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SBM STATE BAR OF MICHIGAN
TAXATION SECTION

CONTENTS

SBM State Bar of Michigan

The Michigan Tax Lawyer is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. The Michigan Tax Lawyer is published three times each year – October (Fall), February (Winter) and June (Summer). Features include the Section's Committee Reports, news of Section events, feature articles with a "how to" approach, and Student Tax Notes.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact Marjorie B. Gell, mgell@mmbjlaw.com; 900 Monroe Ave. NW, Grand Rapids, MI 49503.

Subscription Information

Any member of the State Bar of Michigan may become a member of the Section and receive the Michigan Tax Lawyer by sending a membership request and annual dues of $30 to the Taxation Section, State Bar of Michigan, 306 Townsend Street, Lansing, MI 48933-2083. In addition, any person who is not eligible to become a member of the State Bar of Michigan, and any institution, may obtain an annual subscription to the Michigan Tax Lawyer by sending a request and a $33 annual fee to the Taxation Section at the aforementioned address.

Change of Address

Individual subscribers should attend notification in writing to: Michigan Tax Lawyer, Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend, Lansing, MI 48904.

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Taxation Section

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January 16, 2007

Dear Taxation Section Member:

This year I am honored to serve as Chairman of the Taxation Section of the State Bar of Michigan. Our Section has approximately 1,500 active members. We enjoy a national reputation as one of the leading state bar taxation sections. The Tax Council provides our Section with dedicated and progressive leadership. Our activities are broad based, including a high quality tax journal, active subcommittees, many and varied continuing legal educational opportunities, a grant program to assist low income tax clinics and programs intended to outreach to young lawyers and law school students expressing an interest in tax law.

My personal priorities as Chairman include:

- Raising the visibility of the Taxation Section both within and outside of the State Bar of Michigan;
- Strengthening our current subcommittees (Business Entities, Employee Benefits, Estates & Trusts, Practice & Procedure, and State and Local);
- Continuing to expand our membership and outreach activities; and
- Create meaningful opportunities for interested tax lawyers to participate in the Taxation Section.

In order to provide you with the opportunity to participate in our programming, the Tax Council has substantially completed its calendar of activities for the year. It may be found at our website which is located at www.michigantax.org. Please take a moment to review the schedule and set aside some time to join us in one or more of these programs. You may wish to make a special note of the date of our Annual Tax Conference. This year's program is scheduled for May 2, 2007, and will be held at the St. John's Golf & Conference Center in Plymouth, Michigan. You will, of course, receive more information about this program over the next few months.

I am also proud to announce that the Taxation Section will once again provide $10,000 worth of grants to eligible tax-exempt organizations providing taxpayer assistance to low income individuals. We will provide more detailed information on how and when organizations can apply for a grant.

I encourage each of you to share with me or other Tax Council members any suggestions you may have to improve our Section further. You may contact me at asherbin@jaffelaw.com. Finally, if you need additional information or have any questions about any of the programs, please feel free to contact our Program Facilitator, Deb Michaelian. She can be reached at dlmichaelian@varnumlaw.com.

Sincerely,

Aaron H. Sherbin
Chairman, Taxation Section

20TH ANNUAL TAX CONFERENCE
WEDNESDAY, MAY 2, 2007

THE INN AT ST. JOHN'S
GOLF RECEPTIONS CONFERENCES
PLYMOUTH, MICHIGAN

SPONSORED BY:
TAXATION SECTION
STATE BAR OF MICHIGAN

LASALLE BANK
STOUT RISIUS ROSS
BERNSTEIN GLOBAL WEALTH MANAGEMENT

It's time to register for the May 2, 2007, 20th Annual Tax Conference presented by the Taxation Section of the State Bar of Michigan, sponsored by our long-term supporters, LaSalle Bank and Stout Risius Ross, and joined again this year by Bernstein Global Wealth Management, A Unit of AllianceBernstein, LP.

The all-day conference will take place again at St. John's Golf & Conference Center located in Plymouth, Michigan (off the corner of I-275 & M-14).

FEATURED SPEAKERS

Ira B. Shepard, *Professor of Law, University of Houston Law Center*
A graduate of Harvard Law School and practicing lawyer in a large New York City law firm for seven years, Ira Shepard settled into teaching law at the University of Houston Law Center in 1975, where he has been ever since. He has been the Special Advisor to the Southern Federal Tax Institute since 1974, and is a past chair of the Continuing Legal Education and Research Committee of the American Bar Association Tax Section. Prof. Shepard has been speaking on recent tax developments at numerous national tax institutes for the last 25 years. His annual tax update outline (included in the conference materials), co-authored by Martin J. McMahon, Jr., Professor of Law, University of Florida College of Law, Gainesville, Florida, has been published annually by the Florida Tax Review since 2001. He will present a review of the most recent significant cases, rulings, regulations, and legislation of interest for advisors to privately held businesses and their owners during the past year.

Robert J. Kleine, *State Treasurer, State of Michigan*
Robert J. Kleine was appointed Michigan's 43rd State Treasurer by Governor Granholm effective April 9, 2006. As Treasurer, Mr. Kleine oversees the collection, investment, and disbursement of all state monies. In addition, the Treasurer administers major tax laws, safeguards the credit of the state, and distributes revenue sharing monies to local units of government. Mr. Kleine previously served as president of Kleine Consulting and Vice President, Senior Economist, and Editor of Public Sector Consultants. During the William Milliken administration, Mr. Kleine was Director of the Office of Revenue and Tax Analysis, then housed in the Michigan Department of Management and Budget. Mr. Kleine will speak on state tax reform issues and the budget crisis.

Jay Adkisson, *member, Riser Adkisson LLP*
Jay Adkisson is an attorney, director of an investment advisory firm, and renowned author and speaker on asset protection issues. He is the author, along with Mr. Chris Riser, of *Asset Protection: Concepts and Strategies* (McGraw-Hill, 2004). He is also the creator of Quatloos.com which is an internationally recognized website that exposes various financial and tax scams. Mr. Adkisson has twice testified as an expert witness to the U.S. Senate Finance Committee regarding abusive tax schemes. He will speak on asset protection issues, with a special supplemental presentation on charging orders.

* * *

The conference will begin with registration and continental breakfast sponsored by LaSalle Bank. From 8:00 a.m. to 9:00 a.m. The main program will begin at 9:00 a.m. Lunch will be served at 12:00 noon in the Atrium, sponsored by Stout Risius Ross. The main program resumes immediately following lunch.

Mid-afternoon, we will have breakout sessions so that tax practitioners can attend the sessions of the most interest to their areas of concentration. Breakout sessions will feature over a dozen

speakers addressing topics in the following areas: Tax Practice and Procedure; State and Local Taxation; Estate and Trusts; Business Entities; and Employee Benefits.

Following the breakout sessions, there will be a cocktail hour sponsored by Bernstein Global Wealth Management.

The Inn at St. John's is a beautiful and relaxing conference center. Rooms are available at the new hotel facility adjacent to the Conference Center, for attendees wishing to avoid a rush hour commute before or after the seminar. St. John's also has a restaurant and lounge, providing a place to meet and relax before and after the conference. Tee times are available at St. John's 27-hole Golf Center the days before and after the conference, by contacting the St. John's Golf Center on a first-come, first-served basis.

This conference will present a valuable opportunity to network and learn with your fellow Taxation Section members.

The following agenda lists the topics and speakers for the main program and each breakout session.

AGENDA

8:00 – 8:45 **Registration & Continental Breakfast**
Breakfast cost included through the generous sponsorship of LaSalle Bank

8:45 – 9:00 **Welcome and Introductions**
Aaron Sherbin, 2006-2007 Taxation Section Chair

9:00 – 10:50 **Annual Tax Developments Update**
Ira B. Shepard, Professor of Law, University of Houston Law Center

10:50 – 11:00 **Break**

11:00 – 12:00 **Tax Reform and Budget Crisis**
Robert Kleine, State Treasurer, State of Michigan

12:00 – 1:00 **Lunch & Presentation of Law Student Awards**
Lunch cost included through generous sponsorship of Stout Risius Ross

1:00 – 2:30 **Asset Protection: 10 Things You Must Know Special Supplement: Charging Orders**
Jay Adkisson, Riser Adkisson LLP

2:30 – 2:45 **Break**

2:45 – 4:45 **Breakout Sessions**

Business Entities

- **Like Kind Exchanges**
  Mary Cunningam and Mike Indenbaum, Honigman Miller Schwartz and Cohn LLP

Employee Benefits

- **Recent ERISA Litigation Issues, Fiduciary Liability, and ESOP Fiduciary Issues**
  Tim Hauser, Associate Solicitor, Plan Benefits Security, United State Department of Labor, Washington, D.C.

Estates and Trusts

- **Installment Sales, Private Annuities, and New Private Annuity Regulation Under Code Sec. 72 –**
  Jerome Hesch, Of Counsel, Greenberg Traurig, Miami Florida

Practice and Procedure

- **New Offer in Compromise Rules and the Tax Practitioner**
  James F. Mauro, Dickinson Wright, PLLC
- **New Offer in Compromise Rules and the IRS**
  Lisa Marin, Internal Revenue Service
- **IRS Office of Chief Counsel Initiatives**
  Robert D. Heitmeyer, Internal Revenue Service, OCC and Eric Skinner, Internal Revenue Service, OCC
- **Non-filer Compliance/CP2000/IRS Liaison Group and other IRS Initiatives**
  Kristy Washington, Internal Revenue Service

State and Local

- **Michigan Single Business Tax Repeal/ Replacement**
  Rep. Andy Dillon, Speaker of the Michigan House of Representatives Sen. Michael Bishop, Majority Leader, Michigan Senate June Summers Haas, Honigman Miller Schwartz and Cohn LLP, moderator

4:45 – 6:00 **Cocktail Hour**
Cost of cocktail hour included through generous sponsorship of Bernstein Global Wealth Management

For more information, or if you have requests or ideas, please feel free to contact Warren J. Widmayer, Conference Planner (734-662-0222); E-mail: warren@fw-pc.com, or Deb Michaelian, Program Facilitator (248-567-7423); E-mail: dmichaelian@varnumlaw.com.

TAX SECTION NEWS

TAXATION SECTION ANNOUNCES 2007 GRANT PROGRAM

The Taxation Section of the State Bar of Michigan is pleased to announce that it will make available funds of up to $10,000 for grants to qualifying organizations that provide taxpayer assistance to low income individuals.

Organizations seeking a grant should make a proposal to the Taxation Section by March 31, 2007. A grant proposal should include the following information:

- The name, address and phone number of the organization (including the name of a contact person).
- The federal employer identification number of the organization.
- A copy of the letter from the Internal Revenue Service qualifying the organization as tax-exempt.
- The amount of funds sought and a detailed description of the proposed project or program, its goals, and the intended use of the grant money.
- A description of other potential sources of funds.
- A disclosure of any relationship between the organization and any current or former member of the Taxation Section Council.

Requests can be sent to the Taxation Section as follows:

State Bar of Michigan Taxation Section
c/o Ms. Deb Michaelian, Program Facilitator
39500 High Pointe Blvd., Ste. 150
Novi, MI 48375
248.567.7400
248.567.7440 (fax)
dlmichaelian@varnumlaw.com

TALENTED MSU COLLEGE OF LAW TAX STUDENTS TAKE TOP PRIZE IN ABA COMPETITION

Julie A. Camden (a December 2006 graduate of MSU College of Law) and Jason Frederick Maus (a second year law student at MSU College of Law) are the most recent beneficiaries of MSU College of Law's sterling tax law program: they took first place in the American Bar Association's national student tax law competition. Julie and Jason competed in Hollywood, Florida at the ABA Tax Section's mid-year meeting, after notification in December 2006, that they were one of six J.D. teams nationally to be selected to participate in the competition's oral rounds. Their selection took place after they submitted a ten-page "senior partner" memorandum and a four-page "client" letter involving addressing a complex tax problem related to a client's proposal about acquisition of a target company and its one of its key employees, as well as some employment issues.

At the mid-year meeting, Jason and Julie made a presentation to a group of seasoned tax professionals – including United States Tax Court Chief Judge Colvin – who pretended to be "senior partners," and on the basis of their oral defense were one of three teams nationally to be selected to participate in the "client" rounds on the afternoon of January 19, 2007. (Northern Illinois School of Law and the University of Virginia also advanced to the final session.) Their performance in the client presentation – headed by some of the nation's leading tax practitioners posing as clients, among them IRS Chief Counsel Donald Korb – determined their status as the "best of the best." Learning that they had claimed first place in the competition was not easy, however – at the ABA awards reception, at which all semi-finalists and finalists were recognized for their work in the competition, Jason and Julie were, at first, informed that they had taken third place in the competition. However, the announcer quickly changed his tune – there had been a mistake in the order in which the winners were announced, and the pair, in fact, had taken first, not third, place!

Julie and Jason came by their success in this competition through much diligence – not only have both been dedicated students at MSU College of Law's Tax Clinic, they devoted more than two hundred hours to their written and oral preparations for the competition. Success has its definite perks – not only have they both received monetary awards for taking first place, they also have received "on the spot" multiple job offers from Tax Section members who saw or heard about their stellar performances. Clinical Professor Michele Halloran, Director of Clinical Programs and Director of the Tax Clinic at MSU College of Law, coached Julie and Jason in the competition. This is the second time in the six-year history of the Tax Challenge that one of her teams took the top prize.

Jason, who is from North Dakota, and Julie, who lives in Indianapolis, offer their personal perspectives on the challenges and benefits of participating in the ABA's Law Student Tax Challenge ("LSTC"):

Jason: I first heard about the LSTC through Professor Halloran at the MSU College of Law Tax Clinic. I knew it was going to be a challenge. I was lucky to have a hard-working partner in Julie Camden. Julie and I have talents and personalities that created a perfect balance for our team.

Julie and I each spent hundreds of hours preparing to champion the Tax Challenge. We developed a schedule that allowed us to communicate frequently, even though our schedules varied greatly. Julie and I were privileged to have an energetic coach in Professor Halloran. Furthermore, most of the resources we needed were available to us at the MSU College of Law Tax Clinic. Consequently, the Tax Clinic became our "situation room," where we spent many hours – some very late into the night – developing our written answer to the tax problem.

Julie and I found out in mid-December that our written submission had made the semi-final rounds. We immediately began to develop our oral presentation. Many tax practitioners (and others) volunteered to hear our presentations and critique us. Again,

Professor Halloran led us by organizing professionals and guiding us through the presentations. It was great to have that kind of guidance; it is no wonder that Professor Halloran led another team to Tax Challenge victory just three years ago!

In the end, the work was definitely worth it. It is an honor to be involved with Michigan State University College of Law's tax program. After the finals, many practitioners at the ABA's Tax Section mid-year meeting commented that MSU Law has an outstanding tax law program.

Julie: When Professor Halloran emailed me about the LSTC, I immediately knew that Jason and I should enter. Jason's very likeable personality contrasts well with my strong approach. We made a great team! I called Pa, my grandfather who lives in southern Florida and told him I had entered the competition, and informed him that if I made it to the final two rounds, I would visit him in Florida on his birthday. Pa told me "you'll win and I will see you in Florida."

Jason's residence in Michigan and mine in Indiana added a level of complexity to the logistics of the Challenge. We had to meet when, where, and how we could – in strange places, at strange hours, and by any means (email, cellular phones, etc.). Jason even drove to my home (four hours from East Lansing) so that we could assemble our partner memorandum. Needless to say, I was relieved once we mailed our written submissions to the ABA. And, when the ABA notified us that we were "Team 27," I called Pa. Pa again assured me that we would win the contest because our team number was the birthday of my grandmother who had recently passed away.

Pa continued to send good thoughts our way. A week before Jasun and I learned that we were selected for the semi-final rounds in Florida, Pa called to say that he had just driven someone to the Westin Diplomat where, according to him, I would be staying when I won the tax competition. I told Pa not to count his chickens too soon, but he remained convinced that we were going to win.

A new challenge confronted us once we learned that we were one of six teams selected to compete in Florida – Jason was headed for North Dakota for the holidays, I was at home in Indiana, and our coach was in Michigan. To make things even more difficult, I was to begin my Bar review course and the intensive work associated with preparing to sit for the Bar exam on February 27 and 28! We divided up the work and began to prepare our respective parts. We met when we could – on New Year's Day, Martin Luther King Day, and on one entire weekend. Professor Halloran came into the Tax Clinic on New Year's Day, drove to Fort Wayne on a weekend, and drove to Novi, Michigan on Martin Luther King Day to watch our presentations. Even though our presentations seemed awful to me, Professor Halloran encouraged us.

The day before the competition, I went to my Bar review class and then boarded an airplane for Florida. Our flight stopped in Charlotte, NC – where an ice storm was in progress. I nearly missed my connecting flight to Ft. Lauderdale, and likely would not have made it to the competition had the ice intensified, or had I not run like a gazelle to catch my flight.

Jason and I were unable to practice the night before our oral presentation, although our original plan had been to work on our client presentation. We met the next morning to run through our partner presentation and appeared before the "partner panel" mid-morning. It was our best presentation ever! When I walked out of the room, I knew our team number would be posted for the final rounds, and it was. In the afternoon, we drew straws with the other two advancing teams – we would be the second team to present.

Before entering the room to make our final presentation of the day, I asked one of the competition organizers if Jason and I could have the poster board displaying the advancing and winning teams once we won. His response: "Oh, you're one of *them*." When I again asked if we could have the poster, he stated that he would wait and see. I exited our afternoon presentation with little sense of how we had performed. However, the panel's critiques indicated a positive result – we learned that we had been the only group who understood and cited IRC § 83(b)!

Just as Pa had predicted, we won the competition! Immediately, people approached us with job opportunities. All of this occurred because of Professor Halloran's efforts and Michigan State University College of Law's tax program. Professor Halloran has even gone one step further by offering to help Jason and me with our resumes in the aftermath of the competition. It is an honor to have won this award for her, our school, and Pa.

Note: Julie A. Camden and Jason Frederick Maus will be honored at the Tax Section Annual Conference on May 2, 2007.

Julie A. Camden, Professor Michele Halloran and Jason Frederick Maus at the American Bar Association's national student tax law competition.

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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UPCOMING ACTIVITIES

The Committee will meet on Wednesday, March 7, 2007 at 9:00 a.m. at the offices of Edward rose and Sons, 30057 Orchard Lake Road, Suite 100, Farmington Hills, Michigan. Eric M. Nemeth of Varnum, Riddering, Schmidt & Howlett LLP is the guest speaker. Mr. Nemeth, past Chairperson of the Taxation Section, will be addressing a variety of current issues facing business entities, including the IRS increase in enforcement. Those wishing to attend please RSVP to John O'Hara prior to the meeting.

If you would like to receive notices pertaining to future activities of the Business Entities Committee, please provide me with your email address.

