department's penalty assessment. Although Bantam engaged in business activities in Michigan, it nonetheless believed that it did not have a filing responsibility for the SBT and thus did not file returns. The Department assessed 50 percent failure to pay penalties for the time period of December 31, 1989 through December 31, 1996. The tribunal concluded that penalty abatement was not warranted because Bantam had not established reasonable cause to waive the penalties.

Michigan Legislature Revises Renaissance Zone SBT Credit Calculation

On December 21, 2002, Gov. John Engler approved legislation to modify the calculation of the Renaissance Zone SBT credit.

Senate Bill 1500 (Public Act 622 of 2002) amends the Single Business Tax act (M.C.L. § 208.39b) to revise the credit calculation for tax years beginning after December 31, 2002. For a business that first locates and begins conducting a business activity within a renaissance zone after November 30, 2002, the credit is the lesser of:

1) The tax liability attributable to a business activity conducted in a renaissance zone in the tax year; or
2) Ten percent of adjusted services performed in a designated renaissance zone.

If a business was located and was conducting a business activity within a renaissance zone before December 1, 2002, or the business entered into a purchase or lease agreement for personal or real property to be used for a business activity in a renaissance zone, the credit is the greater of:

1) The amount as calculated for a new business (see above); or
2) The lesser of:
   a. The tax liability attributable to a business activity in a renaissance zone in the tax year, or
   b. The credit allowed for the tax year beginning in 2002 plus 2% of the increase in the amount of adjusted services for C Corporations for the tax year over the amount of adjusted services for C Corporations for the tax year

beginning in 2002.

Senate Bill 1500 also revises M.C.L. § 208.39e to address the calculation of the Renaissance Zone SBT credit for taxpayers that are certified under the Michigan Next Energy Authority Act (i.e., M.C.L. §§ 207.821 to 207.827). For tax years beginning after December 31, 2002, eligible taxpayers may claim a nonrefundable credit for the tax year equal to the lesser of:

a. The amount by which the taxpayer's tax liability attributable to a qualified business activity for the tax year exceeds the taxpayer's baseline tax liability attributable to qualified business activity; or
b. For tax years that begin after December 31, 2002, 10% of the amount by which the taxpayer's adjusted qualified business activity performed in Michigan outside of a renaissance zone for the tax year exceeds the taxpayer's adjusted qualified business activity performed in Michigan outside of a renaissance zone for the 2001 tax year.

Michigan Legislature Amends Brownfield Credit for SBT

On December 30, 2002, Gov. John Engler approved legislation to amend the Single Business Tax brownfield credit. House Bill 6501 (Public Act 726 of 2002) amends M.C.L. §208.38g, extending the time for claiming the credit through December 31, 2007. Previously, the deadline was January 1, 2003. The bill makes several other changes, including changing the application procedures, allowing multiphase projects, enhancing assignment provisions, and revising the definition of a "qualified taxpayer."

In a related measure, Gov. John Engler approved House Bill 6502 (Public Act 727 of 2002) on December 30, 2002. House Bill 6502 amends the Brownfield Redevelopment Financing Act to extend the brownfield redevelopment programs through 2007.

Michigan Legislature Amends Definition of "Gross Receipts"

On December 20, 2002, Gov. John Engler approved legislation to amend the definition of "gross receipts" for Single Business Tax purposes. Senate Bill 1422 (Public Act 606 of 2002) narrows the definition of "gross receipts" by excluding certain items. For example, gross receipts excludes the following items: federal, state, or local tax refunds, case and in-kind discounts, and trade discounts. The bill only applies to tax years beginning on or after October 1, 2003.

Senate Bill 1422 ... narrows the definition of "gross receipts" by excluding certain items.