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

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RECENT ACTIVITIES

November 2006. The Committee's annual joint meeting co-sponsored with the Michigan Emplnyee Benefits Conference was held in November. The presenter at the meeting was James E. Holland, Jr., Manager, Employee Plans Technical, with the Internal Revenue Service, whn discussed the Pension Protection Act. Mr. Holland is the Manager, Employee Plans Technical, with the Internal Revenue Service. He oversees the issuance of private letter rulings and technical advice memorandums in the pension area, and the issuance of opinion letters with respect to Master and Prototype Plans and IRAs. During his 30 years with the IRS in the Employee Plans area, he has also been involved with the development of much of the regulations and guidance that have been issued. Mr. Holland presented on the topic of funding single-employer and multi-employer defined benefits plans under the changes made by the Pension Protection Act.

September 2006. The Committee hosted Derrin Watson who presented on recent pension legislation and regulatory changes. Mr. Watson is a frequent lecturer for the American Society of Pensinn Professionals and Actuaries and the National Institute of Pensinn Administratnrs. He has also authored numerous articles on pension issues. Mr. Watson is also the author of the book "Who's the Employer," a detailed analysis of employee and employer issues that affect qualified retirement plans.

UPCOMING EVENTS

The Committee will host Monika Templeman, IRS, on February 15, 2007. She will be discussing various employee plans examination and compliance initiatives. On May 2, 2007, the Committee will host Tim Hauser from the Department of Labor, Solicitor's Office. Mr. Hauser will discuss fiduciary issues. Sal Tripodi will present the annual benefits update at the Committee's September 20, 2007 meeting.

REPORT OF THE TRUSTS AND ESTATES, TAXATION SECTION COMMITTEE

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RECENT ACTIVITIES

We had our first quarterly committee meeting on November 14, 2006, at the Skyline Club, in Southfield, which was well attended. The next committee meeting is scheduled for February 1, 2007, at Fifth Third Bank, in Southfield. The topic is *Real Estate Transfers and Your Practice.* Jerry Hesch is expected to speak at the committee meeting at the Annual Tax Conference on May 2, 2007.

REPORT OF THE PRACTICE & PROCEDURE COMMITTEE

Joseph Pia
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RECENT ACTIVITIES

We met with the Michigan IRS Practitioner Liaison Group on November 17, 2006. The meeting was also attended by the

Independent Accountants Association of Michigan, the Michigan Association of Certified Public Accountants, the Michigan Society of Enrolled Agents, the National Association of Tax Professionals and the Michigan Department of Treasury Taxpayer Advocate. The purpose of the Liaison Group is to provide a forum for the exchange of information on new and emerging issues of mutual interest to the Internal Revenue Service and the professional tax community.

A panel was organized with Kristy Washington, Senior Specialist with the IRS, and Joseph Pia as co-chairs of the panel. The panel's goal is to exchange information that will enhance the level of understanding between professional tax organizations interfacing with the IRS and its representatives.

Members of the panel may individually advance ideas for improvements to the tax system, but the panel is not intended to serve in an advisory capacity to the IRS.

UPCOMING MEETINGS

January 30, 2007: The Committee will host Lisa Gretchko from Howard and Howard and John Stevens from IRS Detroit Counsel to discuss the Tax Impact of the Bankruptcy Reform Act of 2005.

February, 22, 2007: The Committee will host Mark Rizik of Miller, Johnson, Snell & Cummiskey, PLC to present on tax refund suits and claims.

March 22, 2007: The Committee will host Neal Nusholtz who will present on the pitfalls of filing income tax returns for potential criminal defendants.

If you have any questions or issues that you wish to have the panel address, please feel free to contact me.

REPORT OF THE STATE AND LOCAL TAX COMMITTEE

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INTRODUCTION

I would like to personally thank and commend Wayne Roberts, the outgoing Committee Chair, for his leadership and commitment to advancing the goals of the Taxation Section. His vision and tireless efforts on behalf of the State and Local Tax Committee have created a solid framework for the future.

PUBLICATIONS

The Committee Chair is preparing the submission for the Michigan Tax Matters Column appearing in the winter 2007 edition of the Michigan Tax lawyer.

The Committee Chair provided an email communication on a topic of interest with committee members on a monthly basis.

UPCOMING ACTIVITIES

This meeting was originally scheduled for January 26, but will be moved to February 9, 2007, to accommodate Mitchell Bean, Director of the House Fiscal Agency who will speak regarding the state's current budget projections and its impact on SBT tax reform.

March 16, 2007, Committee Meeting. This meeting will be held in Lansing with senior members of the Department of Treasury's Tax Policy staff. The purposes of the meeting will be a practitioner Question and Answer secession.

The Questions and Answers from this meeting will be reproduced and included in the Michigan Tax Matters Column in the Spring edition 2007 of the Michigan Tax Lawyer.

May 2007: A regular meeting of the SALT Committee will be held concurrent with the 2007 Summer Tax Conference, which is scheduled for May 2007, at the St. John's Conference Center in Plymouth, Michigan. The topic for this meeting will be Michigan SBT repeal/replacement. Rep. Andy Dillon, the new Speaker of the House, and Sen. Michael Bishop, the new Majority Leader, each has been invited to speak but neither have confirmed. June Summers-Haas has tentatively agreed to moderate. The State Treasurer, Robert Kleine, has agreed to speak at the morning session.

OTHER BUSINESS

Wayne Roberts is continuing to work with the MACPA regarding a possible joint MACPA/State Bar-Taxation Section Michigan Tax Conference. The contemplated conference would focus on Michigan tax issues and would attempt to involve the Michigan Department of Treasury, The office of the Michigan Attorney General – Tax Division, the MACPA and the State Bar - Tax Section. This conference would include programs designed to assist both tax practitioners and industry tax departments.

FEDERAL TAX FORUM

Eric M. Nemeth

We have all heard countless reports about the massive Federal budget deficits. The most recent budget deficit estimate for fiscal year ending September 30, 2006 ("FY"), according to the Congressional Budget Office, is about $286 billion.[1] The FY 2005 deficit was about $318 billion.[2] For FY 2007, the projected deficit is $337 billion.[3] While numbers of this magnitude are never an exact science, the sheer size of the problem is clear.

The recently concluded mid-term elections have resulted in a "split" government with the Republican party continuing to hold the White House and the Democratic party holding a majority in both the House of Representatives and the Senate. The Democratic "majority" in the Senate can only be described as razor thin as there is not a true majority of Democrats but rather two (2) independents caucusing with the Democratic party.[4] Nevertheless, because of the Senate's Rules of Procedure, a party that doesn't control sixty (60) three-fifths seats cannot succeed in a cloture vote to stop a debate or filibuster.[5] Therefore, even though the Republican party controlled a "pure" majority in the Senate, they were unable to pass many pieces of legislation that were already passed in the House because they could not muster the necessary sixty (60) votes to end debate. An example of this includes the various attempts at a permanent repeal of the estate tax.

The tax cuts that are scheduled to expire in 2010 have been the topic of endless debate. The new leadership in Congress and the "split" government is unlikely to lead to any significant tax increases or budget cuts prior to the 2008 Presidential and Congressional elections. There remains one avenue to raise revenue but not taxes: that is, better enforcement and collection of existing taxes.

In early 2006, the Service concluded its first exhaustive estimate since 1984 on the tax gap (the amount that should be collected assuming a perfect universe of income and deduction reporting, and payment of tax versus what is actually reported and collected). The projections range from $312 billion to $353 billion.[6] Therefore, it is easy to see that the tax gap presents the perfect opportunity to substantially close or eliminate the budget deficit without raising taxes.

Many readers may recall, with some amusement, the former "kinder and gentler Service" during the first President Bush ("Bush 41") Administration. In fact, the Service was essentially "de-fanged" following the congressional hearings in 1996 and 1997 and resultant legislation passed in 1998 as the IRS Restructuring and Reform Act.[7] The Restructuring Act at least for a time, nearly put the Service out of the enforcement business. Budget surpluses were high, reaching $236 billion in FY 2000,[8] driven by the immense paper wealth created by the "dot com" phenomenon. It was politically popular to beat up on the Service and pass out tax cuts. The recent report on enforcement and service results by the IRS shows...the party's over.

IRS Commissioner Mark W. Everson has promised, and appears to be delivering, increased tax enforcement. On November 20, 2006, the Service reported on its enforcement service results for FY 2006.[9] The report shows across the board increases in examinations, criminal investigation referrals, and most of all, collection enforcement. Practitioners in this area of the law have already no doubt seen concrete examples of the enforcement increase. Nevertheless, the specific results shed light upon the breadth and depth of this enforcement trend.

From a pure collection standpoint, the enforcement revenues collected for FY 2006 were approximately $48.7 billion. This is a 3% increase for FY 2005 where the revenue collected was $47.3 billion, but more strikingly, it is a marked increase for FY 1999 where $32.9 billion was collected through enforcement collection activities. The revenue collection rates are up across the board.

Since FY 1999, the Service's document matching which includes "information reporting systems" or "automated underreporting program" (AUR) collected $1.6 billion to $3.3 billion in FY 2006. The Service attributes much of this increase to its investment in better computer capabilities to process and cross match the multitude of information from third parties.

The staffing for key enforcement operations within the Service has also increased. In FY 2003, the Service had 5,076 revenue officers. In FY 2006, it had 5,627 revenue officers. Correspondingly, revenue agents have increased from 11,780 to 12,778. Only special agents have remained relatively stagnant at approximately 2,800. This stagnation is due in part to the large amount of retirements from the ranks of special agents and the lengthy and extensive time it takes to recruit and train special agents.

Chief of IRS Criminal Investigation, Nancy Jardini, reported at a recent conference in Washington, DC that the Service is aggressively hiring special agents to grow their ranks along with an increased focus from illegal tax enforcement activities such as narcotics to legal source income cases such as underreporting sales from small and large businesses.[10]

In addition to increasing the number of personnel, the Service is putting these people to work. Individual examinations are on the rise. The Service estimates that its field agents examined 302,959 total tax returns for FY 2006 versus 197,388 in FY 2004. Correspondence examinations have increased to 990,722 from 538,744 in FY 2002. Overall, the examination coverage rate stands at 0.98% an increase from 0.57% in FY 2002.

Clearly, not all tax returns present the same audit potential within the ranks of the Service. A W-2 wage earner that has minimal or no itemized deductions would appear to present little opportunity for a meaningful tax adjustment. Correspondingly, a self-employed individual with a pass-through entity such as an S corporation or an LLC with gross receipts in excess of $1.0 million and correspondingly large amount of deductions would appear to present ample audit potential. These adjustments would come by way of underreported gross receipts, overstated deductions, or improper deductions.

For taxpayers reporting income of $1.0 million or higher, examination rates have gone from 9,576 for FY 2004 in the field to 17,015. The overall audit coverage rate is now approximately 6.3% versus 5.03% in FY 2004 for taxpayers in this select group. Taxpayers in the $100,000 to $1.0 million range will find the examination coverage rate increase is no less dramatic. In FY 2006, 112,404 tax returns were examined versus 70,452 in 2004. Correspondence audit rates increased by approximately 60% and the overall audit coverage rate increased from 1.25% in FY 2004 to 1.67% in 2006. For taxpayers whose income was under $100,000 their audit coverage rates have also increased. In 2004, the coverage rate was 0.72% but for FY 2006, 0.89%. The raw numbers show that approximately 194,000 more tax returns were examined in this income bracket.

Not surprisingly, business coverage rates increased dramatically as the Service has found that these tax returns present significant audit potential. While the coverage rate for businesses still remains generally lower than that for individual taxpayers, the increase is noteworthy. For small corporation returns (assets under $10.0 million) the coverage rate increased from 0.32% in FY 2004 to 0.80% in FY 2006. Large corporate returns (assets $10.0 million and higher) still have the highest audit rate coverage of any other return group. In FY 2006, 18.6% of all tax returns filed for this group had coverage. This is an increase from 16.7% in 2004 but reflects a trend going back to FY 1997 where generally between 15% and 25% of all tax returns filed had audit coverage. S corporation tax returns reported a five (5) year high in coverage of 30.38%. Partnership tax returns show continued increases in coverage to 0.36% from 0.26% FY 2004. It should be noted the Large and Mid-Size Business Division examines about 35% returns of $250 million or higher in range.

Tax returns of tax-exempt organizations have been the subject of much or more Service scrutiny in recent months. The IRS reports their coverage rates increased dramatically to 7,079 tax returns from 4,953 for FY 2005. Congress has appropriated funds for the Service to further increase their audit coverage of tax exempt organizations.

The most dramatic revelations are clearly in the Collection Division. The Service is now aggressively using levies (effectively, economic seizures) in its enforcement arsenal. In FY 2000, the Service reported levy action of 219,778. In FY 2006, the number increased to a shocking **3,742,276**. Taxpayers and the representatives must understand that the Service through its revenue officers and often Automated Collection Service ("ACS"), issue levies on an almost routine basis. I have found that once a levy is issued on wages, it is very difficult to have it released. The message is that **taxpayers and their representatives must be proactive.**

IRS lien action is also enjoying an increased resurgence. In FY 2000, the Service reported about 287,517 lien actions. In FY 2006, the number had risen to 629,813. Since there is no Collection Due Process ("CDP") hearing **prior** to the filing of a Federal Tax Lien, the consequences can be severe. Damaged credit reports, unsolicited mail from unscrupulous individuals promising miracle tax results and perhaps worst of all, a tax lien may be a violation of a loan covenant resulting in the calling of a loan. In some professions (read: lawyers), the failure to pay taxes could be grounds for loss of license or dismissal.

The message from all of this information is a simple one: the tax man cometh. Only this time, he is coming with a vengeance along with a Congressional funding mandate evidenced by double-digit funding increases. Tax professionals must be vigilant in advising their clients about the very serious ramifications of the non-compliance or taking aggressive positions on tax returns. We must encourage our clients on the strongest possible terms to be proactive and straightforward in their tax affairs.

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ENDNOTES

1. Congressional Budget Office; Office of Management and Budget. The Budget and Economic Outlook: An Update, August 2006, page 18.
2. Congressional Budget Office; Office of Management and Budget, Historical Budget Duty January 26, 2006, Table 12.
3. Congressional Budget Office; Office of Management and Budget, Historical Budget Duty January 26, 2006, Table 12.
4. www.democrats.senate.gov; news release (November 14, 2006).
5. Standing Rule XXII of the Senate.

6. IR-2005-38.
7. The Internal Revenue Service Restructuring and Return Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (July 22, 1998).
8. Congressional Budge Office; Office of Management and Budget, Historical Budget Duty January 26, 2006, Table 12.
9. All enforcement statistics are taken from Internal Revenue Service FY 2006; Enforcement and Service Results, Nov. 20, 2006; Internal Revenue Service new Release Nov. 20, 2006.
10. ABA Criminal Tax Fraud Conference, Washington, D.C., October 26-27, 2006.

MICHIGAN TAX MATTERS
TAXATION OF LEGAL SERVICES IN MICHIGAN

Paul V. McCord

There can be little doubt that Michigan is in the middle of a financial crisis. This crisis has led the Governor to propose a combination of spending cuts, government reforms and new taxes. The Governor's proposal to resolve the current state budget deficit and the hole left by the repeal of the Single Business Tax, estimated to be nearly $3 billion, was presented to the House and Senate Appropriations Committees on February 8, 2007. The Governor's budget proposal includes, among other things, a 2-cents-on-the-dollar excise tax on services, the so-called "2-penny plan."[1] Denominated as an "excise tax" rather than a sales tax, a distinction presumably made to avoid constitutional questions,[2] this 2-cent service tax extends to legal services. The State Bar of Michigan opposes the imposition of tax on legal services.[3] Though I do not doubt Governor's good intentions, the imposition of the tax on legal services could work disastrous results.

Rethinking Tax Policy

Some experts and policymakers argue that now is the time to consider more fundamental questions of how well Michigan's current state tax system in the dawn of the 21st century reflect the 21st century economy.[4] Consider the following: the share of GNP attributable to the production of goods has declined steadily since the mid-1940s. By 1975, the production of services became a larger share of GNP than that of goods, and the services sector has continued to grow in relation, as well as absolute terms. Consumers in 2000 spent smaller proportions of their incomes on durable and nondurable goods than in 1960, much less on groceries and about the same share on housing. But expenditures on services grew from 25% to 42% of consumer expenditures.[5] In Michigan, the service sector generated almost 48% of Michigan's gross state product in 2005.[6] The trend toward producing and consuming more services and fewer manufactured goods is likely to continue and the services sector is the fastest growing and healthiest part of Michigan's economy.

Getting the Right Balance

Excessive taxation can hinder growth. But apparently so does too little. States with meager revenues cannot provide essential government services.[7] As a result, responsible government should impose the right balance of taxes, together with other resources, to meet its expenses.[8] Experience shows that states with fiscal deficits look toward assessing fees or eliminating current sales tax exemptions as less painful ways to generate revenue.

To be sure, broadening the sales tax base to the remaining non-exempt services, or imposing a service excise tax could yield the State significant additional annual revenues. This is because the sales tax, although originally enacted as a temporary measure, is now Michigan's largest revenue source. In fact, Michigan's tax structure differs perhaps from those of most states in that its principal reliance for revenue is placed on its sales and personal income taxes. However, over the years, Michigan's sales tax revenues have been eroded by the change in the "mix" of products purchased by consumers and the growth in electronic commerce, which is largely tax exempt. Most states, including Michigan, do not tax services which have grown from 41% of household consumption in 1960, to 58% in 2002. According to a 2004 survey by the Federation of Tax Administrators, Michigan taxes 26 of 168 services, ranking the State 39th in the nation.[9]

Tax on Legal Services

As outlined in the Governor's proposal, the service excise tax would be imposed on services, including legal services, consumed or used in Michigan and become effective on June 1st of this year.[10] Placing an excise tax on legal services, seems like a simple answer to the State's budgetary problems, and one that would not, in the end, be hard to pass. A tax on attorneys sounds great to a lot of people because, let's face it, most people don't like attorneys.[11] But a tax on legal services ignores the obvious: a tax on professional services would be itemized separately, added to the cost of the services and paid by clients.[12] The irony here is that legislators, who do not want to unnecessarily burden their constituents and local main street business with taxes, are doing exactly that when a tax is levied on legal services.

As more details of the proposed service excise tax become available, particularly once actual legislation is introduced, we will be able to better analyze the merits and demerits of the proposed excise tax. For now, however, although I do not doubt Governor's good intentions, call me a "naysayer," but the imposition of a tax on legal services is not the right solution for Michigan's budget issues for the reasons outlined below.

1. **Lack of "Fairness."** Consumption taxes, such as sales taxes or the service excise tax in this instance, are often argued as being "fair" over other theories of taxation because they

tax choices to consume goods and services; however, this is not the case with most legal fees incurred by individuals. Clients dealing with, for example, criminal charges, injury, death, divorce, child support, domestic abuse, housing, medical eligibility, credit and bankruptcy seek legal services not from choice, but from necessity.[13]

2. **Erosion of the Attorney-Client Relationship.** Requiring lawyers to collect an excise tax from their clients would intrude on the attorney-client relationship.[14] It could create conflict between lawyer and client and could compromise the confidentiality of client communications.

3. **Double Taxation.** Many transactions already taxed would be subject to additional taxes on related legal fees. For example, property transfers, and estate administration, assuming that the proposed state level estate tax is passed.

4. **Tax Pyramiding.** The tax would result in multiple taxation of the goods and services used in producing taxable services.[15] Currently, producers of taxable goods are allowed exemptions from sales tax on such inputs.

5. **Disproportionate Burden.** The tax would be borne disproportionately by individuals and small businesses; large organizations could avoid the tax by employing in-house counsel whose salaries would not be subject to the tax thus giving these larger organizations that provide their own services a competitive advantage over those who purchase similar services from independent firms.[16]

6. **Regressive.** Like a sales tax, a flat excise tax on services would be regressive – that is, the poor would pay a larger percentage of their income in total consumption taxes than the wealthy.[17]

7. **Avoidance.** The tax could encourage Michigan residents to seek professional services from out-of-state providers, placing Michigan lawyers/law firms at a competitive disadvantage vis-à-vis out-of-state firms. For example, an out-of-state business could simply obtain advice in intellectual property, federal taxes, or international business from a lawyer in Chicago as readily as from one in Michigan. Similarly, a Michigan business in need of a corporate reorganization or an individual could obtain estate planning or business advice from a lawyer in Toledo via electronic communications. In *Quill Corp v. North Dakota*,[18] the United States Supreme Court ruled that taxes of this kind cannot be collected from out-of-state business that do not have a "substantial nexus" with the taxing state; merely having in-state customers does not qualify as "substantial nexus."[19]

8. **Brain Drain.** The tax would create an incentive for large companies to either re-route their need for legal services to out-of-state firms or bring more services in-house. As a result, much of the sophisticated legal work in Michigan could be negatively impacted and along with it the legal expertise often necessary for business development. The tax may also encourage Michigan attorneys and professional firms to relocate to other states in pursuit of this work. Without a base of sophisticated legal work, the attractiveness of the state's law schools will diminish in favor of schools in areas that have climates favorable to such work. There is also research that suggests that 70% of levies such as a gross receipts tax either are passed on to the end user or are forced on to employees, such as associate attorneys, paralegals, and legal secretaries in the form of lower wages.

9. **Administrative Nightmare.** Determining which services were consumed or used in Michigan and subject to tax as oppose to those service consumed or used elsewhere would be an administrative nightmare.[20] Goods have places of delivery and use that can determine taxability; it is difficult to say with certainty where services are delivered or used.[21] For example, suppose that both Michigan and Illinois lawyers provide services to a Michigan and an Illinois company in connection with a business transaction, and activities take place in both states. What fees of the Michigan and Illinois lawyers would be subject to Michigan service excise tax?[22] What records of each would be subject to audit? How would Michigan collect the tax on the Illinois lawyer's fees?

10. **Increased Tax Burden.** Part of the cost of state income and real property taxes is "shifted" to the federal government – that is, such taxes are deductible from federal taxable income, resulting in a lower effective tax rate. Even state sales taxes are presently deductible by individuals under certain circumstances.[23] The proposed service excise tax, in its present proposed form, is a non-deductible state and local tax. Thus, in the end, imposing a service excise tax will only increase the overall tax burden on Michigan taxpayers. Increasing the state income tax by a few tenths of one percent would be a much more efficient and less costly administrative alterative.[24]

"SECOND VERSE, SAME AS THE FIRST"[25]

This isn't something that has not been tried, and failed, before. Taxes on legal services have been considered and rejected in Michigan over a period of three decades. Only South Dakota, New Mexico and Hawaii currently tax legal services. Florida briefly extended its sales tax to legal services in 1987, but it was repealed within a year with some calling it troublesome and confusing. Similarly, Massachusetts enacted a sales tax on services, but promptly repealed the measure when it proved to be unpopular and difficult to administer. Several other states, including Maine, Maryland, Minnesota, Ohio, Vermont, Wisconsin and Wyoming have considered and defeated proposals to tax services in recent years. The District of Colombia also rejected a tax on legal services. Even Canada is struggling with this issue. Recently, in *Christie v. British Columbia*,[26] the British Columbia Court of Appeals ruled that to the extent that the British Columbia provincial sales tax is collected on "legal services related to the determination of rights and obligations by courts of law or independent legal tribunals," the tax is unconstitutional. The Supreme Court of Canada has granted leave to appeal this decision. The appeal is scheduled to be heard in March 2007. The decision in *Christie* casts doubt as to the application of Canada's goods and services tax (GST) to legal services (as well as the application of the

Manitoba, Saskatchewan and Prince Edward Island (P.E.I.) retail sales taxes).

The taxation of services in Michigan will also likely raise questions about Michigan's perceived competitiveness. South Dakota is one of the few states that taxes services and is largely vilified for this. Similarly, Michigan's SBT, the only value-added tax in the United States, was largely vilified by the business community. According to some, the SBT placed Michigan at a competitive disadvantage and contributed to Michigan's poor economic performance. Although most of the problems with the SBT were largely perception and the tax more-or-less functioned as designed,[27] the negative perception of Michigan competitiveness remained. Joining the small fraternity of states that tax legal services will likely only enhance Michigan's perceived negative image.[28]

CONCLUSION

To be sure, the State faces significant structural fiscal difficulties. These difficulties have been exacerbated by the reductions in personal income and business taxes that were cut by the previous administration and phased in over time. Further, the State has been overly dependent on one-time revenues and accounting maneuvers to balance its budget. The State is currently in the process of devising a replacement business tax system and many of you have lent your time, talents and expertise to this effort. And we should continue to do so. However, the experiences of other jurisdictions and the nearly universal rejection of taxing legal services, suggests that the idea is one that is "stubbornly fixed on old solutions that have filed to work in a new economy"[29] and that the arguments against its imposition in Michigan are compelling.

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ENDNOTES

1. *See* Chris Christoff, *Granholm to Call for Tax on Services*, DETROIT FREE PRESS (February 7, 2007).
2. Article 9, § 8 of the state constitution limits the imposition of sales-use tax at a rate of not more than 6% of gross taxable sales of *tangible personal property*. *See* Const 1963, Art 9, § 8 [emphasis added]. Because services are not "tangible personal property" extending Michigan's existing sales and use tax scheme to the rendition of pure services would arguably require an amendment to the constitution.
3. *See* State Bar of Michigan, Position Statement on a Tax on Legal Services (February 9, 2007), www.michbar.org/publicpolicy/pdfs/taxinglegalservices.pdf (last visited February 9, 2007).
4. *See Michigan's Defining Moment: Report of the Emergency Financial Advisory Panel* (February 2, 2007) (on file with the author), available at www.thecenterformichigan.net/Website/Portals/0/EFAP.pdf (last visited February 9, 2007).
5. The source of the data is the personal consumption expenditures component of the Gross Domestic Product Accounts published by the U.S. Commerce Department.
6. *Id.* at 7.
7. *See* Compania General de Tubacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927)(Holmes, J, dissenting) ("[t]axes are what we pay for a civilized society . . . .").
8. In fact, the Michigan Constitution specifically requires this. *See* Const 1963, Art 9, § 1.
9. *Are You Being Served?*, TAX ADMINISTRATORS NEWS (May 2005), at 34, 38. Available at www.taxadmin.org/fta/pub/services/tan0505_services.pdf (last visited February 9, 2007).
10. Jennifer M. Granholm, State of the State Address, *Our Moment, Our Choice: Investing in Michigan's People* at p. 14 (February 6, 2007). Available at www.michigan.gov/documents/gov/2007_SOS_186092_7.pdf (last visited February 9, 2007).
11. Thus, falling into the category of "the first thing we do, let's [tax] all the lawyers." Apologies to William Shakespeare, HENRY VI (Act IV, Scene II).
12. This raises the question as to who will bear the burden of this tax. At the time that this article went to press, it is widely believed that the excise tax will be imposed on those who provide taxable services in Michigan; attorney for purposes of this discussion. According to the language of the proposal, however, the excise tax would be imposed on "*services consumed or used*" in Michigan. *See Our Moment, Our Choice: Investing in Michigan's People*, (February 6, 2007), Appendix B, Tax Restructuring Proposal, at B-3. Available at www.michigan.gov/documents/gov/2007_SOS_186092_7.pdf (last visited February 9, 2007). Thus, while the impact of the excise tax will likely fall on individual attorneys and law firms as the providers of taxable legal services who in nearly all cases will make the payment to the state. The use of the phrase "consumed or used" in the proposal suggests that the incidence or final resting place of the tax burden will be on consumer of the taxed service; the price increases or the price is constant, but the tax will likely be stated separately on the client invoice and collected from the consumer of legal services.
13. The Michigan Constitution guarantees that the "a suitor in any court of this state has the right to prosecute or defend his suit, either in his own proper person or by an attorney." Const 1963, Art 1, § 13. Because the proposed tax on legal services, in its present form, does not afford an exemption to those persons who cannot afford to pay legal fees will pay no tax, the proposed tax on legal services appears to burden the indigent from seeking redress for any injury in the courts. To the extent that the tax could restrict access to and use of the state or federal courts in Michigan, Article III of the U.S. Constitution and the 5th, 6th and 14th Amendments to the U.S. Constitution may also be implicated. The imposition of the tax on legal services also risks placing an unconstitutional burden on the right to legal counsel. The United States and Michigan Constitution

both guarantee rights of persons accused of crimes the right to legal counsel. U.S. Const, Am VI and XIV; Const 1963, Art 1, § 20. The right to legal counsel is a "preservative right" that safeguards many nther constitutional rights and that, therefore, any burden on the exercise of that right is constitutionally suspect. The right to counsel is violated only when access to an attorney is impeded or where the attorney's ability to consult with, advise, or defend his or her client is hindered. *See* United States v. Cronic, 466 U.S. 648 (1984). In its present conceptual form (*see* Jennifer M. Granholm, State of the State Address, *Our Moment, Our Choice: Investing in Michigan's People*, (February 6, 2007), Appendix B, *Tax Restructuring Proposal*, at B-3. Available at www.michigan.gov/documents/gov/2007_SOS_186092_7.pdf (last visited February 9, 2007)), the tax could be viewed has having such an effect because it does not provide an exemption for pro bono legal services and court appointed counsel for indigents. In this regard such tax on legal services may be analogous to the poll tax declared unconstitutional in Harper v. Virginia State Board of Elections, 383 U.S. 663 (1966). In *Harper*, every voter, regardless of financial ability, had to pay a $1.50 tax as a prerequisite to voting. Under such a system, an indigent person would be denied his right to vote should he or she be unable to pay the tax. The contemplated tax on legal services, without an exemption for pro bono legal services and government counsel appointed could lead to a similar result as in *Harper*.

It is also well established that the state's taxing power is subject to the requirements of the equal protection clause of the 14th Amendment to the U.S. Constitution, which provides "nor shall any State . . . deny to any person within its jurisdiction the equal protection of the laws." U.S. Const., Am XIV, § 1. Although the state must adhere to the principles of due process and equal protection when exercising its taxing power, those principles do not "impose an ironclad rule of equality, prohibiting the flexibility and variety that are appropriate to reasonable schemes of state taxation." Allied Stores of Ohio, Inc. Bowers, 358 U.S. 522 (1959). Accordingly, the Supreme Court has accorded the states a wide range of discretion in drawing classifications and distinctions for purposes of taxation. *See* National Private Truck Council, Inc v. Oklahoma Tax Commission, 515 U.S. 582 (1995) (denying declaratory and injunctive relief against state taxation on non-Oklahoma residents operating foreign-based motor carriers under 42 U.S.C. § 1983 and denying attorneys' fees under 42 U.S.C. § 1988); McKesson Corp v. Division of Alcoholic Beverages and Tobacco, Fla Dept of Business Regulations, 496 U.S. 18 (1990) (confirming that the states are afforded great flexibility in satisfying the requirements of due process in the field of taxation); Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983) ("Legislatures have especially broad latitude in creating classifications and distinctions in tax statutes,"); *see also* Lehnhausen v. Lake Shore Auto Parts Co, 410 U.S. 356 (1973); Madden v. Kentucky, 309 U.S. 83 (1940); F.S. Royster Guano Co v. Commonwealth of Virginia, 253 U.S. 412 (1920); Brown-Forman Co v. Commonwealth of Kentucky, 217 U.S. 563 (1910). The bottom line here is that generally as long as the system of taxation is supported by a rational basis and is not palpably arbitrary, it is valid. *See* Western & Southern Life Ins Co v. State Bd of Equalization, 451 U.S. 648, 668 (1981); Kahn v. Shevin, 416 U.S. 351 (1974). That said, as demonstrated by Charleston Federal Savings & Loan Ass'n v. Alderson, 324 U.S. 182 (1945), a state taxation scheme can be voided if "bears unequally on persons or property of the same class. *See also* Township of Hillsborough v. Cromwell, 326 U.S. 620 (1946); Chicago Great Western Railway v. Kendall, 266 U.S. 94 (1924). Admittedly, most of these cases have focused on situations were the discrimination was based on in-state verses out-of-state persons. It should also be note that strict judicial scrutiny is required for statutes which impinge upon fundamental rights. *See* Douglas v. California, 372 U.S. 353, 355-56 (1963) (the right to fair treatment in the criminal process). If the tax is imposed without an exemption for legal services provided to the indigent or the criminally accused, this could be viewed as drawing an arbitrary classification. Can it be said that a person charged with a crime needs an attorney any more or less than a person with a broken arm needs a doctor?

14. The service excise tax could also violate the Michigan Constitution's contract clause depending on how it brought into effect. The Michigan Constitution provides that that "[n]o bill of attainder, ex post facto law or law impairing the obligation of contract shall be enacted." Const. 1963, Art 1, § 10. In its proposed form the tax is anticipated to be effective June 1st of this year. *See* Jennifer M. Granholm, State of the State Address, *Our Moment, Our Choice: Investing in Michigan's People*, (February 6, 2007), Appendix B, Tax Restructuring Proposal, at B-3. Available at www.michigan.gov/documents/gov/2007_SOS_186092_7.pdf (last visited February 9, 2007). Unquestionably, contract rights are ordinarily subject to the state's taxing powers. It is also equally clear, however, that rights existing under a valid contract enjoy protection under the Michigan Constitution. Once enacted into law, the taxing statute would place attorneys on notice that they should take their upcoming tax burden into consideration when entering into engagements after June 1st. However, if the statute ultimately enacted does not provide an exemption for existing legal service engagements, then the statute's effect would not be limited to this permissible burden. Instead, by retroactively placing a tax burden upon all legal service engagements where the services are not fully performed by May 30, 2007, and thereby adding an unknown, uncontemplated cost, it retroactively burdens contracts that were in existence before any party could have reasonably been on notice of the impending tax. As a result, the excise tax could arguably be facially unconstitutional if it fails to provide such and exemption.

15. Technically, "tax pyramiding" refers to the situation where the goods and services businesses buy to use as inputs in the production of other goods and services are taxed when purchased by a business, and then effectively taxed again when its cost is passed through into the price of a taxable good or service into which it has been incorporated. Tax pyramiding results in the actual sales tax imposed on a particular good or service bought by a household being higher than what is added at the cash register. Taxation of business inputs also tends to

complicate sales tax administration. For example, rules need to be developed for taxing services like accounting that are purchased by businesses for company-wide use in multiple states. For a more complete discussion, see Michael Mazzero, *Expanding Sales Taxation of Services: Options and Issues Center on Budget and Policy Priorities* (Washington DC, 2003), available at: www.cbpp.org/2-24-03sfp.htm. The Governor's proposal does offer several exemptions to minimize this risk, such as a very narrow industrial processing exemption. Michigan's sales and use tax statutes provide a similar but much broader exemption. However, legal services consumed by a manufacturer are not considered part of the industrial process under the current understanding of the law and probably would not be under the proposed service excise tax.

16. From and economic standpoint this could also distort the allocation of resources, as larger business organizations would be encouraged to bring these resources in-house even if those same services could be produced more efficiently by an independent firm. This phenomenon is perhaps more problematic in the context of pure professional services verses goods because it is generally easier for businesses to provide for themselves the services that they ordinarily would purchase from others. *See* Walter Hellerstein, *Florida's Sales Tax on Services*, NATIONAL TAX JOURNAL (March 1988). Further, this could also tend to encourage businesses to vertically integrate, because large vertically integrated businesses are not as reliant on outside legal services, giving such businesses a clear advantage over smaller non-integrated businesses.
17. Although this issue is not unique to the taxation of services, in general, or to legal services specifically, but also applies to Michigan's current sales and use taxes on goods, albeit groceries are exempt, and even Michigan's current constitutionally required flat rate personal income tax. That said, the tax is regressive because it will absorb a larger portion of the income of lower-income taxpayers than of higher-income taxpayers. In other words, higher-income persons consume a smaller proportion of their incomes and the portion of their incomes that they save is not subject to sales, excise or other consumption taxes. The regressivity inherent in the proposed service excise tax to the extent it is imposed on legal services will like have a chilling effect on the poorest in Michigan from seeking the legal services they may require. But the regressive nature of the tax also means that the cost of doing business for small business will be higher than for businesses of larger size. The cost of legal services will increase as a result of this tax. This will likely account for a larger budget share of a small business than a medium or large sized business.
18. 504 U.S. 298 (1992).
19. This all assumes, of course, that the price for comparable legal services is the same across state lines. As mentioned in the text, whether an attorney who performs legal services will be subject to Michigan's service excise tax and either incur a tax liability or will be required to collect the tax from its Michigan clients depends upon whether that attorney has sufficient "nexus" with Michigan. The Commerce clause of the U.S. Constitution places limits on the states from imposing taxes that unduly burden interstate commerce. Specifically, the Commerce Clause provides that "the Congress shall have Power . . . to regulate Commerce . . . among the several States . . . ." U.S. Const, Art. I, § 8. While expressed as a grant of power to Congress, it is also well established that the commerce clause "of its own force protects free trade among the States" (Armco Inc v. Hardesty, 467 U.S. 638 (1984) and may serve in certain circumstances as a basis for invalidating state laws that interfere with interstate commerce. This restriction on state power is often referred to as the "dormant commerce clause." *See* Philip M. Tatarowicz and Rebecca F. Mims-Velarde, *An Analytical Approach to State Discrimination Under the Commerce Clause*, 39 VAND. L. REV. 879, 882 (1986). In order for a Michigan to impose a service excise tax collection obligation on an attorney, the Commerce Clause requires that the attorney must have a sufficient connection (substantial nexus) with Michigan. Unfortunately the U.S. Supreme Court has not provided a precise definition of this key term. For example, in *Quill Corp v. North Dakota*, 504 U.S. 298 (1992), the leading Supreme Court case addressing "substantial nexus," the Court held a taxpayer whose only contact with a taxing state was the delivery of goods through common carrier and the licensing of software to customers residing in the taxing state did not have "substantial nexus." In reaching its decision, the Court explained that the bright-line physical presence requirement announced in *National Bellas Hess, Inc. v. Illinois Department of Revenue*, 386 U.S. 753 (1967) – which prohibits a state from imposing use tax collection obligations on out-of-state sellers that have no physical presence in the state – is consistent with the "substantial nexus" requirement. *Quill* provides good general guidance that "substantial nexus" requires physical presence, however, the precise nature of the physical presence is unknown. Nevertheless, Michigan has adopted *Quill's* physical presence requirement for purposes of nexus under the Single Busines Tax, and sales and use tax. *See* RAB 1998-1. As a result, where legal services are performed by an out-of-state attorney to either an out-of-state client or to a Michigan client, the out-of-state attorney, who has no physical presence in Michigan is not subject to Michigan's service excise tax not can he or she be compelled or forced to collect the tax form his or her Michigan client. However, it should be noted that the risk of tax avoidance is curbed somewhat because it appears that the tax will be imposed on the consumption or use of taxable services in Michigan. The implication is that the attorney's client will likely still incur Michigan service excise tax on the purchase of the out-of-state legal services and will have a duty to self-assess their excise tax liability and make payment directly to the state. Without such a mechanism, not only would Michigan law firms be placed at a competitive disadvantage vis-à-vis out-of-state firms, but the tax's potential revenue yield to the state would be compromised.
20. In South Dakota, for example, legal services are specifically subject to sales tax. S.D. Codified Laws §§ 10-45-5 and 10-45-5.2. Furthermore, South Dakota sources service to the location where the service is received. S.D. Codified Laws §§ 10-45-108. More specifically, if the service is received at the attorney's office in South Dakota office, then the service is treated as being first used and received by the client at the attorney's

office. If the service is not received at the attorney's office, then the service is received at the client's billing address. In order to curb tax avoidance by providing the services "off shore," South Dakota's regulations provide that the gross receipts received by a nonresident attorney performing legal services in South Dakota are subject to South Dakota's sales tax. Any person using legal services in South Dakota that are provided by an unlicensed nonresident attorney are liable for use tax on the cost of services if the sales tax is not paid. *See* S. D. Admin. R. 64:06:02:81.01.