Michigan Legislature Provides Tax Incentives for Pharmaceutical Companies

On October 16, 2002, Gov. John Engler approved legislation to create tax incentives for pharmaceutical research and development companies for tax years beginning after December 31, 2002. House Bill 6073 (Public Act 588 of 2002) amends the Single Business Tax act to add M.C.L. § 208.39f, allowing eligible taxpayers to claim a credit for qualified research expenses related to the eligible taxpayer's pharmaceutical-based business activity in Michigan. An eligible taxpayer must be engaged primarily in manufacturing, research, development, and sale of pharmaceuticals, and have at least 8,500 employees in the state, with at least 5,000 of them engaged primarily in research and development of pharmaceuticals. The total amount of the credit cannot exceed $10 million in any specific tax year.

On October 16, 2002, Gov. John Engler approved legislation to allow a renaissance zone to be specifically designated for pharmaceuticals. Senate Bill 1315 (Public Act 587 of 2002) amends the Renaissance Zone Act by revising M.C.L. § 125.2688a. The pharmaceutical renaissance zone would be created to promote and increase the research, development, and manufacturing of pharmaceutical products. The definition of an eligible taxpayer is similar to the definition under House Bill 6073.

Michigan Legislature Changes Corporate Dissolution Process

On October 10, 2002, Gov. John Engler approved legislation to revise the procedures for a dissolving corporation to show that it does not owe any state taxes. Senate Bill 593 (Public Act 579 of 2002), Senate Bill 594 (Public Act 580 of 2002), and Senate Bill 595 (Public Act 581 of 2002) amend the sales tax act, the use tax act, and the income tax act (specifically, M.C.L. § 205.65, M.C.L. § 205.95, and M.C.L. § 206.451), respectively. The amended statute sections remove provisions requiring the Department of Consumer and Industry Services to withhold a certificate of dissolution or withdrawal from a corporation until it has been determined that the corporation does not owe sales, use or income taxes. However, the corporation must request a certification from the Department of Treasury that it does not owe taxes.

The bulletin discusses the application of use tax to transfers of jointly owned vehicles ...

Michigan Department of Treasury Defines Financial Organizations

The Michigan Department of Treasury has issued Revenue Administrative Bulletin ("RAB") 2002-16 to define financial organizations for SBT purposes. On September 9, 2002, the Department issued RAB 2002-16 to provide an index of specific businesses that are considered financial organizations by statute. Additionally, the Department discusses the asset and income test that is used to determine if other businesses are financial organizations. Essentially, the asset and income test provides that if at least 90% of a company's assets consist of intangible personal property and if at least 90% of the company's gross receipts income consists of dividends or interest or other uses of money or credit, then that company is treated as a financial organization. Finally, RAB 2002-16 describes the SBT tax base for a financial organization as well as the assets and gross receipts income used to satisfy the statutory test.

Michigan Department of Treasury Discusses Use Tax Exemption for Vehicle Transfers

On December 10, 2002, the Michigan Department of Treasury issued Revenue Administrative Bulletin ("RAB") 2002-19 to discuss the use tax exemption for the transfer of vehicles (motor vehicles, aircraft, watercraft, mobile homes, off-road vehicles, and snowmobiles) between certain family members. The bulletin discusses the application of use tax to transfers of jointly owned vehicles where one of the joint owners is related to a party on the other side of the transaction. Additionally, the applicability of use tax is explained where names are added to or dropped from titles. RAB 2002-19 replaces RAB 1998-4 and includes several examples illustrating the exemption.

Michigan Department of Treasury Explains the Sales Tax Treatment of Food

On December 10, 2002 the Michigan Department of Treasury has issued Revenue Administrative Bulletin ("RAB") 2002-20 to explain the sales tax treatment of food purchased for human consumption. RAB 2002-20 indicates that while food purchased for human consumption is generally exempt from sales and use taxes, prepared food intended for immediate consumption is subject to sales tax. RAB 2002-20 contains numerous examples highlighting the meaning of "prepared food intended for immediate consumption."

This Update was prepared by **GIANLUCA A.D. PITETTI** and **JENNIFER TROYER** of KPMG LLP.

ENDNOTES

1. The right to receive payment was created under the Michigan Civil Service Commission Compensation Plan.
2. Keiser was owned ninety percent by Kaiser Aerospace & Electronics Corporation ("KAEC").
3. (Docket No. 225119, issued January 15, 2002).