21. Aside from the complications of sourcing the service, the proposal suggested that services such as health care and education should be exempt and that entities such as the federal government and state and local governments, schools, non-profit organizations are likely to be exempt from the service excise tax. As a result, these exempt entities will likely be required to provide an exemption certificate to their attorneys and the attorney's engagement file and accounting records must keep this documentation to show the purchase was paid from government funds. Also exempt would be services purchase for resale, such as where an attorney engages an expert witness and includes the witness' fees on the attorney's bill. In this instance, the attorney's gross charge subject to tax would not likely include the expert's fee being billed through. Instead, the expert would include tax in its bill to the attorney and would likely be responsible for remitting the tax to the state, unless the ultimate customer is an exempt entity. This is likely to spawn considerable litigation. *See* Morgan, Theeler, Wheeler, Cogley & Petersen, LLP v. South Dakota Department of Revenue and Regulations, Dkt. No. HU04235, 2005 SDCC 1 (March 1, 2005) (involving the exclusion from the sales tax base of telephone charges passed through on client bills).

22. This question is whether or not a Michigan attorney who performs legal services either for an out-of-state client, such as preparing and filing patent or for a Michigan client in out-of-state legal matter as, for example, representing a client before the taxing authorities in Illinois will incur Michigan excise tax liability. In other words, will the excise tax reach only that attorney's or clients' activities in Michigan requiring some sort of fair apportionment methodology? *See, e.g.*, Complete Auto Transit, Inc v. Brady, 430 U.S. 274 (1977). The focus of the fair apportionment requirement is to ensure that each state taxes only its fair share of an interstate transaction and to "avoid a situation in which businesses that operate in more than one state are taxed more heavily, just because they operate in more than one state, than businesses operating in a single state." D. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1186 (1986). *See also*, Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995); *Goldberg v. Sweet*, 488 U.S. 252 (1989). The U.S. Supreme Court, however, has carved out an exception to the general rule that a tax most be fairly apportioned for gross receipts and sales and use taxes. In Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995), the Court rejected the notion that a jurisdiction must apportion a sales tax imposed upon an item purchased for interstate consumption (specifically as service, a bus ticket, in *Jefferson Lines*). The Court founded its decision on the grounds that a traditional sales tax is imposed on a set of unique events (e.g., transfer of title or delivery of the goods) that occur in a single jurisdiction. *Jefferson Lines*, 514 U.S. at 186. [Citations omitted]. The Court noted that "a sale of services can ordinarily be treated as a local state event just as readily as a sale of goods can be located solely within the state of delivery." *Id.* at 188 (citing Western Live Stock v. Bureau of Tax Revenue, 303 U.S. 250 (1938) which upheld an unapportioned New Mexico gross receipts tax imposed on advertising revenues for a magazine distributed within and without the state). Thus, a sales or excise tax on services need not be apportioned, even if the purchased services or a portion of the services will be used or consumed outside of Michigan, as along as some portion of the legal service is preformed here in Michigan because the tax is imposed upon a that "discrete event." *See Jefferson Lines*, 514 U.S. at 189. Although apportionment of Michigan service excise tax does not appear to be constitutionally required, the Supreme Court has suggested that states may be required to provide credit for sales or use taxes imposed in other states to avoid multiple taxation of would arise if both the states of sale and the state of use impose a tax on the same transaction or occurrence. As a result, in order to avoid the possibility of multiple taxation, Michigan could provide credit against its service excise tax for similar taxes on services paid to other states. However, with respect to legal services, this would be a meaningless gesture because very few states impose such taxes on legal services. Outside the realm of traditional sales and use taxes, the U.S. Supreme Court has embraced a firm rule that a jurisdiction must bear some meaningful connection (or "substantial nexus") with the tax base it proposes to reach. *See* Allied-Signal, Inc v. Director, Div of Taxation, 504 U.S. 768, 778 (1992) (holding that, "in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax").

23. *See* I.R.C. § 164(b)(5)(A). This deduction requires an individual taxpayer to choose whether to deduct the sales taxes he or she paid or their state income tax. This choice is obvious for residents of states that do not collect state income taxes but do levy state sales taxes: Florida, Nevada, South Dakota, Texas, Washington, Wyoming and Tennessee. In states like Michigan it will be up to individuals to do the math and see which deduction, state income taxes or sales taxes, will save them more. Regardless, Michigan's service excise tax is not a deductible tax because it is not a tax that is described in I.R.C. § 164. Even if it were simply recast as a "sales tax" it would still not be deductible under I.R.C. § 164. The ability to deduct state and local sales and use taxes only applies to that jurisdiction's "*general* sales taxes and compensating use taxes." I.R.C. § 164(b)(5)(A)(ii) (emphasis added.) A general sales tax is a sales tax that is imposed at one rate with respect to retail sales of a broad class of items. I.R.C. § 164(b)(5)(B); *see also* Reg. § 1.164-3(f). Because the service tax, as presently proposed, will be imposed at a rate other than the general 6% rate, it will not qualify for deductibility, even if were included as part of Michigan's sales tax scheme. Nevertheless, even under current law, state and local general sales taxes and compensating

use taxes will no longer be deductible after this calendar year (December 31, 2007). *See* I.R.C. § 164(b)(5)(I).

24. To be sure, this alternative would be political equivalent of jumping on a live grenade. That said, taxpayers would not have to learn and comply with a new tax not would the government have to develop, train it workforce to administer and ultimately enforce a new tax.
25. RAMONES, *Judy is a Punk*, RAMONES (Sire Records 1976). Although the phrase is largely attributed to Herman's Hermits, *I'M HENRY VIII, I AM* (MGM Records 1965).
26. Christie v. British Columbia, 2005 BCCA 631 (December 2005).
27. *See* Steven E. Grob, *The SBT: A Tax Whose Time Has Gone, or Has It?*, MICHIGAN FORWARD (March 2003), at 10.
28. Along this same vein, perhaps of greatest concern is that the taxation of services purchased by businesses can distort the allocation of economic resources. To be sure, any tax system creates a distortion to the economy. However, if purchases of services subject to the excise tax are major cost items for a business (such as legal services for an insurance company), a more efficient business that tries to pass those taxes along to its customers in its prices could lose business to a less efficient competitor located in another state that exempts those inputs from taxation. Alternatively, a business that makes substantial purchases of taxable services might choose to expand in a state that is sub-optimal from an economic efficiency standpoint but that exempts those services from tax. The likelihood of this occurring is an open question at this point.
29. Granholm, *supra note* 13 at 14.

INTERNATIONAL HOME FOODS, INC.: A FINAL DETERMINATION OF THE RETROACTIVE APPLICATION OF MICHIGAN'S SINGLE BUSINESS TAX NEXUS STANDARDS

Lynn A. Gandhi

On January 8, 2007, the Michigan Supreme Court issued its opinion in the appeal of *International Home Foods, Inc. v. Michigan Department of Treasury*,[1] reversing the judgment of the Michigan Court of Appeals and reinstating the Circuit Court's holding which permitted an unrestrained retroactive application of Michigan's nexus standards to taxpayers who had previously relied upon advice promulgated by the Michigan Department of Revenue ("Department"), and had not filed SBT returns.[2] At issue was whether Michigan Single Business Tax ("SBT") nexus standards that had been promulgated by the Department in Revenue Administrative Bulletin ("RAB") 1998-1 could be applied retroactively. Specifically, the appeals by *International Home Foods* presented the question of whether the Department's retroactive imposition of its revised nexus standards to the Michigan SBT violated the 14th Amendment due process rights of taxpayers who had been expressly advised by the Department that they were not previously subject to the tax, and also the question of whether the Department should be bound by its published guidance when taxpayers have relied on that guidance to their detriment.

The taxpayers in *International Home Foods, Inc.* ("*International*") and *Lennox, Inc.* ("*Lennox*") found themselves before the Michigan Supreme Court to seek reversal of the Michigan Court of Appeals October 4, 2005, opinion.[3] The Michigan Court of Appeals had previously ruled that the Department's retroactive application of the jurisdictional standard for the Michigan SBT that had previously been announced in *Gillette Company v. Department of Treasury*.[4] *Gillette* had reversed the Department's prior published jurisdictional standard used to determine whether a corporation was subject to the SBT. Both *International* and *Lennox*, as well as a multitude of other multistate taxpayers, had relied on the Department's advice which had been articulated in several formal pronouncements by the Department prior to the *Gillette* decision. These taxpayers used the Department's formal pronouncements as the basis for structuring their business transactions, reporting their tax obligations, and performing their business activities in Michigan.

Prior to *Gillette*, the Department had taken the position that the proper jurisdictional standard for the application of the SBT was that contained in Public Law 86-272.[5] Public Law 86-272 prohibits states from imposing income tax on companies whose only activity in the state is the solicitation for sales of tangible personal property. Although the SBT is not a traditional income tax, the Department announced that taxpayers would be protected from the imposition of the SBT if their presence in the state was below the standards articulated in Public Law 86-272. This position was first announced in Single Business Tax Bulletin ("SBTB") 1980-1, and again by the Department in an RAB.

Before issuing RAB 1989-46, the Department specifically assured *International*, *Lennox*, and other taxpayers that they could rely on Departmental advise *unless and until* the guidance was revoked or modified[6] in RAB 1989-34, which expressly assured taxpayers that the State's bulletins "had the status of precedence in the disposition of cases unless and until revoked or modified and may be relied on by taxpayers."

Four years after the Department issued its last guidance on the SBT jurisdictional standard, the *Gillette* Court, *sua sponte*, applied a substantial nexus standard to the SBT which effectively expanded the tax base to thousands of out-of-state taxpayers. Under *Gillette*, the Court found that the commerce clause of the U.S. Constitution[7] requires only substantial nexus in a state to subject a corporation to the state's tax.[8]

The 14th Amendment of the U.S. Constitution grants substantive protection against deprivation of life, liberty, or property, without due process of law.[9] The Supreme Court in *Welch v. Henry*[10] set the standard for determining whether the retroactive imposition of tax infringes upon this due process protection. According to the Court in *Welch*, it is "necessary to consider the nature of the tax and the circumstances in which it is levied before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation."[11] Recently, the Supreme Court has also factored notice into its determination of whether the retroactive application of tax laws violates due process. In *United States v. Hemme*[12] the Supreme Court identified one of the relevant circumstances to be "whether, without notice, a statute gives a different and a more oppressive legal effect to conduct undertaken before enactment of the statute." *In Carleton*,[13] the Supreme Court also determined that lack of notice, although not dispositive, is clearly relevant to the due process analysis.

International and *Lennox* asserted that the Department's retroactive assessment raised serious constitutional concerns under the standards set out in *Welch*, *Hemme*, and *Carleton*. From 1980 to 1993, the Department informed the taxpayers in *International*, *Lennox*, and other out-of-state taxpayers, through RABs, that they would not be subject to the SBT if they fell below the thresholds articulated by Public Law 86-272. Until the *Gillette* decision was entered in 1993, there was no indication that the Department's interpretation of the jurisdictional standard was incorrect.

In *Carleton*, the Supreme Court articulated a two-part test to determine if retroactive tax legislation violates due process. First, the Court looked at whether the purpose of adopting the law was illegitimate, arbitrary, or based on improper motive, such as

targeting a taxpayer after deliberately inducing them to engage in a transaction.[14] Second, the Court looked at whether the period of retroactivity was modest.[15] In *International*, the taxpayers alleged that the two-part test of *Carleton*, when applied to the Department's actions to assert the changed nexus standards retroactively, supports the conclusion that the Department's retroactive imposition of tax violates due process. The Department's purpose in retroactively imposing tax on out-of-state companies could be determined to be illegitimate, arbitrary, and based on improper motive, as the Department specifically targeted taxpayers after inducing them to engage in transactions. By issuing guidance to taxpayers which expressly encouraged them to rely upon that guidance in organizing and conducting their business affairs in Michigan, out-of-state taxpayers were told that they were not subject to the SBT if they conducted business within the limitations of Public Law 86-272. Further, these taxpayers were told that the Department's guidance had the force of law and was binding until expressly revoked. After encouraging taxpayers to rely on the Department's published guidance to structure their business operations, the Department now uses *Gillette* to justify targeting out-of-state businesses for retroactive assessment. This retroactive imposition of tax in undoubtedly the type of improper motive *Carleton* was intended to prevent – specifically targeting taxpayers after inducing them to engage in transactions.

International argued that the second prong of the *Carleton* test was not satisfied, that the period of retroactive imposition was not modest. While the *Carleton* court did not establish a bright line rule for determining what would be considered a modest period of retroactivity, the concurring opinion by Justice O'Connor declared that "A period of retroactivity longer than a year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions."[16]

State courts which have looked at this issue have also agreed. In *Rivers v. State*,[17] the South Carolina Supreme Court invalidated the retroactive application of tax legislation to tax years two to three years before the legislation was enacted. In reaching its decision, the Court cited *Carleton* for the proposition that tax legislation with a period of retroactivity greater than one year is constitutionally suspect.[18] And, most recently in *Johnson Controls, Inc. v. Rudolph*, the Kentucky Court of Appeals also held that a period of retroactivity in excess of five years was a violation of taxpayers' due process rights.[19] In relying on *Rivers*, the court in *Johnson Controls* held that "We agree with the Supreme Court of South Carolina's ruled opinion that 'At some point…the government's interest in meeting its revenue requirements must yield to taxpayers' interests in finality regarding tax liabilities and tax credits.'"[20] In the case of *International* and *Lennox*, the period of retroactivity reached back four years from the date of the 1993 *Gillette* decision. The Department assessed *Lennox* back to its tax year beginning September 1, 1989, and assessed *International* back to its tax year beginning January 1, 1989.

For a hypothetical multistate taxpayer who did not file returns based on its reliance on the Department's standard, the possible period of retroactivity could be virtually unlimited. If a taxpayer who relied on the Department's guidance has not yet filed SBT returns, the statute of limitations for a retroactive assessment does not begin to run. Thus, the Department could impose retroactive SBT liability back to the year in which the taxpayer began conducting business in the State, or the date the SBT was originally enacted in 1976, 17 years before the *Gillette* decision was handed down.

Carleton also gave consideration to whether the taxpayers had notice of the potential retroactive liability in determining whether the imposition violated due process. Both *International* and *Lennox* had no reason to be on notice of their potential liability for SBT. Until the *sua sponte* decision by the *Gillette* court in 1993, even the Department had no idea that its longstanding administratively applied jurisdictional standards would be *sua sponte* eradicated. In looking at the significant weight *Carleton* gave to the importance of taxpayer certainty, allowing the Department to retroactively assess tax back to 1989, the same year the Department assured taxpayers that its Bulletins could be relied upon and binding, erodes the ability of taxpayers to achieve certainty and finality in their tax obligations and destroys the credibility of the State in taxing and enforcing laws.

Due process constraints should protect equally against retroactive legislation in statutory interpretations. Until the Court of Appeals' decision on this issue, the Department relied on the argument that the laws of retroactive legislation did not apply to agency pronouncements. This certainly cannot be true, as the same notions of fundamental fairness are involved whether the retroactive imposition of law occurs from the act of the legislature or by affirmative interpretations of an executive agency. The Constitution does not accede a person's due process rights to violation by a specific branch of government. Fundamental fairness should be protected from encroachment by agency actions as it is from legislation action, both having the force and effect of law. It is unfortunate that the Michigan Supreme Court does not concur in these notions of fundamental fairness.

In Michigan, the Department's regulations and other administrative interpretations of statutes have the force and effect of law. The Department has been given statutory authority to promulgate rules and issues bulletins interpreting state tax law.[21] The Michigan Supreme Court has recognized the authority of an agency's bulletins to have the same force and effect as rules.[22] The Department relied on its authority to advise taxpayers that the proper jurisdictional standard for SBT nexus was Public Law 86-272. Having interpreted the law in its Bulletins, one would think that the Department shouldn't be permitted to contradict its position retroactively. To do so is no different than imposing a new law retroactively. Had the Department not issued any Bulletins, taxpayers could not argue that they had been misled. It is only because the Department took a position that it should be precluded from changing that position retroactively.

The Department's SBTB 1980-1 and RAB 1989-46 were intended to establish substantive standards to determine which taxpayers would be subject to the SBT. The Bulletins, therefore, should be viewed as having force and effect of law. While *Gillette* has the effect of overriding the Bulletins and the Court was within its purview to determine that the Bulletins were unreasonable, such

determination does not and should not permit the Department's retroactive application of that decision.

In their reversal, the Michigan Supreme Court has indicated that they will tolerate action by an executive agency, which has misled taxpayers into filing and abiding by its published pronouncements and bulletins, to later penalize those taxpayers for filing the agency's published pronouncements. While the Department was under an obligation to enforce the corrected nexus standard pronounced by the *Gillette* court, the Department's ability to retroactively assess taxpayers for as many open years as were permissible is, at best, questionable, and at worst, duplicative. Regardless of whether the Court applies the *Carleton* line of cases, the Department should be precluded on policy grounds from retroactively assessing taxpayers for periods before *Gillette* was decided. It is critical to the fair and efficient administration of every state's tax laws to ensure that when an administrative agency issues policy directives that require compliance upon pain of penalty and interest, that taxpayers who rely on such pronouncements on good faith are not later punished for the government's error.

Taxpayers that justifiably rely on promises made by their government should not do so at their peril. This concept of trust in government is fundamental and was emphasized by the Michigan Supreme Court in *Heckler v. Community Health Services of Crawford Co., Inc.*,[23] where the Court stated,

> ... It is no less good morals and good law that the Government should turn square corners in dealing with the people than that the people should turn square corners in dealing with their Government; *Federal Crop Insurance Corp. v. Merrill*, 332 U.S., at 387-388 (Jackson, J. dissenting) ("It is very well to say that those who deal with the Government should turn square corners. But there is no reason why the square corners but should constitute a one-way street."); *Brandt v. Hickel*, 427 F.2d 53, 57 (CA 9 1970) ("To say to these appellants: 'The joke is on you, you shouldn't have trusted us,' is hardly worthy of our great government.") *Menges v. Dentler*, 33 P.A. 495, 500 (1859) ("Men naturally trust in their government, ought to do so, and they ought not to suffer for it.") *See also Giglio v. United States* 405 U.S. 150, 154-155 (1972).

This fundamental principle that those who justifiably rely on promises made by their government can do so safely, reflects the strong belief of the framers of the Constitution when they stated in *The Federalist* that men should not have to act at their peril, fearing that the state may change their mind and alter the legal consequences of their past acts.[24] As James Madison indicated, "...[p]eople were weary of the fluctuating policy of state legislatures and wanted it made clear that under the new Government men could safely rely on States to keep faith with those who justifiably relied on their promises."[25]

International and *Lennox* were distinguished by prior cases challenging the retroactive application of the SBT based on their reliance on the case of *In re D'Amico Estate*.[26] In *D'Amico*, the Department had for eleven years construed a statute as exempting state lottery proceeds from the inheritance tax. Subsequently, the Department changed its interpretation and sought to apply its new interpretation retroactively. Before the Department had changed its interpretation however, it had issued written guidance which was relied on by the taxpayer in *D'Amico*. The Michigan Supreme Court in *D'Amico*, had concluded that, "The Department of Treasury should be held to be bound by the first contemporaneous construction by the State, at least with regards to the estates of persons who purchased lottery tickets before September 13, 1993, when the Treasury advised inheritance tax field examiners of a "new development."[27] Based on the public policy set out in *D'Amico* the Department should be prohibited from retroactively imposing tax on *International* and *Lennox*. The Court of Appeals in the present case agreed with the *D'Amico* analysis and held that the Department, by virtue of taxpayers' reliance on previously-issued bulletins was precluded from retroactively applying the nexus standard handed down in *Gillette*.[28] This is a departure from the previously-published cases of *Syntex v. Department of Treasury*, 233 Mich. App. 286; 590 N.W.2d 612 (1998); *Rayovac Corp. v. Department of Treasury*, 264 Mich. App. 441; 691 N.W.2d 57 (2004); and *J. W. Hobbs v. Department of Treasury*, 268 Mich. App. 38; 706 N.W.2d 460 (2005), as these cases did not specifically raise the issue of whether defendant is bound by the taxpayers' reliance upon its earlier interpretative rulings.

The Department sought to distinguish D'Amico from the present case by relying on the unpublished decision of *Topps Co. v. Department of Treasury*.[29] In *Topps*, the Court of Appeals declined to apply *D'Amico*, arguing that *D'Amico* was distinguishable because the Department had changed its position before the courts had endorsed that change.[30] The Court had viewed as significant that in *Topps* the Department changed its position after the *Gillette* decision. In *International*, the Court of Appeals held that it was not bound by its own unpublished decision and rejected its previous holding in *Topps* as incorrectly decided. Rather than focusing on whether the Department's interpretation was changed voluntarily or by court decision, the court placed focus on taxpayer's reliance. According to the court, "A taxpayer's reliance does not differ in situations where defendant voluntarily changes its interpretation of the statute or where that change is stressed upon the Department by a court decision."[31] In either case, the Department should be bound by its word and taxpayers should be able to rely upon its governmental proclamations. Obviously, the Michigan Supreme Court does not think so.

The Court of Appeals' view of governmental responsibility avoided the harsh and inequitable consequences which flow from taxpayers' reliance upon incorrect agency direction. Destroying the public trust and blindsiding taxpayers are not characteristics of good government. Only by upholding the certainty of governmental proclamations can Michigan uphold its fair administration of tax laws. With the Department's position allowed to prevail, the possibility of retroactive application of future tax laws may be unrestrained not only with respect to any item about which there is clear uncertainty, but even on issues where the Department has issued clear guidance. The Department's and the Michigan Supreme Court's endorsement of, disregard of its word undercuts

our voluntary tax collection system. This was underscored by Justice O'Connell's dissent in *J. W. Hobbs*, in which he states, "Not only does defendant's sudden policy switch blow a dark cloud over this state's credibility, it forces out-of-state businesses to think twice about doing business in this state. Trust is the cornerstone to a good business foundation, and if an outside business cannot trust this state's interpretation of its own tax laws, how can it trust the state enough to build and grow here?"[32]

The public policy principles of *D'Amico* have been recognized by the federal courts which apply an abuse of discretion standard to retroactively applied regulations.[33] Determining if it is an abuse of discretion to apply a regulation retroactively would depend on to what extent the retroactive application of the settled prior law or policy upon which "the taxpayer justifiably relied and if the change causes the taxpayer to suffer inordinate harm."[34] In *GEHL*, the Court found a retroactive change in interpretation to be an abuse of discretion where the Treasury had assured taxpayers that they could rely on the original interpretation. The Treasury had issued a pamphlet interpreting a recently-enacted law. Regulations were further promulgated that significantly changed the interpretation put forth in the Treasury pamphlet. The Treasury pamphlet, however, promised that any change to interpretation would be applied prospectively only. The *GEHL* Court found the government's pamphlet representation dispositive. Having assured taxpayers that they could rely on the statements without fear of liability, *GEHL* found the government's statement "designed to evoke" an "designed to alter business behavior" and refused to allow the government "to renege on such express promises with impunity [as being] grossly unfair."[35] It is important to note that the federal statute granting authority to promulgate regulations creates a presumption of retroactivity.[36]

International and *Lennox* are identical to *GEHL* in that the Department's Bulletins instructed taxpayers regarding the law and then guaranteed that they could rely on these Bulletins as binding. RAB 1989-34 is unequivocal. It indicates that Bulletins may be relied on by taxpayers unless and until revoked. Having made such express promises, the Department should not be allowed to renege. The Department's assurance in RAB 1989-34 was designed to guide companies doing business in Michigan, guaranteeing them protection from the SBT under the standards of Public Law 86-272. Having engaged in business pursuant to that assurance, *International Home Foods* and *Lennox* have now faced an attempt by the Department to renege on its guarantee. While the State of Michigan has a long history in honoring its pledges made in the course of giving advice to its citizens, the upholding of the Circuit Court's judgment now undermines that record.

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ENDNOTES

1. Consolidated with this matter was also the appeal of *Lennox, Inc. v. Department of Treasury*.
2. Order 130542, 130543, Mich. S. Ct. 1/5/07. (J Cavanaugh dissented.) At the time of this article no written opinion was available, nor is required.
3. Docket Nos. 253748 and 253760.
4. 198 Mich. App. 303; 497 N.W.2d 595 (1993).
5. Enacted in 1959 and codified at 15 U.S.C. 381-384.
6. RAB 1989-34 at 1.
7. U.S. Constitution, Article 1, § 8.
8. Retroactive application of the change was particularly damaging to taxpayers who had relied upon the Department and included the relevant protected income on their tax returns for their home states. Because the statute of limitations had expired on many of these taxpayers' ability to claim a refund, the Department's position resulted in double taxation.
9. U.S. Constitution, Article 14, §1.
10. 305 U.S. 134; 59 S.Ct. 121; 83 L.Ed. 87 (1938).
11. *Id.* at 147.
12. 476 U.S. 558; 106 S.Ct. 2071; 90 L.Ed. 2d. 538 (1986).
13. United States v. Carletun, 512 U.S. 26; 114 S. Ct. 2018; 129 L. Ed. 2d. 22 (1994).
14. *Id.* at 32.
15. *Id.*
16. *Id.* at 38 (O'Connor, J., concurring).
17. 327 S.Ct. 271; 490 S.E. 2d. 261 (1997).
18. *Rivers*, 327 S.C. at 277-278.
19. Johnson Controls, Inc. v. Rudolph, ___ S.W.3d. ___, 2006, W.L. 1195498 (Kentucky Appeals 2006).
20. *Id.* at 6, quoting *Rivers*, 327 S.C. at 279.
21. M.C.L. § 205.3.
22. Detroit Based Coalition for the Human Rights of the Handicapped, et al v. Department of Social Services, 431 Mich 172; 438 N.W. 2d 335 (1988).
23. 467 U.S. 51, n. 13; 104 S.Ct. 2218; 81 L. Ed. 2d. 42 (1984).
24. THE FEDERALIST No. 44 (James Madison)(Cook ed., 1961).
25. *Id.* at 301.
26. 435 Mich. 551; 460 N.W.2d. 198 (1990).
27. *Id.* at 564.
28. *International Home Foods*, 268 Mich. App. at 362.
29. Unpublished opinion per curium of the Court of Appeals, issued June 11, 1999 (Docket No. 203495).
30. *Topps* at 2.
31. *International Home Foods*, 268 Mich. App. at 363.
32. *Id.* at 55.
33. GEHL Co. v. CIR (795 F. 2d. 1324 (7th Cir. 1986); CWT Farms, Inc. v. Commissioner, 755 F.2d. 790 (11th Cir. 1985); Lecroy Research Systems Corp. v. Commissioner, 751 F.2d 123 (2nd Cir. 1984).
34. *CWT Farms*, 755 F.2d. at 802
35. *Id.* at 1333.
36. *Id.*

WHAT A LONG STRANGE TRIP IT'S BEEN: THE SAGA OF THE MICHIGAN SINGLE BUSINESS TAX

Gregory A. Nowak

1975. Nixon resigns. Jimmy Huffa disappears. Microsoft is founded. And in the same dramatic year, the Michigan legislature took one of the boldest steps in state tax history in enacting the Single Business Tax ("SBT"). The tax became effective on January 1, 1976, and was the nation's first, and to date its only major value-added business tax. The term "single" in the name was a reference to the fact that the tax replaced not only the corporate income tax, but a total of seven business taxes, including a property tax on inventory and various other taxes. However, unlike more endearing products of the psychedelic 70's like the bean bag, the lava lamp, and the mood ring, the public never really warmed up to the SBT, and it has now reached the end of its relatively short and extremely stormy life.

While the tax was fairly successful in its objective of providing a more stable source of revenue to the general fund because its broad base made it relatively resistant to the fluctuation of profits in the automotive-dominated Michigan economy, the tax has suffered from a life of almost continuous controversy. From a series of major constitutional challenges, to fundamental battles over the jurisdictional standard for imposition of the tax, to numerous disputes over measurements within the tax, there has been almost no time during the history of the SBT when its future was not surrounded by uncertainty. A 23-year phase out of the tax was initiated in 1999, lowering the rate 0.1% per year from 2.3% to 1.9% until 2003 when the rate reduction was frozen. New legislation in 2003 accelerated the scheduled repeal of the SBT to the end of 2009. In 2006, the Michigan legislature accelerated the demise of the SBT pursuant to Public Act 325 of 2006, which provides for the complete repeal of the tax as of December 31, 2007.

With apologies to the Grateful Dead, this article will review the history of conflicts concerning the tax, outline some of the events leading to its repeal, and describe some of the potential alternatives tax structures that could replace it.

"She Lost Her Sparkle, You Know She isn't the Same"

During the years following the enactment of the SBT in 1975, it was subject to seemingly constant challenge. Being the only value-added tax in the country, there was no established case law in other states concerning the various unique elements of the tax. While the various controversies which surrounded the SBT were all ultimately resolved, these challenges served to undermine confidence in the SBT, and helped earn it a reputation as a complex and problematic tax.

The first major challenge began in the early 1980's, when taxpayers argued that the inclusion of compensation paid outside of Michigan should not be includible in the SBT "value added" tax base calculation and apportioned to Michigan, since it represented value added outside of the state of Michigan. The taxpayers argued that the SBT violated the fair apportionment and discrimination prongs of the Commerce Clause, and that a relief provision of the SBT required the alternate apportionment method of including only Michigan compensation. The appellate courts in Michigan initially agreed with the taxpayers,[1] resulting in virtually every major taxpayer in Michigan filing claims for refund. The legislature subsequently changed the statute to narrow the application of the relief provision,[2] and the Michigan Supreme Court in *Trinova Corp. v. Michigan Department of Treasury* ultimately ruled that the statute was valid and that taxpayers were not entitled to relief.[3] However, the U.S. Supreme Court granted *certiorari* in the case, and thus the controversy continued until the U.S. Supreme Court rendered a decision in 1991.[4] That decision upheld the SBT, finding that it was fairly apportioned since it was an indivisible tax on value added, and not a series of separate taxes imposed on the components of the tax base.[5] In total it took almost a decade to resolve this first fundamental attack on the SBT.

The next major attack on the SBT was initiated before the controversy in *Trinova* had even been resolved. In *Caterpillar v. Department of Treasury*,[6] the Michigan Court of Claims held that the capital acquisition deduction ("CAD") provisions of the SBT were discriminatory, because they provided for deductions based on real property physically located in Michigan and personal property apportioned based on the ratio of Michigan property and payroll to total property and payroll, while the tax base was apportioned based on a three factor formula consisting of property, payroll, and sales. The trial court originally severed the CAD provisions from the act entirely, but the Michigan Court of Appeals[7] subsequently held that the proper remedy was to allow a CAD deduction without apportionment. Motivated in part by a short 90-day statute of limitations that applies to constitutional challenges to Michigan taxes,[8] taxpayers filed more than 550 refund claims totalling more than $560 million.[9] The legislature responded to the fiscal uncertainty created by this litigation by amending the CAD to provide for a deduction apportioned in the same manner as the tax base is apportioned. The intent of this legislation was to prescribe a remedy that would not only apply prospectively, but would be the retrospective remedy in the event the constitutional challenge to the CAD was ultimately sustained. This "protective" amendment proved to be unnecessary, because in 1992 the Michigan Supreme Court reversed the Court of Appeals and held that the CAD apportionment provisions were constitutional.[10] However, the modification of the CAD apportionment remained in the law until 1995.

Shortly after *Caterpillar* was resolved, another broad challenge to

an element of the SBT was brought. In *Thiokol Corp v. Michigan Department of Treasury*,[11] it was argued that the SBT violated federal law ("ERISA") by including employee benefit contributions within the SBT tax base. This challenge asserted that ERISA pre-empted federal law, and accordingly was brought in federal court. The Federal District Court upheld federal court jurisdiction over this state tax issue despite the Federal Tax Anti-Injunction Act,[12] and in 1994 ruled in favor of the taxpayer. Consequently, more than 212 refund claims totalling more than $142M were filed. Ultimately the 6th Circuit Court of Appeals reversed in 1996 and held in favor of the Department, and the U.S. Supreme Court in 1997 denied *certiorari*.[13] As with the two challenges in *Trinova* and *Caterpillar*, the claims for refund regarding the *Thiokol* issue were ultimately dismissed, and the SBT suffered yet another blow to its already beleaguered reputation. Fundamental uncertainty about the validity of the tax had at that point been around for more than 20 years.

After a few years of relative calm, another CAD challenge was raised in connection with certain 1995 amendments which limited the CAD to investments in Michigan multiplied by the Michigan apportionment percentage for years 1997 through 1999. In 1999, the Michigan Court of Claims in *Jefferson Smurfit v. Department of Treasury* held that limiting the apportioned CAD to Michigan property discriminated against interstate commerce.[14] This led to yet another round of refund claims by numerous taxpayers, as well as legislation that repealed the CAD and replaced it with an investment tax credit for years beginning in 2000. In 2001, the Michigan Court of Appeals reversed the Court of Claims decision in *Jefferson Smurfit*, holding that the earlier *Caterpillar* case which had upheld a CAD deduction for Michigan property only was controlling.[15] The Court in this decision largely ignored the distinction that the 1997-1999 deduction was also apportioned, while the earlier CAD provision at issue in Caterpillar was not. In 2002, the Michigan Supreme Court denied review of the decision, and in 2003, the U.S. Supreme Court also denied *certiorari*.

Four more years of constitutional uncertainty transpired as a result of the *Jefferson Smurfit* litigation, and while the Department of Treasury in 2003 believed that this challenge was at last behind them, in 2004 yet another challenge surfaced in *Dana Corp. v. Dept of Treasury*.[16] This challenge was based on the argument that the Michigan Court of Appeals had failed to address the argument that the CAD violated the internal consistency requirement to be fairly apportioned under the Commerce Clause. The Court of Claims again held in favor of the taxpayer, distinguishing the decision in *Jefferson Smurfit*, and another appeal was brought by the Department to the Court of Appeals. The Court of Appeals reversed the decision of the Court of Claims in 2005,[17] finding that the *Jefferson Smurfit* and *Caterpillar* decisions were controlling, and the Michigan Supreme Court denied leave to appeal in 2006.[18] In total, these cases kept a cloud of uncertainty over the SBT for another seven years, right up until the year in which the legislature finally acted to repeal the SBT effective at the end of 2007.

And these were not the only challenges brought to the SBT over the years. The question of whether the SBT was subject to the limitations of Public Law 86-272 was raised in the cases of *Gillette v. Department of Treasury* and *Guardian Industries v. Department of Treasury* in the early 1990's. *Gillette* involved both the standard for imposition of the SBT, and *Guardian* involved the standard to be applied to a taxpayer's activity in another state for purposes of avoiding the throwback of sales in the Michigan sales factor. The Department argued that in both cases that PL 86-272 was the proper standard for both purposes, but the appellate courts held that PL 86-272 did not apply to the SBT, and was limited only by the constitutional limits of the Commerce Clause.[19] Other cases followed addressing whether the activities of independent sales representatives would be attributed to the taxpayer. The Department initially sought to narrowly apply these decisions only to the activities of employees. Ultimately the Department conceded that the activities of independent representatives create nexus, but the Department's policy position which implemented these 1993 Court of Appeals decisions was not issued until 1998. In its 1998 guidance, the Department stated that the decisions would be applied retroactively to 1989, four years prior to the issuance date of those decisions based on Michigan's four year statute of limitations.[20]

Other cases over the years addressed fundamental questions including what constitutes a "royalty"[21] or "interest,"[22] (neither of which is either taxable or deductible for SBT purposes), and what constitutes a "casual transaction,"[23] the income from which is excludible from the SBT base.

In addition to the legal controversies plaguing the SBT, criticism of the tax has been rampant among businesses, politicians, and analysts. The most common complaint surrounding the tax focuses on the complexity of the tax laws enacted over the past 15 years. What began as a simplified tax designed to eliminate confusion has snowballed into an increasingly intricate system that is extremely difficult to understand, compute, and even audit. As a result, compliance costs have significantly increased. Further criticisms center around the lack of sensitivity of the tax to the ability to pay. Because the tax requires substantial addbacks such as compensation and depreciation, taxpayers may find themselves paying tax despite the fact that they are in a loss position. The $350,000 filing threshold also presents an issue. A taxpayer can very easily move from zero tax liability to a substantial tax liability if it crosses the threshold from one year to the next. Further there has been criticism related to special provisions in the SBT Act. For example, financial organizations and transportation companies are subject to different tax base and apportionment provisions which, in some cases, result in dramatically varying tax burdens.

"HANG IT UP AND SEE WHAT TOMORROW BRINGS"

SBT reform or replacement has been discussed for many years. In her campaign for governor in her first term (2003 – 2006), Governor Jennifer Granholm ran on a platform that included doing away with the SBT, which had gained the label of "job killer" due to the inclusion of compensation in the SBT base. In early 2005, the Governor offered a plan, the Michigan Jobs and Investment Act, to revise the SBT by eliminating tax relief for the service industry and

other labor intensive businesses, lowering the tax rate, providing personal property tax relief to manufacturers, and increasing the tax on the insurance industry. The overall plan was revenue neutral. The proposal was not well received, the principal complaint that it unfairly picked winners and losers, and was particularly burdensome on the insurance industry in Michigan. A 15% personal property tax credit for manufacturers was ultimately passed in late 2005,[24] but the rest of the plan was not enacted.

In March of 2006, as the fall elections were approaching, the Republican controlled legislature passed a bill to repeal the SBT that the Governor vetoed.[25] The stated reason for the repeal was that it was irresponsible to repeal the tax without a plan to replace the revenue. A petition drive was then initiated to place the question of repeal of the SBT on the November 2006 ballot. The petition called for accelerating the repeal of the SBT to the end of 2007. The petition drive was successful, and allowed the legislature to subsequently pass a "veto proof" initiated law to repeal the SBT as of December 31, 2007.[26] The passage of this initiated law precluded the need to seek a vote of the people to approve the repeal of the SBT. It provides that "(t)he Department of Treasury shall prorate the liability for the tax imposed in under the single business tax as necessary to impose the equivalent of a tax at the rate of zero on business activity after December 31, 2007."[27] The law also encourages the legislature "to adopt a tax that is less burdensome and less costly to employers, and more conducive to job creation and investment."[28]

Subsequent to the passage of this legislation the general elections were held, and Democratic Governor Granholm won re-election for a second term. Mirroring the result in the U.S. Congress, the Democrats also took over majority control of the House, while the Senate remained narrowly in control of the Republicans. The increased influence of the Democrats in the Michigan legislature makes business tax cuts less likely in the 2007 session, and increases the potential for a business tax increase. While there is a general consensus that the state of the Michigan needs a tax structure more conducive to retaining and creating jobs, as well as one that reduces the burden of the personal property tax on businesses in the state, Michigan also faces serious fiscal challenges including a significant projected budget deficit for 2007 and 2008. Michigan has a constitutional balanced budget amendment, and a projected budget deficit therefore mandates either spending cuts or revenue increases to avoid deficit spending. The replacement for the SBT needs to balance these budget issues with the objective of encouraging job creation and investment.

"I GUESS THEY CAN'T REVOKE YOUR SOUL FOR TRYING"

A number of alternate replacement tax plans were developed in late 2006 after the legislation repealing the SBT was enacted. While the ultimate replacement tax is unlikely to completely conform to any of these plans, the following review of the proposals developed in 2006 is illustrative of some of the issues faced in the SBT reform debate.

MICHIGAN CHAMBER PLAN

The Michigan Chamber of Commerce developed a proposal using four "guiding principles," and required that the tax be broad-based with a low rate, result in a net tax reduction, be simple to administer and easy to comply with and be similar to other states' tax structures. The result was a combination Business Income Tax and Business License Tax. The plan also includes a 50% personal property tax credit for all industries. Overall, the Chamber's plan would propose a $500 million tax cut.

The Business Income Tax rate would be 3.05%. This tax would be paid on the excess above $350,000 of gross receipts. It would include a $150 minimum tax on businesses with at least one employee. Unitary filing would be mandatory for the Business Income Tax. For unitary filers, the "Joyce" nexus standard applies, meaning that if one member has nexus in Michigan it does not create nexus for any other member of the unitary group in the state. The Business Income Tax is apportioned based on a 100% sales factor with no throwback rule. Special apportionment rules will be determined for certain industry groups such as financial institutions, transportation companies, or insurance companies, similar to the SBT.

The general Business License Tax rate would be 0.48% and 0.24% on wholesale and retail companies. A $2 million per return cap would apply. The License Tax would allow Michigan to assess all companies that do business in Michigan whether a company has its primary operations in Michigan or is an out-of-state company with a sales force in Michigan. The Business License Tax would be imposed at the affiliated group, consolidated, and unitary levels. Special apportionment rules would also apply for industries such as insurance companies, transportation companies, banks, etc.

One controversial aspect of the Chamber's plan concerns the application and constitutionality of the $2 million cap. Some argue that the largest taxpayers provide the greatest benefits to the economy and therefore deserve the greatest tax relief, while others argue that large companies can afford to pay more. Another interesting aspect of the Chamber's plan is the fact that a business organization is promoting the adoption of a unitary income tax, while normally governments promote unitary taxation and business interests oppose it. In addition, the administration has stated its opposition to granting utilities the personal property tax credit proposed in the plan.

DETROIT CHAMBER PLAN

The Detroit Chamber of Commerce issued a proposal in 2005 calling for an annual Michigan Business License Fee that would be based upon sales made by a business in Michigan to replace the SBT. These fees range from $1,000 to $1 million and would be determined based on the numerator of the SBT sales factor. The effective rate varies from about 0.2% to 0.5%. The maximum tax is set at $1 million, which raises question regarding a tax "cap" similar to those presented by the Michigan Chamber of Commerce proposal. This proposal, like the Michigan Chamber of Commerce proposal, offers a $500 million tax cut. This plan, while more of

a conceptual framework than a fully developed replacement tax plan, states as its goals the simplification of tax compliance and the provision of a consistent revenue stream that grows with the economy.

GRAND RAPIDS CHAMBER PLAN

The Grand Rapids Chamber of Commerce developed a replacement tax proposal in 2006 that imposes a "margin" tax on Michigan business activity. It is similar to the Texas Margin Tax in that one takes the Michigan sales or service revenues less the cost of tangible personal property purchased for resale, manufacturing, leasing or cost of funds for financial institutions. The most fundamental difference between the Grand Rapids plan and the Texas tax is that the Grand Rapids Chamber did not propose an alternate deduction for compensation as exists under the Texas Margin Tax. The Grand Rapids tax proposal is therefore less favorable to service businesses. The Michigan Business Activity Tax (MBAT) would replace the SBT and the personal property tax. The MBAT will not be considered an income tax, therefore P.L. 86-272 would not apply, and instead Commerce Clause nexus standard would apply. The goal of the plan is to create a net business tax reduction, in turn, attracting and retaining more businesses. The rate is not to exceed 0.75%, however there is some doubt concerning whether this is realistic. There is a flat fee of at least $150 for businesses with at least one employee. A flat fee for filers with less than $350,000 in gross revenue would apply. Consolidated filing may be elected, however business activity would normally be determined on a single entity basis. This plan proposes a $390 million tax cut.

GOVERNOR'S PLAN

In December on 2006, Governor Granholm proposed the Michigan Business Tax (MBT), which is also described as a "factor tax" that includes an asset tax, gross receipts tax, and income tax component. The goals of the MBT is to allow Michigan to become more competitive in the marketplace, enact a fair, simple, and stable new tax, provide substantial personal property tax relief to industrial and commercial taxpayers, eliminate the tax on payroll, benefits and health care, preserve economic development tools, and spread the tax fairly amongst all types of business organizations. The plan would produce a net reduction of tax on Michigan businesses of $150 million, which will be shifted to out of state companies. Governor Granholm does not want any cuts to be taken from the education system, health care, or public safety funds. The tax would be levied upon the privilege of doing business and not on income or property. The rates imposed would be 0.125% for gross receipts, 0.125% for assets, and 1.875% for business income. Any taxpayer whose apportioned or allocated gross receipts are less than $350,000 would not have to file a return or pay the tax. The tax would be based on modified gross receipts and would be defined as "gross receipts" before apportionment or allocation. Under the legislation, if business income less dividends received is greater than zero, taxpayers must multiply that amount by 15 and add it to gross receipts. Generally, taxpayers with business activity that is taxable both in and out of the state must utilize a single sales factor apportionment formula. A taxpayer with no sales in Michigan would apportion its tax base using the average of its property and payroll factors. Special apportionment provisions would be imposed for spun-off corporations, transportation companies, and financial organizations.[29] The MBT estimates that 111,000 businesses will experience lower tax liabilities, while 34,000 will experience increased liabilities. It is important to note that no state imposes a tax on assets, and this portion of the tax raises the largest portion of revenue of the three components.

FAIR TAX AND OTHER SALES TAX EXPANSION PROPOSALS

The Fair Tax is by far the most ambitious proposal for expanding the sales and use tax. The Fair Tax would eliminate the state personal income tax, the SBT, the personal property tax, as well as the 6-mill state education tax, and replace them all with a retail sales tax on new goods and services with a tax rate that could reach or exceed 9%. Used goods and business-to-business purchases used in the production of goods and services would not be taxed. Some critics refer to the Fair Tax as a regressive tax since it would be imposed at the individual level. Because it proposes to increase the sales and use tax rate which is set by the Michigan Constitution, this proposal would require a state constitutional amendment.

Numerous other suggestions for expanding the sales tax base to services have been raised that would leave the tax rate at its current level of 6%. Proposals for expanding the sales tax to services are expected to be part of the SBT replacement debate, but are also expected to continue to be considered regardless of what structure replaces the SBT given the shift of the U.S. economy from a goods-based economy to a services-based economy.

"SOMETIMES THE LIGHT'S ALL SHINING ON ME"

There are many potential issues surrounding the enactment of a receipts-driven tax, as proposed by the Michigan and Detroit Chambers, and by the Governor. Ohio recently enacted the Commercial Activity Tax ("CAT") which is based on Ohio gross receipts. Although not fully phased in, a number of concerns have arisen with respect to the viability and constitutionality of the CAT. The following are some examples:

- Economic nexus - Ohio adopts an aggressive theory that every company with sales over $500,000 is subject to tax, even without any in-state activity. The constitutionality of this rule under the Commerce Clause is uncertain.

- Taxation of Services - The very concept of taxing services is unique, since most services are not subject to sales tax, and applying Ohio's rule of taxing services based on the location of the purchaser and not the service provider is very challenging.

- Forced Combined Reporting - Ohio adopted a very aggressive rule requiring affiliated taxpayers to file a combined returns and imposing joint and several liability on all affiliates in a combined group. They also established a "consolidated election" which is required to avoid the taxation of intercompany sales of goods and

services. The complexity and burden of combined filing on large businesses with multiple separate business entities in significant.

- Taxation of Warehousing/ Distribution Activity - Companies that warehouse products in Ohio for shipment outside the state face a significant tax burden, and the rules for taxability and where delivery taxes place are complex. Law changes are being studied but they raise Commerce Clause constitutional issues.

- Trading activities - Any business that engages in any sort of trading, such as utilities (gas, oil, electricity), or commodities (grain, produce) face significant issues in terms of the measure and burden of the tax and how to determine what receipts are taxable in Ohio.

- Financial transactions - Even more complex than trading physical goods, financial trading (futures, options, hedging, foreign currency), and other financial transactions (repurchase agreements, factoring, reinsurance, etc) face huge challenges in terms of measurement and sourcing.

- Expense reimbursements/agency issues - Major issues exist in determining when income received on behalf of another or reimbursements for expenses constitute taxable receipts. The taxation of these items results in multiple taxation or "pyramiding" similar to the issues in the taxation of distribution, trading, or financial transactions.

- Quarterly reporting burdens - Determining taxable receipts on a quarterly basis is especially challenging for companies other than retailers that do not collect and remit sales tax, and are only set up currently to do annual reporting with quarterly estimates.

- Taxability of Food - While food sales are currently taxed under the CAT, there is uncertainty regarding the legality of taxing food under the state constitution and political efforts to exempt food transactions.

- Exemptions - The CAT has numerous exemptions whose scope and limitations have yet to be addressed, since the CAT is a novel tax without limited precedent from other states.

- Transition and Credits - The five-year phase out of the franchise tax and complex rules for credits that carry over from the franchise tax add to the complexity of the CAT implementation.

- Cross-industry equity issues - Serious dissent continues to exist in Ohio regarding the wisdom of enacting the CAT and the shifting of tax burdens between industries that it has created. Calls for its repeal began as soon as it was enacted and continue today.

ISSUES WITH A MARGIN TAX

Like a gross receipts based tax, a tax structure similar to the one recently implemented in Texas (referred to as the "Margin" Tax) and proposed by the Grand Rapids Chamber is also very controversial. The following lists some of the potential issues identified related to the Texas Margin tax:

- Difficulty in accounting for deferred taxes and accrued liabilities for such a unique tax due to the significantly different base.

- Difficult to evaluate cost of goods sold (COGS) components and focus on the availability of specified COGS items due to differing qualifiers related to "production or acquisition" or "directly used in production." Additionally, how should one go about capturing the financial data necessary to compute and document the cost of goods sold deduction?

- Difficult to determine flow through entities' tax bases and apportionment formulas, as well as exclusion of flow through entity revenue, cost of goods sold, compensation and receipts factors from "parent" computations.

- Difficult to determine combined group and whether combination is before or after the tax computation (i.e., if rates differ by industry, can these be applied by company or after combination?).

- Uncertainty and increased complexity in applying the economic nexus standard and in choosing apportionment and sourcing methodologies for certain services.

- Ambiguity surrounding whether NOLs are permitted to be used against the Margin Tax, and, if not, whether (and how) accumulated NOLs can be used under temporary credit.

- As enacted, the law lacks clear definitions for all major components of the tax including exemptions/exclusions.

- State agencies face several challenges including developing computer systems to capture combined reports, training audit and tax policy personnel in unique and complex tax structures, timely drafting regulations, and interacting with industry and accounting firms to assist with complex issues.

ISSUES WITH EXPANDING THE SALES TAX TO SERVICES

Much criticism has stemmed from the suggestion of applying a sales tax on services as outlined in the Fair Tax proposal. The largest problem noted is the inherent inequity of "pyramiding" through the taxation of business-to-business transactions. It is noted that the taxation of business-to-business services would tend to punish small businesses, because those companies are most likely to need to outsource services to other businesses and least likely to operate in a vertically integrated fashion. This detriment to small businesses is a major hurdle in the taxation of services. The taxation of health care is another controversial issue. Excluding business-to-business and health care services would eliminate roughly two thirds of the services that could be taxed. The inevitable debate over inclusion or exclusion of other services, as well as the definitional challenges, are other hurdles in the consideration of an expansion to the sales tax base.

ISSUES WITH AN APPORTIONED ASSET TAX

There are also serious questions regarding the constitutionality of a tax imposed on assets and apportioned based on sales in the state. A review of a similar constitutional challenge to the SBT considered by the U.S. Supreme Court in *Trinova*,[30] suggests how the courts might analyze an apportioned asset tax under the commerce clause.

In *Trinova*, the Court rejected a challenge to apportionment of the compensation portion of the SBT base by concluding that the SBT is not a tax on compensation, but an indivisible tax upon a bona fide measure of business activity–the value added–not three separate and independent taxes on compensation, depreciation, and income. Unlike the SBT, the new Michigan Business Tax mixes three unrelated measures: assets, net income times 15, and gross receipts (and there is no suggestion that this aggregate number measures anything in particular). The Granholm administration's own descriptions of the plan describe it as three taxes with three separate rates, and while they may refer to the tax as having a single base, the lack of any relevance to that base in the aggregate, coupled with their own descriptions, strongly suggests that it would be viewed as three separate taxes by a court. Therefore, a constitutional challenge to a sales apportioned asset tax may succeed because under *Trinova*, each component of the tax must be tested for constitutionality separately.

It could be argued that a tax on net assets is comparable to a net worth tax, and net worth taxes are recognized as being able to be apportioned. However, while there may be some similarities between net worth and net assets, the accounting concept of measuring net wurth is very different, because the latter considers liabilities and reserves. Thus, one can easily understand why "net worth" is not subject to precise geographic measurement, while assets are. The concern is that the tax on assets is simply a property tax on tangible and intangible property, and taxing property outside of Michigan based on sales in Michigan is discriminatory.

Other technical problems were also noted with the initial Michigan Business Tax proposal. Section 91 of the MBT proposal provides that if the tax is considered subject to P.L. 86-272, the income *and* asset portions of the tax are severed, and it converts to a 0.375 percent tax on gross receipts. This is the same result which occurs under that provision if the apportionment of the asset ur income measures of the tax are held unconstitutional. The MBT is very likely to be considered a tax subject to P.L. 86-272. If viewed as three separate taxes, it is clear that the income tax is subject to P.L. 86-272 as a tax "on or measured by income." While the plan apparently seeks to avoid this result by combining the three taxes together into a single base, for the same reasons noted above, it is difficult to see this being sustained.

THERE WERE SEVERAL OTHER TECHNICAL ISSUES WITH THE MBT PROPOSAL:

Throwback: There is serious concern among in-state business interests regarding the proposed throwback rule under the MBT. The SBT had a throwback rule until 1998, when it was repealed. Local business interests view this as bad tax policy, in conflict with the goal of making Michigan a more attractive place to make investments and create jobs, since it would impose a burden on companies that manufacture and export products from Michigan and operate in the global marketplace.

Combination: While the initial MBT proposal adopted the existing SBT combination rules, there has been some consideration of whether a unitary filing method should be adopted under the new tax structure. Adopting the current combination provisions would clearly simplify the transition to the new tax, and could also prevent an initial loss in revenue from taxpayers being more likely to file on a unitary basis when it is beneficial but resisting unitary combination when it results in a higher tax. These factors are being weighed against the consideration of capturing more revenue from out of state business in the long run under a unitary methodology.

Tax versus book measure of assets: There is some question regarding whether the proposed tax basis measure of net assets is more appropriate than a GAAP-based measure of assets. Most states that impose net worth taxes use a company's net worth for accounting purposes under GAAP, while only a couple of states (i.e., Delaware, Maine) use a tax balance sheet. The tax basis of assets may be easier to identify and audit for smaller businesses that do not prepare financial statements in accordance with GAAP, but Michigan appears to be concerned with conformity with other states and also wants to align the asset measure of the tax with net wurth taxes as much as possible.

Sourcing of interest income: There is some question regarding whether interest income should be included or excluded under the sales factor for non-financial organizations. Both the gross receipts and income measures of the initial MBT proposal would include interest income in the base, but the sales factor provision of the initial proposal was unclear as to whether interest was included, and if so, how it would be sourced.

Intercompany sales: Another technical issue under the SBT is whether intercompany sales should be taxed under the gross receipts measure of the tax. Outside of the context of a combined return it would appear that these sales would generally be included in both the gross receipts base and in the sales factor of the tax as originally propused.

Asset included in base: There are a number of questions regarding the inclusion of various assets in the asset measure of the base. One example, foreign assets, raises a question nf the jurisdictional reach of the tax, while another, deferred tax assets, raises other questions of the tax policy.

Treatment of flow through entities: Because the definition of "person" under the MBT as originally introduced adopted the SBT definition that includes partnerships and other flow through entities, another technical problem arises with double counting inherent in all three measures of the tax since the income, assets, and sales of such entities would also be included in the base of

the owner. As with the SBT, it is logical for partnership and other flow-through entity components to be excluded from the base since those entities would be taxed at the entity level.

Holding companies: Similar to the treatment of flow through entities, there is a concern that under the MBT holding companies could be subjected to tax based on the value of their assets including the stock of subsidiaries, which would potentially impose substantial tax burdens on Michigan based holding companies.

Credit companies as financial organizations: There is a question of whether credit companies should be included in an expanded definition of financial organizations, in order to permit the current market based sourcing for receipts of financial organizations under the SBT to apply to a broader category of entities under the MBT.

Definition of gross receipts: It is recognized that the current SBT definition of gross receipts has various ambiguities, and may not be the best model to adopt for a tax heavily dependent on the measurement of gross receipts.

Services sourcing: The SBT sources service receipts based on the "cost of performance" or origin method as opposed to the "market" or destination method. The cost of performance method maximizes the burden of the tax on local service providers that service a national market from a base of operations in Michigan. Several other states have moved to a market sourcing rule for services to reduce the burden on in-state service businesses and encourage those businesses to locate in their states, and it is expected that this issue will be debated as this proposal begins to receive further consideration.

Failure to provide smoothing for losses: The MBT proposal includes income in the tax base only if positive, and gives no relief for losses. This punishes businesses in cyclical industries (like the auto industry) who experience large swings from income to loss, as well as companies that have fluctuations in income as a result of the application of the tax rules to their facts. While the intent of a broad base may not support allowing losses to reduce the other measures of the base, we expect some discussion to occur relative to the merits of a carryforward/carryback mechanism to smooth the effects of fluctuations in income by allowing current losses to offset prior year or future income, and result in the tax of true "net" income.

Treatment of LLCs in definition of "person": The current SBT definition of "person" fails to specifically reference LLC's in the definition. While the definition of "corporation" includes an entity that has elected to file as a corporation for federal tax purposes, and the definition of "partnership" has a similar provision, an ambiguity remains in the treatment of LLCs that elect to be disregarded for federal tax purposes. While the Department currently has a policy to follow the federal status of an LLC, it is not clear that a disregarded LLC that otherwise meets the criterion to qualify as a "person" should not be taxable at the entity level. This definition could be clarified to specify that "person" includes an LLC taxed as a corporation or partnership for federal tax purposes, but an entity disregarded for federal tax purposes and treated as a division of its owner is treated in the same manner for SBT purposes.

"JUST KEEP TRUCKIN' ON"

Throughout its lifespan, the SBT has been described in many ways. At its onset, it was considered a viable revenue producing source, and at its demise, as overly burdensome and complex. It served its purpose for many years, but at this critical juncture, with a struggling Michigan economy, it is of enormous importance to reach an agreement concerning the adoption of an effective replacement plan. The decision will require a careful weighing of business, government and citizen interests, and will hopefully work towards balancing budget issues and creating new jobs. As taxpayers, policy makers, and administrators take a hard look at the different options presented, and as these options are further clarified, the next chapter in Michigan's business tax saga will be written.

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ENDNOTES

1. Jones and Laughlin Steel Corp v. Department of Treasury, 145 Mich. App. 405 377 N.W.2d 397 (1985).
2. 1987 Mich. Pub. Acts 39.
3. Trinova Corp. v. Michigan Department of Treasury, 433 Mich. 141; 445 N.W.2d 428 (1989).
4. Trinova Corp. v. Michigan Dept. of Treasury, (89-1106), 498 U.S. 358 (1991).
5. *Id.* at 377.
6. Caterpillar, Inc. v. Department of Treasury, NOS-84-9664-CM, 87-11109-CM (1989).
7. Caterpillar, Inc. v. Department of Treasury, 188 Mich. App. 621; 470 N.W.2d 80 (1991).
8. M.C.L. § 208.27a(6).
9. Michigan House Fiscal Agency FISCAL FORUM, Vol 3, No 2, 10/1/97, p. 3.
10. Caterpillar, Inc. v. Department of Treasury, Revenue Division 440 Mich. 400; 488 N.W.2d 182 (1992).
11. Thiokol Corp. v. Roberts, 858 F. Supp. 674 (1994).
12. 26 U.S.C. § 7421(a).
13. Thiokol Corp., Morton Intern., Inc. v. Roberts, 76 F.3d 751 C.A.6 (Mich.) 1996; Thiokol Corp. v. Revenue Div., Dept. of Treasury of Michigan, 117 S.Ct. 2448 (Mem.) U.S. (1997).
14. Jefferson Smurfit Corp. v. Department of Treasury, No 120925 (Docket) (Mich. Dec. 28, 1999).
15. Jefferson Smurfit Corp. v. Department of Treasury, 248 Mich. App. 271; 639 N.W.2d 269 (2001).
16. Dana Corp v. Department of Treasury, No. 129573 (Docket) (Mich. Jun. 9, 2004).
17. Dana Corp v. Department of Treasury, 267 Mich. App. 690; 706 N.W.2d 204 (2005).
18. Dana Corp v. Department of Treasury, 474 Mich. 1111; 711 N.W.2d 748 (2006).
19. Gillette v. Michigan Department of Treasury, 198 Mich. App. 303, 497 N.W.2d 595 (1993): Guardian Industries Corp v. Dep't of Treasury, 198 Mich. App. 363; 499 N.W.2d 349, *lv app den* 444 Mich. 943; 512 NW2d 846 (1994).

20. Revenue Administrative Bulletin 1998-1 (February 24, 1998).
21. Little Caesar Enterprises, Inc. v. Department of Treasury, 226 Mich. App. 624; 575 N.W.2d 562; (1997); Mobil Oil Corporation v. Department of Treasury, 373 N.W.2d 730, (1985); Realtron Corporation v. Michigan Department uf Treasury, MTT No. 173926, 2001 WL 1818094; Zenith Data Systems v. Department of Treasury, Mich. App. 742; 555 N.W.2d 264, 218 (1996).
22. Perry Drug Stores, Inc. v. Department of Treasury, 229 Mich. App. 452; 582 N.W.2d 533; (1998); J.C. Penney Co., Inc. v. Department of Treasury, 171 Mich. App. 30; 429 N.W.2d 631, (1988); Town & Country Dodge, Inc. v. Department of Treasury, 420 Mich. 226; 362 N.W.2d 618, (1984).
23. Guardian Photo, Inc. v. Department of Treasury, 243 Mich. App. 270; 621 N.W.2d 233, (2000).
24. Public Acts 290 - 293 of 2005.
25. 2006 House Bill 5743.
26. Public Act 325 of 2006.
27. Public Act 325 of 2006, Section 2.
28. Public Act 325 of 2006, Section 1.
29. 2006 House Bill 6676.
30. *Trinova Corp., supra* note 3.

PITFALLS OF PREPARING TAX RETURNS FOR POTENTIAL CRIMINAL DEFENDANTS

Neal Nusholtz

Illegal profit-making activities are not exempt from tax. Taxpayers who engage in illegal activities have a problem filing their tax returns. If their activities are not yet known to the government, filing a return could trigger an investigation and be used to convict them. Preparers of tax returns for those individuals have three objectives: (1) compliance with the tax laws; (2) not damaging the client; and (3) not damaging themselves.

Compliance with the tax law is actually simple. All you need is a document signed under penalties of perjury with sufficient information to compute the tax.[1] Satisfying the other two objectives at the same time is much harder.

For example, an illegal activity can be omitted from a valid tax return, but sometimes "nothing" means "something". Prosecutors have argued to juries that, in conjunction with large income and other evidence of crime, only an illegal activity could explain the omission. The same inference has been drawn from the not filing at all:

> ...the evidence of a lack of federal tax filing (or underreporting) in combination with proof of valuable tangible possession or extravagant purchases creates the inference that the defendant does not possess a legitimate source of income to report his affluent lifestyle, and therefore, the income must originate from narcotics operations. *U.S. v. Carter*, 969 F2d 197, 201 (6th Cir. 1992)

Asserting a "Fifth Amendment privilege against incrimination" on the tax return might avoid judicial inferences of concealed activity, but that assertion would likely cause an investigation.

In 1973, an attorney filed an anonymous complaint in a Richmond, Virginia Federal District Court. His client had late 1970 and 1971 tax returns to file but was, "fearful of filing same upon the ground that the returns will be used and admitted as evidence against him in a non-filing charge." The attorney sought an order preventing the government from using his client's filed tax returns as evidence against the client in a criminal action. The court denied the request. The Court of Appeals for the Fourth Circuit affirmed saying:

> In the event of any subsequent criminal prosecution, the taxpayer may then assert what Fifth Amendment rights, if any, he may have against the prosecution's use of any return he may have filed. *Doe v. Boyle*, 494 F2d 1279, 1280 (4th Cir. 1974).

The Fifth Amendment appears to offer no protection because disclosure of an illegal business on a tax return is not compulsory. *Garner v. U.S.* 424 U.S. 648 (1976). In *Garner*, the court held that disclosure on the tax return of the taxpayer as a gambler was voluntary. Therefore, it was admissible as evidence of illegal gambling.

Suppose a taxpayer were to report illegal income on the front page of the Form 1040 under "miscellaneous income." This was suggested as a solution in *U.S. v. Johnson*, 577 F2nd 1305, 1311 (5th Cir. 1978). It didn't work. A prosecutor successfully argued to a jury, over defense counsel's objection, that large amounts of income reported under "miscellaneous," can only be explained by an illegal source of drug income. *U.S. v. Barnes*, 604 F2nd 121 (2nd Cir. 1979).

Once the client discloses an illegal activity to the preparer, the genie can't be put back in the bottle. No federal accountant client privilege exists in criminal matters. Statements made to an attorney or an accountant in the course of preparing tax returns are not protected by any privilege and can be obtained by the government from the preparer.[2] Worse, if a tax preparer conceals an illegal activity on a tax return, he or she is exposed to being accused of committing or conspiring to commit any one of the following crimes: (1) money laundering (18 U.S.C. 1956); (2) engaging in financial transactions with the proceeds of specified unlawful activities (18 U.S.C. 1957); (3) conspiracy to defraud the federal government (18 U.S.C. 371); (4) corruptly impeding the administration of the Internal Revenue Code (26 U.S.C. 7212); and (5) willfully aiding or assisting in the preparation of any fraudulent or false document relative to any matter arising under the revenue laws (26 U.S.C. 7206(2).

Under certain circumstances, concealment of an illegal activity can occur when the return and the source of income are truthful and complete. This happened in a criminal case against an Atlanta tax attorney named Gerald Popkin. In March 1985, Popkin got a call from a former client, Stephen Musick. Musick had served a prison sentence for drug dealing. While in prison, Musick made a deal with government agents to set up a sting on Popkin.[3]

Musick met with Popkin wearing a wire and told Popkin he had made approximately $200,000 selling cocaine in prison in 1983 and 1984. The money, according to Musick, was held in an offshore account by a company called Mid-American Financial. Musick wanted to show the unreported cocaine money. Popkin recommended that Musick: (1) form a corporation to hold the money; (2) have Mid-American transfer the $200,000 to the corporation in exchange for corporate stock; (3) buy the corporate stock from Mid-American for $3,000 – $10,000; and (4) liquidate the corporation in the year of his choosing to retrieve the money. Under the plan, Musick could report the income in the year of liquidation as capital gains from the sale of stock without having to mention that the money was from cocaine.

Popkin was convicted in the lower court for corruptly impeding the

administration of the Internal Revenue Code under I.R.C. § 7212. The 11th Circuit affirmed. *U.S. v. Popkin*, 943 F.2d 1535 (11th Cir. 1991) *cert denied* 112 S Ct 1760 (1991). In the absence of a money laundering statute,[4] the issue was whether the term "corruptly" covered Popkin's conduct. The Court said that corruptly "[forbids] those acts done with the intent to secure an unlawful benefit either for oneself or for another." (Popkin at 1540). The Court of Appeals said:

> The effect of all these maneuvers would be more than just to disguise the source of the money thus repatriated. It would also place in Musick's wholly owned corporation the power to determine when, if ever, the $200,000 earned in 1983 and 1984 would be reported for income tax purposes. The income tax laws require annual reporting of all income in the year earned. The entire system is built on the basis of annual reporting, and any arrangement that permits a taxable entity to avoid reporting income in the taxable year when earned has the effect of skewing the system and thus impeding or obstructing the due administration of the tax laws. (Popkin at 1541.)

What Popkin did was create a second tax liability in a different year with a different source of income. This created the appearance of a decoy year that could be used as evidence that Musick's had reported $200,000 of income from a legitimate source (capital gains from liquidation of a corporation). This would be like taking any year, reporting $200,000 from whatever source and saying, "There is the income. It's not from cocaine." From a practitioner's standpoint, Popkin was not helping his client comply by having income reported in the correct years.[5]

So what does this all mean? Evidently the courts seem have it both ways: in tax cases where a criminal defendant claims he should be exempt from filing because of compelled incrimination, the claim is rejected, yet in non-tax cases the returns are always allowed in as incriminating evidence. This creates an ethical dilemma and a technical challenge for criminal lawyers and tax preparers who want their clients in compliance with the law. In some respects, perhaps the lesson is not complicated: tax returns should always be prepared with an eye toward their admission in court.

Neal Nusholtz a practicing attorney in Birmingham, Michigan, has a broad tax, estate & corporate practice. He has represented hundreds of taxpayers in disputes with the IRS. He frequently works with criminal defense attorneys. In 1999, Corp! Magazine listed Neal as one of the Top Ten Business attorneys in Southeastern Michigan.

ENDNOTES

1. Edward A. Cupp, 65 TC 68 (1975). Lies on a tax return, to be actionable, must be material and are considered material if they might interfere with an investigation. *U.S. v. Fawaz*, 881 F2d 259 (6th Cir. 1989).
2. United States v. Lawless, 709 F.2d 485, 487-88 (7th Cir. 1983); United States v. Bornstein, 977 F.2d 112, 116-17 (4th Cir. 1992); In re Grand Jury Investigation, 842 F.2d 1223, 1224-25 (11th Cir. 1987); United States v. Davis, 636 F.2d 1028, 1043 [47 AFTR 2d 81-941] (5th Cir. 1981), Frederick v. U.S., 182 F3d 496 , (7th Cir. 1999).
3. Popkin had misrepresented the source and amount of Musick's illegal drug income on Musick's 1977 return.. He also was selling illegal tax shelters. Popkin v. U.S., 699 F Supp 893 (USDC No, Dist. of GA, Atlanta Div. 04/21/1988).
4. Money laundering was not a crime until 1986 (18 U.S.C. §1956)
5. Under a Treasury Regulation known as Circular 230 (regarding practice before the Treasury Department), once retained a practitioner is to have told the client if he has not complied with the tax laws and (since 2002) the consequences of not fixing it. Failure to do so exposes the practitioner to possible censure, suspension or disbarment from practicing before the Internal Revenue Service (31 CFR Sections 10.21 and 10.50).

PET TRUSTS: ESTATE AND TAX PLANNING CONSIDERATIONS UNDER MICHIGAN LAW

Eric Thomas Carver

It is becoming an increasingly common practice for pet owners to provide for the well being of their domestic animals upon their death or disability. Some pet owners simply make a gift of their pet in their will or trust, while other pet owners set up a trust to provide for their domestic or pet animal's needs after their death. While most states have laws that both allow pets to be named as beneficiaries of trusts and provide for enforcement of the trust by someone acting on the pet's behalf, Michigan has only had such a law since 2000.[1] This article will give an overview of this type of trust under Michigan law, and will discuss some of the tax considerations associated with a pet trust.

Overview of Michigan Law

A pet trust is a legally sanctioned arrangement providing for the care and maintenance of one or more domestic or pet animals in the event of the grantor's disability or death. Michigan law specifically permits a pet owner to set up a trust for the care of his or her domestic or animal pet(s).[2] The trust can be valid up to 21 years, whether or not the terms of the trust contemplate a longer duration.[3] Michigan law also provides that the trust will terminate upon the death of the last pet covered by the trust.[4]

Pet trusts can be included in the pet owner's (or grantor's) revocable trust agreement, or can be a separate trust document. The grantor can designate the institution or person that would serve as trustee in the trust document, or a fiduciary may be appointed by the court.[5] The trustee can invest and manage the funds and monies that would provide for the domestic or pet animal's care and keep.[6] In the trust, the grantor can either designate a specific guardian of the domestic or pet animal or permit the trustee to make that determination.

Unlike a will, a trust can provide for pets immediately, since the pet owner determines when his or her trust becomes effective. When a trust is created for pets, money is set aside to be used for the pet's care, and trustees are specified to control the funds. Pet trusts can include provisions for food, licensing, maintenance, shelter, and veterinary care. In addition, the grantor can indicate that a pet shall be provided with adequate exercise and companionship, be kept comfortable and as free of pain as possible, be mercifully euthanized in the event of a terminal illness, and how the pet's remains will be disposed of upon death. A trust created separately from the will carries certain benefits: it can be written to exclude certain assets from the probate process so that funds are more readily available to care for a pet, and it can be structured to provide for a pet even during a lengthy disability.

Michigan law liberally construes the grantor's language so that a pet trust will be considered valid, as opposed to an honorary trust or precatory language.[7] One of the primary purposes of the Michigan statute is to bring poorly-drafted bequests under the pet trust statute, based on the rebuttable presumption that the grantor's *primary* intent in gifting the pet and/or any funds to an individual is to provide for the care of the animal.[8] Michigan law goes so far as to render extrinsic evidence admissible to determine the grantor's intent.[9] Therefore, in the event the language of the trust is ambiguous or unclear, Michigan courts will look beyond the trust to ascertain the grantor's wishes.[10] Therefore, if the pet owner intends to make an outright bequest of a pet or a sum of money to a beneficiary, the provision should *expressly* state that a pet trust is *not* intended.

Upon the death of the last pet covered by the trust, under Michigan law the trustee is directed to distribute the remaining unexpended income and principal in the following order:

- As directed in the trust instrument.
- If the trust was created in a nonresiduary clause in the transferor's will or in a codicil to the transferor's will, under the residuary clause in the transferor's will.
- If no taker is produced by the application of subparagraph (i) or (ii), to the transferor's heirs under section 2720.[11]

Careful thought should be given to prevent disgruntled heirs the opportunity and standing to reduce the amount passing to the pet trust and make any other challenges to the trust. To limit potential litigation, the grantor should consider expressly designating a remainder beneficiary of the pet trust with interests that would not be adverse to expending monies for the care of the pet, such as an appropriate nonprofit organization. Typically, the recipient of the remaining funds would be a charity or the grantor's heirs.

What is a reasonable amount to leave?

The answer to the question of how much should be designated to a pet can vary widely, depending on the age, health, estimated lifespan, and number of pets involved. For example, the funds needed to care for a young horse will certainly be much greater than those needed for an aged cat. It also depends on how much care the grantor expects the trust to provide. If the domestic or pet animal gets cancer, diabetes, hip dysplasis, or some other ailment, what kind of treatment should be provided? And should it be provided indefinitely or for a limited period of time? The cost of cremation and burial may need to be considered.

Just as leaving too much money in the trust can cause problems with heirs or potential heirs, leaving too little could compromise the care of the animal. The trust should stipulate the frequency

and amounts of payments, as well as whether amounts should be adjusted for inflation.

Under Michigan law, the probate court is authorized to reduce the amount of the property transferred if its determines that amount substantially exceeds the amount required for the intended use, and the amount of this reduction, if any, passes in the same manner as if the pet trust terminated.[12] As noted above, if disgruntled beneficiaries (who could be heirs) and the court do not agree that the pet should have as high a standard of living as the grantor, the amount passing to the pet trust may be reduced. The drafter of a Michigan pet trust should be cognizant of this possibility and the potential for litigation by disgruntled heirs and, if advisable, insert a clause providing that if a court determines that the designated amount is too much, then the excess will be distributed such that the challenging parties would not benefit (e.g., to a nonprofit organization).

Finally, the payment of a fee to caretakers and/or trustees for their time and effort should be considered.

PROBATE FILING REQUIREMENTS

Except as required by a court or the terms of the pet trust, Michigan law provides that the caretaker-trustee is excused from making filings, reports, registration, periodic accountings, separate maintenance of funds, appointments, or fees normally associated with a fiduciary relationship.[13] It appears that the Michigan statute places more trust in the caretaker-trustee than a trustee of a traditional trust, perhaps based on the assumption that pet trusts will be modest in amount and should not be burdened with the expense of meeting such duties. Nonetheless, whether this statutory relief is appropriate depends on the grantor's intent – that is, how much the grantor trusts the designated caretaker-trustee.

TAX CONSIDERATIONS FOR PET TRUSTS

If the client decides that a pet trust is the appropriate estate planning option to take, the taxes for pet trusts relate to the actual funds allocated for the care of the pet(s). How they are taxed is based on how the pet and its care are represented in a trust. The actual receipt of a pet (property) or funds for its care, by gift, bequest, or inheritance is not an event that is subject to federal income taxation. However, if a trust for the benefit of an animal is valid under state law, like Michigan, the trust itself will be subject to federal and state income taxation. If the net taxable income from the pet trust exceeds $100, the trustee is generally required to file an income tax return and pay any income taxes.

ESTATE TAXES

Under current federal uniform transfer tax law, a decedent may, through a combination of taxable gifts made during the decedent's lifetime or passing at death through the decedent's "gross estate", transfer up to a certain amount to nonspouse/noncharitable beneficiaries without incurring federal estate or gift taxes. Under the current statute, for gift tax purposes, this "exemption" amount is $1 million. For estate tax purposes, the exemption amount is currently $2 million, but will rise to $3.5 million in 2009; and in 2010, the estate tax is repealed, only to return again with a $1 million exemption (adjusted for inflation) in 2011.

Within this tax framework, any amount passing to a Michigan pet trust by reason of the grantor's death will generally be included in his or her gross estate.[14] This conclusion is supported by Revenue Ruling 78-105, where the Service ruled that no portion of the amount passing to a valid trust for the lifetime benefit of a pet qualifies for the charitable estate tax deduction, even if the remainder beneficiary is a qualifying charity.[15] With that understanding, the relatively wealthy pet owner should consider how the taxes attributable to such a trust should be paid under the federal and state apportionment rules.

INCOME TAXES

Under the federal income tax law, if the caretaker is considered the beneficiary of the trust (which is the case with a traditional legal trust for pets), then under Section 661, the trust is entitled to deduct the amount of "distributable net income" paid out to the caretaker, and the caretaker is required to recognize this taxable income on his or her own income tax return. When all is said and done, either the trustee or the caretaker must pay the income taxes, depending on whether the taxable income is accumulated or distributed each year. As a result, any trust provisions intending to make the caretaker whole should also take into account potential tax consequences.

However, a problem arises in the income taxation of a pet trust. An animal is not a beneficiary recognized by the Service and, therefore, cannot be taxed.[16] A caretaker of the domestic or pet animal could not be charged with the tax liability because the caretaker serves only as an agent of the animal and does not consume the distributions for his or her own benefit (similar to a court appointed guardian of a minor or incapacitated person).[17]

Therefore, Revenue Ruling 76-486 provides that if the pet is considered the beneficiary of the trust (which would be the case under Michigan law), the trust would receive no income distribution deduction for such distributions and would be required to pay income taxes.[18] Nor would the trust qualify as a charitable trust, even if the remainder beneficiary is a qualifying charitable organization.[19] In summary, the trust would be taxed as a complex trust that has not made any distributions.

CONCLUSION

Michigan law and proper estate planning facilitate a method to provide for those whom we want to comfort after we die and for those who have comforted us, including our pets. Pets provide unconditional love and steadfast loyalty. Therefore, the benefits of having a pet trust are simply the peace of mind of knowing that a domestic or pet animal that you care about is going to be cared for once you are gone.

However, keep in mind that committing a substantial amount of money or property to a trust for the domestic or pet animal's benefit may prove to be controversial from the point of view of a relative or heir. Moreover, trusts are legal entities that are relatively expensive to administer and maintain – all of which underscores the need for careful estate planning. By using a properly constructed traditional trust or a separate pet trust, you may carry out your client's intent to protect his or her non-human family members.

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ENDNOTES

1. M.C.L. § 700.2722, effective April 1, 2000.
2. M.C.L. § 700.2722.
3. M.C.L. § 700.2722(1).
4. M.C.L. § 700.2722(2).
5. M.C.L. § 700.2722(3)(d) and (g).
6. M.C.L. § 700.2722(3)(d) and (g).
7. M.C.L. § 700.2722(2).
8. M.C.L. § 700.2722(2).
9. M.C.L. § 700.2722(2).
10. SUZETTE DANIELS, AN INTRODUCTION TO PET IN WILLS AND PET EUTHANASIA, Michigan State University-Detroit College of Law (2004).
11. M.C.L. § 700.2722(3)(b).
12. M.C.L. § 700.2722(3)(f).
13. M.C.L. § 700.2722(3)(e).
14. Rev. Rul. 78-105, 1978-1 C.B. 295.
15. The trust provided for an annual payment for the benefit of the pet during its lifetime with the remainder passing to the charity. The Service concluded that the trust would have been classified as a statutory charitable remainder trust, qualifying for a partial estate tax deduction under I.R.C. § 2055(a), if the annuity had been payable to a "person" and not a pet. *See* I.R.C. § 7701(a)(1) (definition of "person") and Regs. §§ 1.664-2(a)(3) and 1.664.3(a)(3) (requiring that term payments be made to a designated person or persons to qualify as a statutory charitable remainder trust).
16. I.R.C. § 7701(a)(1).
17. Darin I. Zanove and Barbara Ruiz-Gonzalez, *Trusts for Pets*, THE FLORIDA BAR JOURNAL, Volume 79, No 11 (December 2005).
18. Rev. Rul. 76-4876, 1976-2 C.B. 192.
19. I.R.C. §§ 170, 664, and 7701(a)(1); Reg. §§ 1.664-2(a)(3), 1.664-3(a)(3).

UNITED STATES V. DETROIT MEDICAL CENTER: STIPENDS TO MEDICAL RESIDENTS DO NOT QUALIFY FOR FICA EXCEPTION

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The Federal Insurance Contributions Act ("FICA")[1] imposes taxes on all wages paid or received with respect to employment.[2] Under Section 3101(a) and (b), wages received with respect to employment are taxed at 6.2% for Social Security and 1.45% for Medicare. Likewise, employers are responsible for an identical tax on those wages. The term "wages" is defined in Section 3121(a) as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash."[3] Furthermore, "employment" is defined in Section 3121(b)(A) and includes "any service, of whatever nature, performed by an employee for the person employing him."

Section 3121(b)(10)[4] provides an exception from FICA taxes. Under Section 3121(b)(10), more commonly referred to as the "student exception," "services performed in the employ of a school, college, or university" are excepted from the definition of employment "if such service is performed by a student who is enrolled and is regularly attending classes at such school, college or university."[5]

The application of the student exception to stipends paid to medical residents was at issue in *United States v. Detroit Medical Center.*[6] In *Detroit Medical Center,*[7] the Government sought repayment of social security refunds that were previously granted to the Detroit Medical Center ("DMC").[8] The DMC sponsors a graduate medical education program ("GME") with Wayne State University.[9] The GME program supplies resident physicians to DMC hospitals.[10] These resident physicians are required to attend classes and provide patient care and are to receive stipends from the DMC.[11]

The DMC argued that the stipends to the medical residents fell under the student exception to FICA found in Section 3121(b)(10).[12] Additionally, the DMC posited that a "facts and circumstances" test be utilized. The Government countered and took the position that the stipends are to be considered "wages."[13] Relying on legislative and statutory history, as well as case law, the government argued that the student exception does not apply to the stipends paid to medical residents as a matter of law.[14]

Cognizant of the fact that this issue is currently being litigated in twelve cases nationwide, the court digressed into the current legal landscape of the topic.[15] The court noted the following: that the Eight Circuit is the only Circuit court to address a similar issue; "at least one other circuit, the 11th Circuit, will soon address the issue; only one district court has sided with the Government's position that medical residents, as a matter of law, cannot qualify for the student exception; and at least four other district court's have issued decisions that have [utilized a] . . . case-by-case analysis."[16]

Minnesota v. Apfel[17] is the seminal case in this area of the law. In *Apfel,* the Eighth Circuit found that medical residents in the GME program at the University of Minnesota qualified as students for purposes of Section 3121(b)(10). Since *Apfel,* two different approaches have been employed for these types of cases.[18] The first approach, a majority and the approach urged by the DMC, is that GME programs "may establish through a facts and circumstances inquiry that their residents qualify for the student exception" based on Section 3121(b)(10) or Treasury Regulation 31.3121(b)(10)-2.[19] The second approach, urged by the Government, relies on the statutory and legislative history of the student exception and general principles of tax and Social Security law to find that "medical residents, as a matter of law, do not qualify for the student exception."[20]

DMC urged the court to follow the recent case of *United States v. University Hospital Incorporated.*[21] In *University Hospital,* the Southern District of Ohio concluded that Section 3121(b)(10) requires a case-by-case analysis of the facts and circumstances of the stipends. The court, in opposition to *University Hospital,* disagreed and found that the language of Section 3121(b)(10) is "ambiguous as to whether medical residents may qualify for the student exception."[22] The court noted that the statute is ambiguous in many respects, namely "whether a medical resident may be considered a student; whether a GME program may be classified as a school, college or university; and . . . whether the services provided by medical residents may be considered services performed in the employ of the school, college or university."[23] Examining Treasury Regulation 31.3121(b)(10)-2, the court concluded that a definite answer to these crucial categorizations is lacking.[24] Unable to find certainty in either the statute or the regulations, the court stated, "[A] review of the statutory and legislative history is appropriate."[25]

Evaluating the statutory and legislative history, the court noted that Congress previously eliminated a medical intern and a self-employed

physician exception, widening the scope of FICA coverage. Armed with that information, the court found that "to exempt medical residents conflicts with Congress' intent to have young doctors covered by social security. . . ."[26] Furthermore, the court stated that medical residents have never qualified for the student exception.[27] Ultimately, the court accepted the Government's assertion that medical residents have traditionally been subject to FICA tax.[28]

Finally, the court noted that the development and expansion of GME programs lends "some weight to the argument for the expansion of the student exception to cover residents-in-training."[29] However, the court was unambiguous that changing the legislative landscape in regards to medical residents is a clear function of the legislation and not of the judiciary.[30]

As an alternative to the student exception, the DMC contended that the stipends were noncompensatory scholarships (and not "wages") and therefore exempt from FICA under Section 117.[31] In response, the Government argued that the stipends paid to the medical residents should be considered wages for FICA purposes and therefore ineligible for the scholarship exception because the stipends were conditioned on the provision of patient care services.[32]

Section 117(a) states that gross income "does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization . . . ."[33] Section 117(c) provides that the Section 117(a) scholarship exclusion from gross income does not apply to the portion of "any amount received which represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship . . . ."[34]

The DMC argued that the stipends provided to the medical residents were to be considered FICA exempt scholarships.[35] The court relied on *Bingler v. Johnson*.[36] *Bingler* laid out the test that the definition of "scholarships" was to be viewed "as relatively disinterested, 'no strings' education grants, with no requirement of any substantial *quid pro quo* from the recipients."[37] The court in *Detroit Medical Center* illustrated that the limitation in 117(c) "make[s] it impossible for residents to exclude their stipends from the income tax."[38]

Despite not qualifying as a Section 117 scholarship exception, the DMC then argued that the medical resident stipends are to be considered FICA exempt scholarships under Section 3121.[39] DMC urged a "facts and circumstances" type analysis to evaluate whether the stipends were scholarships or wages.[40] To illustrate that a medical resident has a primary purpose of study, DMC illustrated five main points:

> . . .1) the institution's primary purpose is to be a teaching institution; 2) the existence of full-time faculty; 3) the absence of any requirement for the residents to remain at the hospital following their residencies; 4) the close supervision of residents by faculty members; and 5) the fact that the medical center does not bill for activities of residents.[41]

Despite the DMC's arguments, the court held that the stipends were wages.[42] Relying on *Saint Luke's Hospital, Bingler*, Section 117(c) and the treasury regulations, the court reasoned that the stipends paid to the residents were not scholarships due to the stipends being given as a "substantial *quid pro quo* for patient care."[43] The court noted that in order to receive the stipend, the residents must perform valuable patient care services. The court, citing Bingler, proclaimed that the stipends are not "relatively disinterested, 'no strings' education grants, with no requirement of any substantial *quid pro quo* from the recipients."[44]

Ultimately, the court granted summary judgment to the government holding that stipends paid to the resident physicians are "wages" and are therefore not scholarships as defined in Section 117.[45] Furthermore, the court declared that medical residents do not qualify for the student exception as a matter of law.[46] If the government continues to pursue hospitals to reclaim past social security tax refunds, the impact on the hospitals could be significant.

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ENDNOTES

1. I.R.C. §§ 3101-3128 (2006).
2. No. 05-71722, 2006 U.S. Dist. LEXIS 86998, at *4 (E.D. Mich. Dec. 1, 2006).
3. I.R.C. § 3121(a) (2006).
4. I.R.C. § 3121(b)(10) (2006).
5. *Id.*
6. 2006 LEXIS 86998.
7. *Id.*
8. *Id.* at *2
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.* at *3.
13. *Id.* at *14.
14. *Id.* at *3, *14.
15. *Id.* at *16.
16. *Id.* at *17.
17. 151 F.3d 742 (8th Cir. 1998).
18. Detroit Medical Center, 2006 LEXIS 86998, at *22.
19. *Id.* (citing United States v. Mayn Found. For Med. Educ. & Research, 282 F. Supp. 2d 997, 999 (D. Minn. 2003); United States v. Univ. Hosp., Inc., 2006 U.S. Dist. LEXIS 52159, 2006 WL 1173455 (S.D. Ohio July 26, 2006); Center for Family Medicine v. United States, 2006 U.S. Dist. LEXIS 76234 (D.S.D. 2006); and Univ. of Chi. Hosps. v. United States, 2006 U.S. Dist. LEXIS 68695 (N.D. Ill. 2006)).
20. *Id.* at *24 (citing United States v. Mt. Sinai Med. Center, 353 F. Supp. 2d 1217, 1223-27 (S.D. Fla. 2005).
21. No. 1:05-CV-445, 2006 U.S. Dist. LEXIS 52159 (S.D. Ohio

July 26, 2006).
22. Detroit Medical Center, 2006 LEXIS 86998, at *26.
23. *Id.* The court alsn noted that the ruling follows the reasoning of Univ. of Chi. Hosps., 2006 U.S. Dist. LEXIS 68695; Minnesota v. Apfel, 151 F.3d 742, 747 (8th Cir. 1998); and Mt. Sinai Med. Center, 353 F. Supp. 2d at 1222.
24. Detroit Medical Center, 2006 LEXIS 86998, at *27-28.
25. *Id.* at *32.
26. *Id.* at *36.
27. *Id.*
28. *Id.* at *32-33. Similar to the court in Mt. Sinai Med. Center, 353 F. Supp. 2d 1217.
29. *Id.* at *40 quoting St. Luke's Hosp. Ass'n v. United States, 333 F.2d 157, 164 (6th Cir. 1964).
30. Detroit Medical Center, 2006 LEXIS 86998, at *40.
31. *Id.* at *2-3, 5.
32. *Id.* at *3.
33. I.R.C. Section 117(a) (2006).
34. I.R.C. Section 117(c) (2006).
35. Detroit Medical Center, 2006 LEXIS 86998, at *5.
36. 394 U.S. 741, 742 (1969).
37. *Id.* at 751; Detroit Medical Center, 2006 LEXIS 86998, at *6.
38. Detroit Medical Center, 2006 LEXIS 86998, at *8.
39. *Id.* at *9.
40. *Id.* at *9-10.
41. *Id.* at *10.
42. *Id.* at *11.
43. *Id.*
44. *Id.*
45. *Id.* at *4.
46. *Id.*